SULLIVAN & CROMWELL LLP

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EU State Aid and Tax

EU Court of Justice Annuls Commission Decision that Luxembourg Granted Illegal State Aid to Fiat in Ruling on Transfer Pricing

SUMMARY

Yesterday, the Court of Justice of the European Union overturned the ruling of the General Court and annulled the Commission's decision finding that Luxembourg had granted illegal state aid to Fiat Finance and Trade Ltd, SA by accepting the transfer pricing methodology proposed by Fiat in relation to intra-group financing transactions.

In doing so, the Court of Justice has put an end to the Commission's attempt to apply its own version of the arm's length principle, rather than the national tax framework, to determine whether a measure confers a selective advantage under state aid rules and has reaffirmed the national autonomy of EU member states in the field of direct taxation.

I. BACKGROUND

Even though direct taxation lies within the autonomous legislative competence of each EU member state, tax measures granted by or through member state resources which confer a selective advantage on a beneficiary vis-à-vis other undertakings such as to distort competition in the internal market are prohibited under EU state aid rules. Whether or not a tax measure constitutes state aid therefore depends on the national framework in question: it is the reference point to judge whether a beneficiary has received a selective advantage.

Sullivan & Cromwell represented Fiat in this litigation.

II. THE FACTS OF THE CASE

2012: Following a request from the tax advisers of Fiat Finance and Trade Ltd, SA ("**Fiat**"), the Luxembourg tax authorities approve an advance transfer pricing arrangement setting out how intra-group financing transactions should be priced in order to determine Fiat's annual taxable profit in Luxembourg for the next five years (the "**Tax Ruling**").

2015: Following an in-depth investigation, the Commission finds that the Tax Ruling constitutes illegal state aid under Article 107 TFEU. The Commission alleges that Luxembourg has accepted "artificial and complex methods" that do not "reflect economic reality" in finding that the transfer pricing arrangement contemplated by the Tax Ruling complied with Luxembourg transfer pricing law and regulation. Applying the "arm's length principle", the Commission concludes that the Tax Ruling conferred a selective advantage on Fiat, which other comparable taxpayers do not enjoy, thus distorting competition in the EU.

2017: Fiat and Luxembourg challenge the Commission's decision before the General Court of the European Union ("**GCEU**"), arguing that the Tax Ruling did not confer a selective advantage. They submit that the Commission has used an incorrect reference framework and misapplied the rules provided by Luxembourg law.

2019: The GCEU endorses the Commission's reasoning. Fiat and Ireland (as an interested Member State), with the support of Luxembourg as intervener, appeal the GCEU judgment before the Court of Justice of the European Union ("**CJEU**").

YESTERDAY: The CJEU sides with Ireland and Fiat, upholding Fiat and Luxembourg's arguments before the GCEU, and annulling the Commission's 2015 decision in its entirety.[1] The CJEU's judgment overturns the Commission's stance on transfer pricing and provides welcome clarification of the application of state aid rules to corporate income taxation, an area of the law that remains within the autonomous competence of each individual EU member state.

III. THE JUDGMENT

The CJEU recalled that it is the EU 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 [of] … the 'normal' tax regime". A tax measure does or does not confer a selective advantage only by comparison with that normal tax regime.

In its 2019 judgment, the GCEU held that the arm's length principle is a "general principle of equal treatment in taxation which falls within the scope of Article 107(1)TFEU" irrespective of whether or not, or to what extent, it is incorporated in national tax legislation. The CJEU overturned this finding holding that the arm's length principle forms part of the reference framework for a state aid analysis only if it has been incorporated into national law in the relevant EU member state.

It is important to note that tax law in Luxembourg incorporates (a version of) the arm's length principle. However, the CJEU found that the Commission applied its own version of the arm's length principle and that "its analytical framework did not include all the relevant norms implementing the arm's length principle under Luxembourg law". The CJEU pointed out:

> "*It is true, as the parties all agree, that the national law applicable to companies in Luxembourg is intended, as regards the taxation of integrated companies, to bring about a reliable approximation of the market price. While that objective corresponds, in general terms, to that of the arm's length principle, the fact remains that, in the absence of harmonisation in EU law, the specific detailed rules for the application of that principle are defined by national law and must be taken into account in order to identify the reference framework for the purposes of determining the existence of a selective advantage.*"[2]

The CJEU highlighted that, by applying methods outside the normal Luxembourg tax rules, the Commission had infringed on the autonomy of Luxembourg in tax matters. The Commission was not entitled to apply OECD guidelines over applicable provision of Luxembourg tax law. Similarly, the CJEU dismissed as unfounded the Commission's often-repeated assertion that the CJEU's judgment in *Forum 187* was a precedent for an autonomous EU arm's length principle under EU state aid law. In fact, as argued by Fiat, Ireland and Luxembourg, that case concerned the arm's length principle as incorporated into Belgian law, and does not establish a generalised arm's length principle under EU state aid law. Finally, the CJEU rejected the Commission's subsidiary line of reasoning that the Tax Ruling was not compliant with Luxembourg law, finding that it was neither autonomous nor severable from the Commission's (defective) principal line of reasoning: the CJEU agreed with the Advocate General that it relied in substance on elements of the principal line of reasoning that should be rejected.

As a result, the CJEU set aside the GCEU judgment which endorsed the Commission's reasoning and methodology and annulled the underlying Commission decision.

IV. REMARKS

The CJEU's judgment is not only an important win for Fiat, Luxembourg and Ireland, but for other companies and member states in the EU. It reaffirms the national autonomy of member states in tax matters and dispels the legal uncertainty that would have resulted if the Commission's reasoning had prevailed.

The judgment corrects the Commission's expansive application of the EU state aid rules to advance tax rulings and will have implications for current and future Commission state aid investigations and related cases on tax rulings before the European courts. The message is crystal clear: although the Commission may investigate tax measures for compatibility with state aid rules, in doing so, it cannot apply its own version of the arm's length principle to tax measures; in particular, it cannot apply the arm's length principle to tax measures in jurisdictions unless – and then only to the extent that – the law of the jurisdiction incorporates that principle. Instead, the Commission must carefully consider national tax rules to assess whether or not a measure confers a selective advantage for state aid purposes.

The Sullivan & Cromwell team advising Fiat alongside Maisto e Associati was led by Juan Rodriguez and included Nicolas de Boynes, Andrew Thomson and Marielena Doeding.

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ENDNOTES

1 Judgment dated 8 November 2022 in Cases C-885/19 P and C-898/19 P.

2 Judgment dated 8 November 2022 in Cases C-885/19 P and C-898/19 P, paragraph 93.

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