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INSIGHT: Fiat State Aid Case—Impact on Luxembourg

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This article provides an overview of the facts and circumstances of the Fiat case, outlines the Luxembourg transfer pricing rules applicable to finance companies, and analyzes the decision of the General Court of the EU and its impact on Luxembourg.

On September 24, 2019, the General Court of the EU rendered its judgment (T-755/15 and T-759/15) regarding the action brought by Fiat Chrysler Finance Europe (formerly Fiat Finance and Trade Ltd, FFT) and Luxembourg for the annulment of the final state aid decision of the European Commission of October 21, 2015 on Fiat (SA.38375).

In its decision, the General Court dismissed the actions and confirmed the validity of the Commission's decision in regard to a tax ruling granted by the Luxembourg tax authorities on September 3, 2012. The tax ruling endorsed a method for determining FFT's remuneration for treasury and financing services rendered to other group companies.

Fiat Case at a Glance

FFT is a Luxembourg subsidiary of Fiat S.p.A., the Italian parent company of the Fiat Group, which is one of Italy's largest industrial enterprises. FFT provided treasury services and financing to Fiat Group companies based (mainly) in Europe (excluding Italy) and also managed several cash pool structures for Fiat Group companies. FFT operated from Luxembourg, where its head office is located, and through two branches, one based in London, U.K. and one in Madrid, Spain.

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Fiat decided to centralize its financial and treasury functions, where all funding, corporate finance, bank relationship, foreign exchange and interest rate risk management, cash pooling, money market operations, cash balances management, collection and payment initiation were performed by FFT and the other treasury companies. FFT performed treasury functions for Fiat Group companies in Europe.

The transfer pricing analysis prepared for FFT was based on the guidelines and methodologies set out in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines) which reflect the international consensus on the interpretation and application of the arm's-length principle.

The transfer pricing analysis relied on the determination of the amount of capital at risk in line with the Basel II criteria. Moreover, FFT was meant to realize an arm's-length risk remuneration in regard to its capital at risk (by using the capital asset pricing model, CAPM) and an arm's-length remuneration for its functions performed. The transfer pricing method which was applied to determine an arm's-length risk premium was the transactional net margin method (TNMM).

Transfer Pricing Regimes Applicable to Finance Companies

Luxembourg has traditionally been a preferred location for the implementation of financing activities. However, the tax rules applicable to financing activities have undergone a significant transformation throughout the last decade.

While, until 2010, there were no formal transfer pricing rules governing the tax treatment of financing ac-

tivities, as from 2011, the transfer pricing aspects of financing activities have been governed by Circular 164/2 of January 28, 2011 (the 2011 Circular). On December 27, 2016, the Luxembourg tax authorities released Circular 56/1–56bis/1 (the 2016 Circular) which replaced the 2011 Circular as from fiscal year 2017.

Transfer Pricing Regime Applicable from 2011

As from 2011, the transfer pricing aspects of financing activities were governed by the 2011 Circular. Under this transfer pricing regime, financing companies were required to have a real presence in Luxembourg, run economic risks, and report an arm's-length remuneration on their financing activities in conformity with the OECD Transfer Pricing Guidelines (a second Circular released on April 8, 2011 set out that an advance tax clearance granted before the release of the Circular would lose its binding character as regards the quantum of the finance margin as from January 1, 2012).

In addition, the arm's-length character of the remuneration had to be substantiated in a transfer pricing study. The 2011 Circular was inspired by the Dutch regime for service-providing companies. According to Circular 164/2bis of April 8, 2011, tax rulings granted before the release of the 2011 Circular lost their binding character as regards the arm's-length nature of the finance margin as from 2011.

The scope of the 2011 Circular covered entities principally engaged in intra-group financing transactions. The term ''intra-group financing transaction'' was to be interpreted broadly, including any activity involving the granting of loans (or advancing of funds) to associated enterprises that were financed by debt (for example, intra-group loans, bank loans, public issuances, etc.).

According to the 2011 Circular, finance companies had to comply with the so-called real risk requirement that was deemed to be satisfied when the company's equity at risk amounted to at least 1% of the outstanding loan(s) or 2 million euros ($2.2 million).

The arm's-length remuneration of a Luxembourg finance company consisted of (i) a handling fee (for loan management activities), and (ii) a risk premium (as a consideration for the exposure of its equity). Both components were added and expressed in basis points and resulted in an arm's-length (gross) margin that was included in the interest rate charged to the borrower. Since the remuneration was gross, related costs such as operating expenses were tax deductible (up to the amount of the handling fee).

The methodology for determining the remuneration of FFT in regard to treasury and financing activities deviated from the 2011 transfer pricing regime. However, this might have been the result of a particular functional and risk profile which may have justified the application of a different transfer pricing methodology.

Transfer Pricing Regime Applicable as from 2017

On December 27, 2016, the Luxembourg tax authorities released the 2016 Circular which replaced the 2011 Circular as from 2017. The 2016 Circular follows the introduction of the new Article 56bis of the Luxembourg Income Tax Law (LITL) (Article 56bis of the LITL has been introduced as from January 1, 2017 into Luxembourg tax law) which provides additional guidance on the application of the arm's-length principle.

The scope of the 2016 Circular remains generally the same as under the previous transfer pricing regime and covers entities principally engaged in intra-group financing transactions. However, while the 2011 Circular referred to ''cross-border'' financing transactions between associated enterprises, the 2016 Circular refers more generally to financing transactions between related enterprises. It follows that domestic financing transactions between Luxembourg companies come within the scope of the 2016 Circular as much as cross-border transactions.

This change is consistent with Luxembourg legislative developments and the introduction of a new version of Article 56 of the LITL in 2015 that formally introduced the arm's-length principle into Luxembourg tax law.

The 2016 Circular stresses that a finance company has to bear the risks in relation to its intra-group financing transactions. This is a key change compared to the former transfer pricing regime which allowed a fixed minimum capital at risk, with the result that risks (in particular, the credit risk) were routinely limited contractually to the lower of 1% of the outstanding loan(s) or 2 million euros (for example, through limited recourse clauses or guarantees).

In contrast, under the new regime, the risks assumed by a finance company cannot be limited to a fixed amount and the equity at risk of a finance company has to be determined on a case-by-case basis.

In practice, the equity at risk should be calculated as the expected loss of the financing activity, considering the credit rating of the borrower. Finance companies must be financed with an amount of equity that is sufficient to cover the expected loss in case it materializes (i.e. so as to have the financial capacity to bear the risk).

Finance companies must have control over the risks in relation to their financing activities. Thus, finance companies should have the power of decision to enter into the risk-bearing financing transactions and take the decisions needed to handle related risks.

The amount of equity at risk should further be remunerated with an arm's-length return on equity. Where the functional and risk profile of a Luxembourg finance company is similar to that of a regulated financial institution, the 2016 Circular states that a return on equity of 10% after tax can be observed in the market and may be considered as reflecting arm's-length terms. However, when the profile of a Luxembourg finance company differs significantly from that of a regulated financial institution, a search for returns on equity realized by companies which perform comparable activities must be performed when benchmarking an arm's-length return on equity.

As the return on equity is defined as the ratio of net profit to equity, the multiplication of the arm's-length return on equity and the finance company's equity at risk provides a net (after-tax) remuneration. In order to determine an arm's-length gross remuneration (defined as the difference between interest income and interest expense), the net remuneration needs to be grossed up by the applicable corporate tax rate and recurring operating expenses relating to the financing activity.

The new transfer pricing regime is consistent with all post-BEPS transfer pricing standards (control over risk,

financial capacity to bear the risk, etc.) and should therefore be immune to challenges by the European Commission.

Decision of the EU General Court

The General Court confirmed that the European Commission has the right under EU law to verify whether the tax ruling granted to FFT conferred an advantage as compared to the ''normal'' taxation as defined by Luxembourg national law. Moreover, the Court confirmed that the Commission was entitled to analyze the tax ruling in light of the arm's-length principle, which is deemed to be a tool that allows the Commission to test whether intra-group transactions are remunerated as if they had been negotiated between independent companies.

With regard to the existence of an advantage, the General Court stated that the Commission was right to find that the methodology for calculating FFT's remuneration did not comply with the arm's-length standard. In this regard, the application of the TNMM as set out in the tax ruling was incorrect as all FFT's capital (rather than merely that part of capital being the equity at risk linked to the group financing activity) should have been included in the calculation and only one single rate should have been applied.

On this basis, the Court concluded that the methodology approved in the tax ruling reduced FFT's remuneration, which led to a lower tax liability for FFT in comparison to the tax that would have been paid under Luxembourg tax law, resulting in an advantage. According to the General Court, this advantage was selective in nature and the three-step test of selectivity had been met.

Finally, the General Court held that the advantage led to a restriction of competition, given that the corresponding tax reduction improved the financial position of FFT and the Fiat Group to the detriment of its competitors. Overall, the European Commission requested Luxembourg to reclaim an amount of circa 30 million euros from the taxpayer.

Nevertheless, despite the decision of the Court, there remains at least a question mark as to whether the methodology approved by the Luxembourg tax authorities was clearly inconsistent with the arm's-length standard.

Several points can be made here. First, the transfer pricing analysis was based on the guidance provided in the OECD Transfer Pricing Guidelines. Second, the contested tax ruling and related transfer pricing analysis date back to September 2012, when transfer pricing was a fairly new discipline in Luxembourg, with a first transfer pricing circular on the tax treatment of finance companies released on January 11, 2011. Third, the approach taken by FFT seems to resemble the excess profit regime adopted by Belgium, where the General Court recently decided that no illegal state aid has been granted by Belgium to taxpayers. Fourth, it is common knowledge that transfer pricing is not an exact science, but rather an art, which requires judgment.

However, while transfer pricing experts may dispute the approaches and parameters chosen in the transfer pricing analysis on which the ruling was based, the analysis of the European Commission is far from flawless. For instance, the Commission concluded without too much scrutiny that an arm's-length return on equity to be realized by a finance company should be 10% post tax; this was based on some studies regarding banks and the expectations of Deutsche Bank regarding its own profitability (which, as we know today, did not materialize), deviating from the principle that arm's-length pricing has to be determined on a case-by-case basis. Notably, the return on equity realized by commercial banks in the Benelux region is rather below 10% post tax.

Moreover, it is at least debatable why a Luxembourg finance company that has a more limited functional and risk profile than a commercial bank should have the same level of profitability.

Potential Impact on Luxembourg

While the fact pattern and the transfer pricing approach adopted by FFT seems to be very particular to this case, the Court's decision may still have an impact on Luxembourg and, more specifically, on the role of tax rulings as a means to manage tax risks. As it currently appears, the very existence of a tax ruling may be perceived as a tax risk, despite the fact that the primary purpose of tax rulings is to provide advance certainty on tax treatments.

The General Court confirmed that the European Commission may investigate whether the transfer pricing methodology confirmed in a tax ruling is consistent with the arm's-length principle. When the Commission investigates a tax ruling in the context of state aid, it does not, however, suffice to challenge a transfer pricing approach. Instead, it is for the Commission to demonstrate the existence of an economic advantage within the meaning of Article 107 of the Treaty on the Functioning of the European Union.

The recently released Luxembourg 2020 budget draft law also includes a measure concerning tax rulings. Specifically, the period of validity of tax rulings granted prior to January 1, 2015 should be limited to five years, as is the case for tax rulings granted under the current ruling procedure (i.e. before 2015, the binding effect of tax rulings was in principle not limited in time). Hence, tax rulings granted before January 1, 2015 will not be binding on the Luxembourg tax authorities as from 2020.

However, given that tax rulings may only confirm the application of tax law to a specific case, the impact of this measure should be limited in practice. While it is not clear whether this measure is a reaction to the decision of the General Court, it aligns the framework applicable to tax rulings granted before and after January 1, 2015.

In Conclusion

The General Court agreed with the European Commission that the transfer pricing methodology confirmed in the tax ruling granted to FFT was not consistent with the arm's-length principle. According to the Court, this was a selective advantage that represents illegal state aid. It remains to be seen whether the decision of the General Court will be challenged before the Court of Justice of the European Union.

Over the last few years, transfer pricing and related documentation has become the hot topic in Luxembourg taxation in an evolving environment that is relying increasingly less on tax rulings (including advance

pricing agreements). At the same time, the Luxembourg transfer pricing landscape changed significantly, including the introduction of new transfer pricing legislation, the release of a new circular on the tax treatment of finance companies, and new reporting obligations regarding intra-group transactions.

All of these developments place more emphasis on transfer pricing and the proper application of the arm's-length standard. As such, Luxembourg was an early adopter of post-BEPS transfer pricing standards.

While it is somewhat speculative, the authors are of the view that if the Commission's standards in testing the arm's-length standard, as they transpire from the Fiat case decision and the confirmation by the General Court, were applied to a finance company organized in line with the 2016 Circular and current transfer pricing practice, the result would be positive for the taxpayer. If, however, a ruling granted today in the same circumstances were to be tested in six years' time according to future practice, as was effectively done in the Fiat case, we could not form a view.

Planning Point

While, in principle, the granting of a ruling should not change the analysis, as a practical matter, it seems to raise the risk profile in the face of an ever more assertive Commission. Ultimately, taxpayers that still rely on tax rulings may reconsider their approach towards tax risk management.

While it is a somewhat perverse result in an environment where most stakeholders are promoting more cooperation among taxpayers and tax authorities, in the current context, it might be a wiser strategy to rely on robust tax advice and sound transfer pricing documentation to mitigate tax risks in Luxembourg and abroad.

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