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You Say ‘Tomato’ and I say “Tomato”. Whose Arm’s Length Standard?

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> “It follows that only the national law applicable in the Member State concerned must be taken into account in order to identify the reference system for direct taxation, that identification being itself an essential prerequisite for assessing not only the existence of an advantage; but also whether it is selective in nature.”[1]

With this statement, the European Court of Justice, Grand Chamber, overturned the General Court’s decision in favor of the EU Commission’s power grab to act as a national ‘tax administrations appeal chamber’.

In 2014, the EU Commission formally opened a State Aid investigation of an advanced tax ruling issued by the Luxembourg Tax Authority to Fiat. In 2015 the EU Commission concluded that the advance ruling to Fiat bestowed State aid and that Luxembourg was thus required to claw back the amount of the aid with interest.[2] Luxembourg, Fiat Chrysler Finance Europe (“Fiat Finance”), joined by the government of Ireland, appealed to the General Court of the European Union the Commission’s finding classifying the advance tax ruling as State aid. In its 2019 judgment, the EU General Court sided with the EU Commission, dismissing the appeal.[3]

The Luxembourg government contended that the EU Commission exceeded its powers, infringing the Treaty on European Union Articles 4 and 5 by engaging in “tax harmonization in disguise”. Article 4 and Article 5 both state that competencies not conferred upon the EU in the EU treaties remain with the Member States.[4] The Treaty on the Functioning of the European Union (TFEU) Article 114 states that the Member States’ governments have reserved exclusive competence on fiscal provisions (direct taxation).[5] The government of Luxembourg argued that EU Commission established itself as a national ‘tax administrations appeal chamber’ by reviewing whether a Luxembourg Tax Authority ruling, having regard to Luxembourg law and the OECD, was abnormal.

The General Court responded that if a tax measure discriminates between companies in a comparable situation and confers selective advantages to some undertakings over others, then the measure can be considered State aid within the meaning of TFEU Article 107(1). A tax measure considered by the tax authorities that impacts the tax base determination is within the scope of Article TFEU 107(1), because, the General Court held, it may confer a selective advantage.[6]

Thus, the General Court concluded that the EU Commission could examine a tax ruling to monitor TFEU Article 107 State aid compliance.[7]

The governments of Luxembourg and Ireland, and Fiat, alleged that the EU Commission assessed the Tax Authority's ruling, in breach of the fiscal autonomy of the Member States, with an arm's length principle derived from EU law instead of Luxembourg's law.[8] The Commission countered that the arm's length principle necessarily formed part of the Article 107 State aid assessment of tax measures granted to group companies irrespective of whether the Member State had incorporated that principle into its national legal system because the arm's length principle was a general principle of equal treatment in taxation.[9]

The tax ruling was issued based on Article 164(3) of the Luxembourg Income Tax Code ('the Tax Code') and Circular L.I.R. No 164/2 of 28 January 2011, issued by the director of Luxembourg taxes ('Circular No 164/2').[10] These provisions establish the arm's length principle under Luxembourg tax law according to which transactions between intra-group companies are to be remunerated as if they had been agreed to by independent companies negotiating under comparable circumstances at arm's length. Circular No 164/2 sets out how to determine an arm's length remuneration specifically in the case of intra-group financing companies. The Luxembourg Tax Authority tax ruling relied upon a transfer pricing report that proposed two components calculating Fiat's total remuneration for its financing and treasury activities and the risks that it bore:[11]

1. a 'risk remuneration', calculated by multiplying Fiat Finance's hypothetical regulatory capital of EUR 28,500,000, estimated by applying the Basel II framework by analogy, with the pre-tax expected return of 6.05 percent that was estimated using the Capital Asset Pricing Model ('CAPM');
2. a 'functions remuneration', calculated by multiplying what is designated as Fiat Finance's capital used to perform the functions, estimated as EUR 93,710,000, by the market interest rate applied to short-term deposits, estimated to be 0.87 percent.

In addition, the Commission noted that the tax ruling had endorsed a proposal in the transfer pricing report not to remunerate the portion of Fiat Finance's equity designated as supporting Fiat Finance's financial investments in Fiat Finance North America Inc. and Fiat Finance Canada Ltd.

The EU Commission assessed whether the methodology accepted by the Luxembourg tax administration in its tax ruling for determining Fiat Finance's taxable profits in Luxembourg departed from a methodology that leads to a reliable approximation of a market-based outcome, and thus from the arm's length principle.[12] The EU Commission did not assess the ruling within the framework of Luxembourg's Tax Code and Circular No 164/2 transposing the arm's length principle into Luxembourg's tax system. The Commission ruled that the methodology applied by the Luxembourg Tax Authority for determining Fiat Luxembourg's remuneration could not result in an arm's length outcome.[13] Instead, the EU Commission concluded that Luxembourg's Tax Authority minimized Fiat's remuneration to reduce Fiat's tax base and correspondingly, Fiat's tax liability. The General Court agreed with the EU Commission that the tax ruling provided a selective advantage because the tax ruling at issue was considered to constitute individual aid and that the conditions attached to the presumption of selectivity were fulfilled. The Court added that, in any event, the Commission had also demonstrated based on the three-step analysis of selectivity that the measure at issue was selective.

Fiat Chrysler Finance Europe appealed the General Court decision to the European Court of Justice

based on three grounds:[14]

1. The General Court infringed Article 107(1) TFEU in that it made several errors in its analysis of whether the applicant had received an economic advantage.
2. The General Court infringed the obligation to state reasons because its analysis of the legal basis for the arm's length principle was inadequate and contradictory.
3. The General Court infringed the principle of legal certainty by (i) endorsing the ill-defined arm's length principle without addressing its scope or content, and (ii) holding that the presumption of selectivity applied to the tax ruling at issue.

The government of Ireland joined the appeal in support of Fiat, arguing that the application of the arm's length principle in state aid cases is in breach of the principle of legal certainty.

On December 16, 2021, the Advocate General rendered an opinion to the European Court of Justice agreeing with the General Court's holding, urging the rejection of the appeal.[15] The Advocate General held that the General Court's reasoning about the legal basis of the arm's length principle meets the requirements of clarity and consistency imposed by the ECJ case law. The Advocate General argued that the General Court did not make any error of law in holding that three errors identified by the Commission in the calculation of the remuneration of Fiat Finance's financing and treasury activity prevented a reliable approximation of an arm's length outcome. Moreover, the Advocate General argued that businesses benefiting from State measures of economic support could not rely on a legitimate expectation, the subjective face of the objective principle of legal certainty, of their lawfulness if they have not been granted in compliance with the procedure for notification of State aid to the EU Commission.[16]

Luxembourg and Ireland's Big Win Today

In an approximately 20 page decision issued this morning, the ECJ annulled the General Court's decision that Luxembourg had granted Fiat state aid via a 'too favorable' advanced tax ruling. The most important aspect of the ECJ decision is that the Court held that the Commission must consider the specific rules implementing the arm's length principle by the member state. Said another way, the ECJ held that the Commission could not generate its own EU arm's length reference framework to benchmark whether the member state's application of the arm's length standard is correct. The ECJ ruled that only the national law applicable in the Member State concerned must be taken into account to identify the reference system for direct taxation, that identification being an essential prerequisite for assessing not only the existence of an advantage; but also whether it is selective in nature.[17]

The ECJ reasoned that to classify a national tax measure as 'selective', the Commission must, as a first step, identify as its reference system the normal tax system applicable in the Member State concerned. Then the Commission must demonstrate, as a second step, that the tax measure at issue is a derogation from the reference system, in so far as it differentiates between operators who, in the light of the objective pursued by that system, are in a comparable factual and legal situation.[18] Then the ECJ held that:[19]

> "… it is the Member State concerned which determines, by exercising its own competence in the matter of direct taxation and with due regard for its fiscal

> autonomy, the characteristics constituting the tax, which define, in principle, the reference system or the 'normal' tax regime, from which it is necessary to analyse the condition relating to selectivity. This includes, in particular, the determination of the basis of assessment and the taxable event."

From this holding, the ECJ concluded that only the national law applicable in the Member State concerned must be considered to identify the reference system for direct taxation.[20] Because the Commission applied an arm's length principle different from that defined by Luxembourg law, the Commission's resulting determination was necessarily invalid.[21]

In another development today, the EU's Ecofin Council approved a revised Code of Conduct, broadening the scope to include not just preferential tax measures, but also 'tax features of general application', which create opportunities for double non-taxation or can lead to double or multiple uses of tax benefits.[22] Perhaps the EU Commission can develop an innovative argument that any national law derivation from the OECD's arm's length standard as defined by its Transfer Pricing Guidelines is a preferential tax measure that generates unallowable tax competition under the EU Code of Conduct for Business Taxation?

I think that the EU Commission will keep investigating transfer pricing advance rulings as potentially violating the EU State aid rule. However, today's Fiat decision is a major setback for the Commission. The Commission must regroup to undertake its State aid analysis investigations using the Member States' transposition of the arm's length standard.

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[1] Fiat Chrysler Finance Europe v Commission C-885/19 P and Ireland v Commission C-898/19 P (E.C.J. Nov. 8, 2022) ¶ 74 (hereafter Fiat ECJ 2022). Available at https://curia.europa.eu/juris/documents.jsf?num=C-885/19%20P.

[2] Comm. Dec. on State Aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat (Oct. 21, 2015).

[3] Grand Duchy of Luxembourg v Commission, Judgment in Cases T-755/15 and T-759/15, (J. Gen. Ct. 7th Cham, Ext Comp Sep. 24, 2019) (hereafter "Fiat EGC 2019").

[4] Consolidated version of the Treaty on European Union – Title I: Common Provisions – Articles 4 and 5, Official Journal 115, 09/05/2008 P. 0018 – 0018. Available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12012M004.

[5] Consolidated version of the Treaty on the Functioning of the European Union – Part Three: Union Policies And Internal Actions – Title VII: Common Rules On Competition, Taxation and Approximation Of Laws – Chapter 3: Approximation of laws – Article 114, Official Journal 115, 09/05/2008 P. 0094 – 0095. Available at https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12008E114.

[6] Fiat EGC decision 2019 ¶ 113.

[7] Fiat EGC decision 2019 ¶ 107.

[8] Fiat EGC decision 2019 ¶ 126.

[9] Fiat EGC decision 2019 ¶ 131.

[10] Fiat ECJ decision 2022 ¶ 11.

[11] Fiat EGC decision 2019 ¶ 11.

[12] Fiat ECJ decision 2022 ¶ 18.

[13] Fiat ECJ decision 2022 ¶ 20 referring to Comm. Dec. on State Aid SA.38375 (2014/C ex 2014/NN) which Luxembourg granted to Fiat (Oct. 21, 2015) ¶¶ 234-240.

[14] Fiat Chrysler Finance Europe v Commission, C?885/19 P (Adv. Gen., Dec. 16, 2021) ("Fiat AGO") ¶ 43.

[15] Fiat AGO.

[16] Fiat AGO ¶ 188.

[17] Fiat ECJ decision 2022 ¶ 74.

[18] Fiat ECJ decision 2022 ¶ 68.

[19] Fiat ECJ decision 2022 ¶ 73.

[20] Fiat ECJ decision 2022 ¶ 74.

[21] Fiat ECJ decision 2022 ¶ 91.

[22] Available at https://www.consilium.europa.eu/en/council-eu/preparatory-bodies/code-conduct-group/.

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