The Huhtamäki State Aid Investigation: No Selective Advantage in Sight

by Oliver R. Hoor

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In this article, the author examines the European Commission's state aid investigation into tax rulings Luxembourg granted to Huhtamäki.

On May 10 the European Commission published the nonconfidential version of its decision (C(2019) 1615 final) to open a state aid investigation into whether tax rulings granted by the Luxembourg tax authorities to food packaging company Huhtamäki may have entailed illegal state aid. The commission's decision, first announced on March 7, found that Luxembourg granted a selective advantage to Huhtamäki by accepting a downward adjustment in advantages shifted to a Luxembourg group company.

This article outlines the facts and circumstances of the Huhtamäki case, analyzes the tax treatment under Luxembourg domestic tax law, and assesses whether state aid was granted to Huhtamäki.

I. Introduction

Since June 2013 the European Commission has been investigating the tax ruling practices of EU states. As part of those investigations, the commission reviewed tax rulings granted to members of multinational groups.[1] So far, the commission has opened formal state aid investigations in 11 cases,[2] finding a selective advantage was granted in seven of eight decided cases. Only in the McDonald's case did the European Commission conclude that no selective advantage had been granted to the taxpayer, meaning there was no illegal state aid under EU state aid rules.[3]

In many of its state aid investigations, the European Commission challenged the taxpayer's transfer pricing approaches. Given that transfer pricing is not an exact science, and requires the exercise of judgment, it is perhaps understandable that the commission might take different positions. However, it seems to consider its transfer pricing position so objectively superior that the taxpayer and tax authority's contrary position constitutes state aid.[4]

The Huhtamäki state aid investigation is another case that seems to involve transfer pricing, although at its core, there is the question about the proper application of Luxembourg tax law and whether accepting a downward adjustment was a discretionary decision by the Luxembourg tax authorities that potentially entailed a selective advantage.

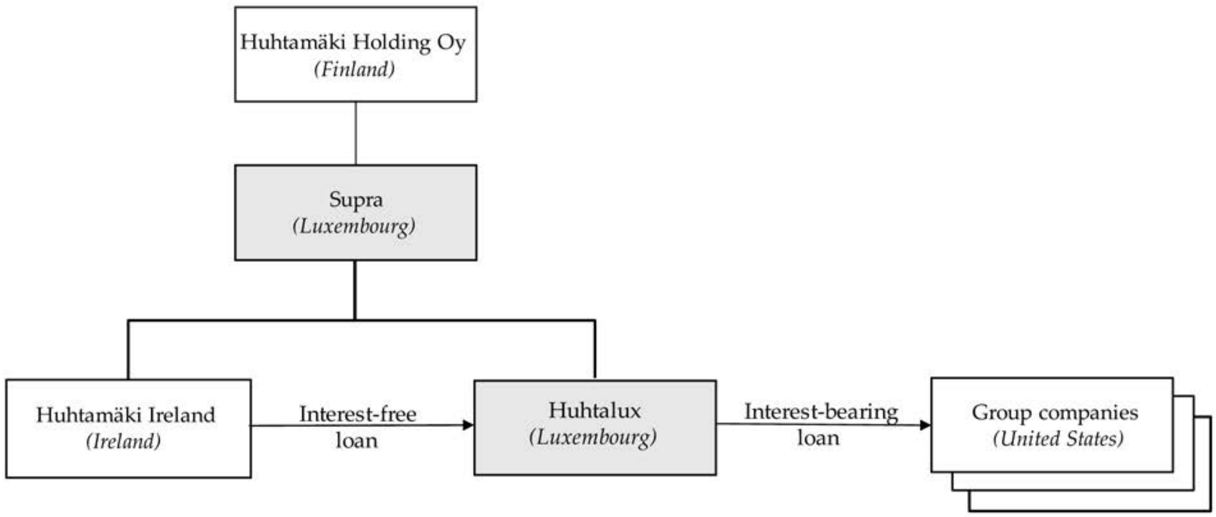
[1] One source of advance tax clearances granted by the Luxembourg tax authorities is the website of the International Consortium of Investigative Journalists, which features a "Luxembourg Leaks Database."

[2] *See* European Commission, "State Aid Tax Rulings."

[3] *See* Oliver R. Hoor and Keith O'Donnell, "McDonald's State Aid Investigation: What the European Commission Got Wrong," *Tax Notes Int'l*, Sept. 12, 2016, p. 975; and Hoor, "European Commission Finds No Illegal State Aid," Bloomberg Tax, Nov. 23, 2018.

[4] The author has his doubts whether that position will be upheld in the appeals to the Court of Justice of the European Union, however.

Figue 1. The Huhtamäki Group



II. Overview of the Huhtamäki Case

The Huhtamäki group consists of Huhtamäki Holding Oy, a company established in Finland, and all companies directly or indirectly controlled by Huhtamäki Oy, the ultimate parent. Huhtamäki was founded in 1920 and is based in Espoo, Finland. It specializes in the manufacturing of packaging for food and drinks such as paper and plastic cups, fruit trays, and takeout packaging.

Huhtamäki has business operations in Europe, Asia, the Americas, and Oceania. It has 76 manufacturing units, 24 sales offices, and 17,400 employees in 34 countries. In 2017 the group's net sales were approximately €3 billion. Huhtamäki is listed as "Huhtamäki Oy" on the Nasdaq Helsinki Ltd.

Huhtamäki has an investment platform in Luxembourg that consists of several companies, including Supra, a Luxembourg resident holding company. Supra is the sole shareholder of Huhtalux, another Luxembourg company, which performs holding and financing activities. Huhtalux has a real presence in Luxembourg, growing from one part-time employee in the period 2010-2013, to four full-time employees and one part-time employee in 2014, to eight full-time employees in the period 2015-2016.

Since 2009 Huhtalux has provided interest-bearing loans to U.S.-based Huhtamäki companies that are financed by interest-free loans granted by Huhtamäki Ireland Ltd., an Irish sister company that is wholly owned by Supra, and equity granted by Huhtalux. The initial financing volume was approximately $300 million (plus accrued interest) and has increased to approximately $435 million.

In a tax ruling issued November 11, 2009, the Luxembourg tax authorities confirmed that a finance margin of 9.375 basis points (applied on the annual average outstanding amount of the U.S. receivables) adheres to the arm's-length principle as provided under articles 56 and 164(3) of the Luxembourg Income Tax Law (LITL). On March 21, 2012, a new ruling request was submitted regarding the financing activity performed by Huhtalux. The transfer pricing study that provided for a 3.75-basis-point handling fee plus a risk premium for the amount of equity at risk was consistent with Tax Circular 164/2 of January 28, 2011, regarding intragroup financing activities. The related tax ruling was issued October 9, 2013, and bound the Luxembourg tax authorities for a period of five years from 2012 until 2016.

Figure 1 shows the financing activities performed by Huhtalux.

III. Tax Treatment in Luxembourg

Companies that have their seat or place of central administration — that is, the place of effective management — in Luxembourg are subject to corporate income tax[5] and municipal business tax[6] on their worldwide income.[7] The worldwide income is determined by applying the equity comparison method.[8] Accordingly, the profit is the difference between the net assets as of the end of the reporting period and the net assets as of the beginning of that period, increased by the withdrawals for personal use and decreased by additional contributions performed during the fiscal year. According to LITL article 40, the tax treatment follows the accounting treatment unless a specific tax rule (or concept) requires different tax treatment.

A. Financing Activities in Luxembourg

Luxembourg is a prime holding location and a financial center that has traditionally been a preferred location for the implementation of financing activities. However, the tax rules applicable to financing activities have significantly changed over the last decade.

Until 2011 Luxembourg had no formal transfer pricing rules governing the tax treatment of financing activities. On January 28, 2011, the Luxembourg tax authorities released Circular 164/2 to govern the transfer pricing aspects of financing activities. On December 27, 2016, they released Circular 56/1–56-*bis*/1, which replaced Circular 164/2 as of fiscal 2017.

1. Administrative Practice Before 2011

Before 2011 Luxembourg tax law did not have any specific rules governing the tax treatment of financing activities performed by Luxembourg companies. Instead, according to administrative practice, Luxembourg companies had to realize a finance margin depending on the financing volume that was deemed consistent with the arm's-length standard if conditions were met. That administrative practice was inspired by the approach historically taken by the Dutch tax authorities.

2. 2011 Transfer Pricing Regime

Beginning in 2011 the transfer pricing aspects of financing activities was governed by Circular 164/2, which was inspired by the Dutch regime for service-providing companies. Under the new 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.[9] Further, the arm's-length character of the remuneration had to be substantiated in a transfer pricing study.

The 2011 circular covered entities that were principally engaged in intragroup financing transactions. The term "intragroup 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, intragroup loans, bank loans, and public issuances).

According to the circular, finance companies had to comply with the so-called real risk requirement that was deemed satisfied when the company´s equity at risk amounted to the lesser of 1 percent of the outstanding loans or €2 million. The arm's-length remuneration of a Luxembourg finance company consisted of a handling fee for loan management activities and a risk premium as a consideration for the exposure of its equity.

Both components were added and expressed in basis points and resulted in a (gross) arm's-length margin that was included in the interest rate charged to the borrower. Because the remuneration was gross, related costs such as operating expenses were tax deductible up to the amount of the handling fee.

3. 2017 Transfer Pricing Regime

The 2016 circular is consistent with all transfer pricing standards stemming from the OECD's base erosion and profit-shifting project. It follows the introduction of LITL article 56-*bis*, which

[5] LITL article 159(1)A No. 1.

[6] Gewerbesteuergesetz section 2(2) No. 2.

[7] LITL article 159(2).

[8] LITL article 18(1).

[9] A second circular (Circular 164/2-*bis*), released April 8, 2011, specified that an advance tax clearance granted before the release of Circular 164/2 would lose its binding character regarding the quantum of the finance margin as from January 1, 2012.

provides additional guidance on the application of the arm's-length principle.[10]

The scope of the circular is generally the same as that under the 2011 circular, covering entities that are principally engaged in intragroup 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 as much within the scope of the circular as cross-border transactions. That change is consistent with Luxembourg legislative developments, including the 2015 introduction of a new version of LITL article 56, which formally established the arm's-length principle into Luxembourg tax law.

The 2016 circular stresses that a finance company must bear the risks in relation to its intragroup financing transactions. That is a key change from the former transfer pricing regime, under which the risks (particularly the credit risk) were contractually limited to the lower of 1 percent of the outstanding loan or €2 million (for example, through limited recourse clauses or guarantees). In contrast, under the new regime, the risks assumed by a finance company are not limited, and the equity at risk must be determined case by case.

In practice, the equity at risk should be calculated as the expected loss of the financing activity, considering the borrower's credit rating (this is the methodology that is also applied by financial institutions when determining the equity financing requirements). Finance companies must be financed with an amount of equity sufficient to cover the expected loss should it materialize — that is, they must 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 be able to enter into the risk-bearing financing transactions and take the actions necessary to handle related risks.

The amount of equity at risk should further be remunerated with an arm's-length return on equity. When 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 percent after-tax can be observed in the market and may be considered to reflect 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 that perform comparable activities must be performed when benchmarking an arm's-length return on equity.

Because 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 remuneration.

To determine an arm's-length gross remuneration (defined as the difference between interest income and interest expense), the net remuneration must be grossed up by the applicable corporate tax rate and recurring operating expenses for the financing activity. The gross remuneration can be expressed as follows:

$$\textit{Gross remuneration} = \frac{\textit{Net remuneration}}{(1 - \textit{corporate tax rate})} + \textit{operation expenses}$$

B. Transfer Pricing Adjustments

Because companies have a legal personality separate from that of their shareholders, they are free to enter into agreements with their shareholders as they do with third parties. For Luxembourg tax purposes, a clear distinction must be made between those agreements that adhere to the arm's-length principle and those agreements that, motivated by the shareholding relationship, shift advantages from the company to the shareholder and vice versa. Accordingly, the conditions of any contract entered into by a company and a shareholder must be compared with the terms and conditions that would have been agreed on had the agreement been entered into by unrelated companies.

Agreements entered into by a company and its shareholder that are consistent with the arm's-

[10] LITL article 56-*bis* became part of Luxembourg tax law January 1, 2017.

length principle are considered for the computation of the company's taxable income. In contrast, agreements between a company and its shareholder that do not satisfy the arm's-length principle should be subject to tax adjustments in accordance with the concepts of hidden dividend distributions and hidden capital contributions or, in some cases, with LITL article 56.

1. Hidden Dividend Distributions

a. Characteristics

Luxembourg tax law does not exhaustively define hidden dividend distributions. They are mentioned only in LITL article 164(3), which provides that they arise when a shareholder directly or indirectly receives advantages from a company that a third party would not have received. It also states that those kind of profit distributions are to be included in the company's taxable income.[11]

In accordance with the relevant case law, hidden dividend distributions under LITL article 164(3) bear the following characteristics:

- a decrease (or adverted increase) of a company's net equity;
- that is motivated by the shareholding relationship;
- that affects the company's taxable income — that is, either in the form of expenses or income that has been abandoned; and
- that is not a regular dividend distribution (under Luxembourg commercial law).

It follows that advantages granted to a shareholder may be classified as hidden dividend distributions. The concept applies when a company shifts advantages to corporate and individual shareholders, and is not limited to cross-border cases.

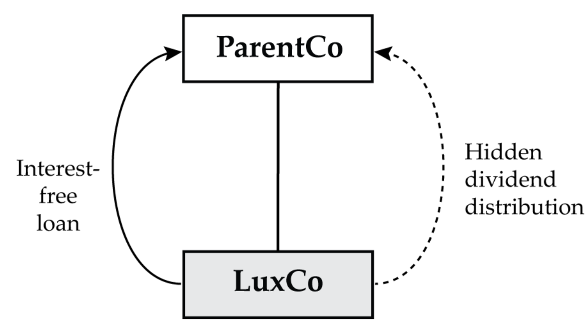
b. Tax Treatment

For Luxembourg tax purposes, hidden dividend distributions require tax adjustments at both the company and shareholder levels. Those tax adjustments must be analyzed case by case. In general, however, the company's taxable income should be increased by the fair market value of the advantage the company shifts to its shareholder.

The advantage is further classified as income under LITL article 97(1) No. 1, which is generally subject to Luxembourg withholding tax at a standard rate of 15 percent.[12] Under specific conditions, corporate shareholders may benefit from a withholding tax exemption under domestic tax law.[13] In a cross-border context, tax treaties concluded by Luxembourg may provide for a reduced or zero withholding tax rate. At the level of a Luxembourg shareholder, hidden dividend distributions are treated as regular dividend distributions.[14] The deemed income may benefit from a full[15] or partial tax[16] exemption under domestic tax law.

Consider an example. A Luxembourg company (LuxCo) grants an interest-free loan to its parent company (ParentCo). The arm's-length interest rate is 4 percent. (See Figure 2.)

Figure 2. The Upstream Loan



The advantage shifted by LuxCo to ParentCo should be classified as a hidden dividend distribution. Hence, LuxCo's taxable income should be increased by deemed income amounting to the arm's-length interest income —

[11] *See* Léon Kunsch, "La Réforme de l'impôt sur le revenu des collectivités," 29/30 *Études Fiscales* 50 (Dec. 1969); and Hoor, "Hidden Dividend Distributions in Luxembourg: A Technical Guide," 51(9/10) *Eur. Tax'n* 383 (2011).

[12] LITL article 146(1) No. 1 in connection with article 148(1).

[13] LITL article 147.

[14] LITL article 97(1) No. 1.

[15] For Luxembourg companies, LITL article 166 provides a full tax exemption if conditions are fulfilled (the participation exemption regime). In cross-border cases, tax treaties concluded by Luxembourg may provide for a tax exemption even if the conditions of the Luxembourg participation exemption regime are not met.

[16] LITL article 115 No. 15 (a) provides for a 50 percent tax exemption for Luxembourg resident individuals and Luxembourg companies if the Luxembourg participation exemption regime does not apply.

that is, 4 percent. Further, ParentCo is deemed to receive income under LITL article 97(1) No. 1, which is generally subject to Luxembourg withholding tax at 15 percent unless a reduced or zero withholding tax applies in accordance with Luxembourg domestic tax law or based on a tax treaty concluded by Luxembourg. If ParentCo is a Luxembourg company, the deemed dividend income may benefit from the Luxembourg participation exemption regime. At the same time, ParentCo may deduct deemed expenses amounting to the arm's-length interest expenses because those expenses are deemed not in direct economic relationship to the deemed dividend payment by LuxCo.[17]

c. Triangular Cases

The scope of hidden dividend distributions extends to advantages a company shifts to a related party of the shareholder. Here, a rebuttable presumption that the advantage was motivated by the shareholding relationship is derived from the relationship between the shareholder and the related party.

Related-party transactions may in particular involve groups of companies shifting advantages through the chain or between (indirect) sister companies. While unrelated parties should have no interest in shifting advantages to each other, in the absence of a divergence of interests, related parties may intentionally circumvent the arm's-length principle to reduce the overall tax burden.

Hidden dividend distributions through the chain may occur when a company shifts an advantage to an indirect shareholder. Here, in the absence of a direct shareholding relationship, the company may not directly distribute the advantage to the beneficiary. Rather, for tax purposes, several hidden dividend distributions are deemed performed subsequently:

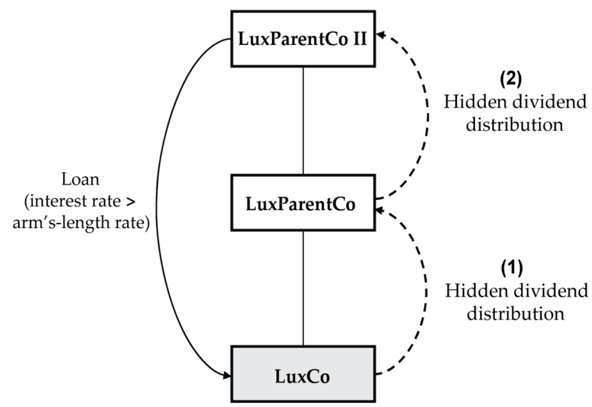
- the company is deemed to shift an advantage to its direct shareholder (hidden dividend distribution 1); and
- the direct shareholder is deemed to shift an advantage to the indirect shareholder (hidden dividend distribution 2).

[17] *See* Hoor, "Hidden Dividend Distributions & Hidden Capital Contributions: A Technical Guide," *Legitech* 55 (2011).

Chain transactions may involve any number of intermediary companies and therefore any number of hidden dividend distributions.

Consider an example. A Luxembourg company (LuxParentCo II) grants a €5 million interest-bearing loan to its indirect subsidiary LuxCo. The applicable interest rate is 10 percent, whereas the arm's-length interest rate is 6 percent. Accordingly, LuxCo shifts an advantage of €200,000 per year (€5 million * [10% - 6%]) to LuxParentCo II. (See Figure 3.)

Figure 3. Hidden Dividend Distributions Through the Chain



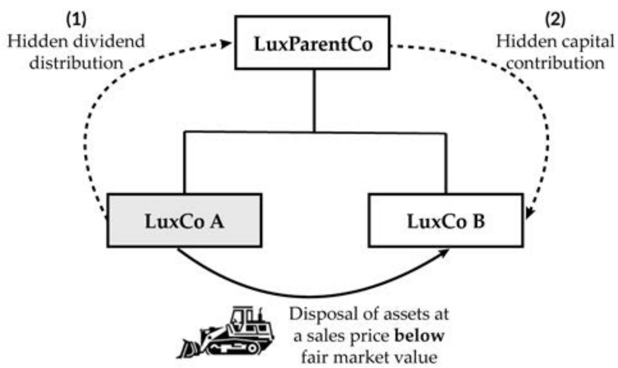
For Luxembourg tax purposes, the advantage shifted up the chain should be classified as a hidden dividend distribution via the direct parent company (LuxParentCo). Accordingly, a first hidden dividend distribution is considered from LuxCo to LuxParentCo (€200,000), and a second from LuxParentCo to LuxParentCo II (€200,000).

Advantages may also be shifted between sister companies. Here, the advantage is deemed to be motivated by the relationship with the common shareholder. Therefore, for Luxembourg tax purposes, the advantage is deemed granted to the common shareholder that subsequently shifts the advantage to the beneficiary sister company.

While the advantage shifted to the common shareholder should be classified as a hidden dividend distribution, the advantage shifted to the beneficiary company may qualify as a hidden capital contribution.

Consider an example. LuxCo A sells an excavator worth €100,000 to its sister company LuxCo B for €70,000. Although LuxCo A grants the advantage (€30,000) directly to LuxCo B, the economic reason is to be found in the companies' common shareholding relationship with the Luxembourg parent company (LuxParentCo). A hidden dividend distribution is therefore considered from LuxCo A to LuxParentCo (€30,000), and a corresponding hidden capital contribution from LuxParentCo to LuxCo B (€30,000). (See Figure 4.)

Figure 4. Advantages Shifted Between Sister Companies



d. Cross-Border Situations

The concept of hidden dividend distributions might also apply when non-Luxembourg resident parties are involved. In those cross-border situations, the Luxembourg tax treatment of the Luxembourg parties involved does not differ from the general tax consequences analyzed above. In other words, the tax adjustments for hidden dividend distributions for Luxembourg tax purposes do not depend on the foreign tax treatment of the other party or parties involved.

2. Hidden Capital Contributions

a. Characteristics

Hidden capital contributions generally refer to advantages a shareholder shifts to a company. While Luxembourg tax law does not define the concept, hidden capital contributions bear the following characteristics in accordance with the relevant case law:

- a shareholder or a related party of the shareholder;
- motivated by the shareholding relationship;
- grants an advantage to a company that may be reflected in the balance sheet — that is, either an increase in assets or a decrease in liabilities (if the shareholder does not receive an arm's-length compensation); and
- the contribution is not a regular contribution (under Luxembourg commercial law).[18]

In principle, contributions increase the net equity in the receiving company's balance sheet. The *object* of a hidden capital contribution should generally directly relate to balance sheet items — namely, an increase in assets or a decrease in liabilities. However, this very point is not unanimous in Luxembourg doctrine and some Luxembourg authors take the view that any advantage including free services (for example, interest-free loans and free advisory services) granted by a shareholder to the company should be classified as a hidden capital contribution. This is because such advantages increase the net equity of the beneficiary company through cost savings.

b. Tax Treatment

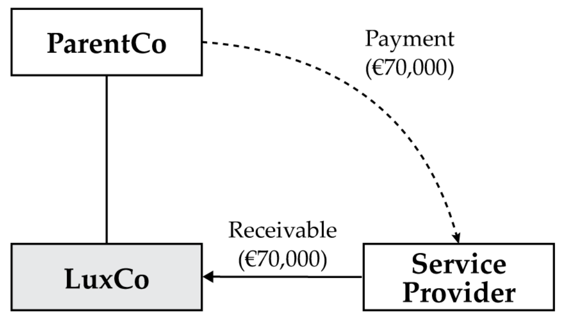
Hidden capital contributions may require complex tax adjustments at the company and shareholder levels and must be analyzed case by case. In general, income realized accounting-wise from the hidden capital contribution should be excluded from the company's taxable income.[19] At the shareholder level, the book value of the participation in the company receiving the advantage should be increased by the FMV of the contribution, and deemed income corresponding to the amount of the hidden capital contribution should be considered when determining the taxable income.

Consider an example. LuxCo has a €70,000 liability to a service provider. ParentCo pays that liability and waives its claim to receive a refund in Luxco's favor. LuxCo records the transaction accounting-wise as extraordinary income of €70,000, whereas ParentCo records expenses of €70,000. (See Figure 5.)

[18] *See* Guy Heintz, "L'impôt sur le revenu des collectivités," 113/114/115 *Etudes Fiscales* 30, 68 (Jan. 1999); and Hoor, *supra* note 17, at 81.

[19] The tax adjustment is made in the company's corporate tax return. The legal basis for the exclusion is in LITL article 18(1), which provides that contributions should be deducted from the tax basis.

Figure 5. Takeover of Liabilities



The advantage of €70,000 shifted by ParentCo to LuxCo should be classified as a hidden capital contribution. Accordingly, the income linked to the contribution should be excluded from LuxCo's taxable income. If ParentCo were a Luxembourg company, the expenses reflected accounting-wise (when taking over LuxCo's debt) would be neutralized by deemed income of €70,000. The book value of the participation in LuxCo would be increased by the amount of the hidden capital contribution in ParentCo's tax balance sheet.

c. Triangular Cases

Advantages willfully granted to a company by a related party of the shareholder may also be classified as hidden capital contributions. Related-party transactions may involve groups of companies shifting advantages through the chain or between sister companies. Whilst unrelated parties should have no interest in shifting advantages to each other, in the absence of a divergence of interests, related parties might intentionally circumvent the arm's-length principle to reduce the tax burden.

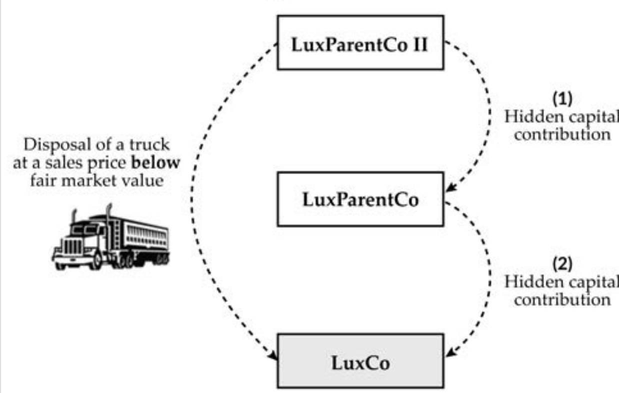
Hidden capital contributions through the chain might occur when a corporate shareholder shifts an advantage to an indirect subsidiary. Here, in the absence of a direct shareholding relationship, the shareholder may not directly contribute the advantage to the beneficiary. Rather, for tax purposes, several hidden capital contributions are deemed performed subsequently:

- the corporate shareholder is deemed to shift an advantage to its direct subsidiary (hidden capital contribution 1); and
- the direct subsidiary is deemed to shift an advantage to the indirect shareholder (hidden capital contribution 2).

Chain transactions may involve any number of intermediary companies and therefore any number of hidden capital contributions.

Consider an example. LuxParentCo II disposes of a truck worth €120,000 to its indirect subsidiary LuxCo for €80,000. Here, the advantage shifted down the chain is classified as a hidden capital contribution via LuxParentCo. Accordingly, LuxParentCo II performs a hidden capital contribution to LuxParentCo (€40,000), which itself performs a hidden capital contribution to LuxCo (€40,000). (See Figure 6.)

Figure 6. Hidden Capital Contributions Through the Chain

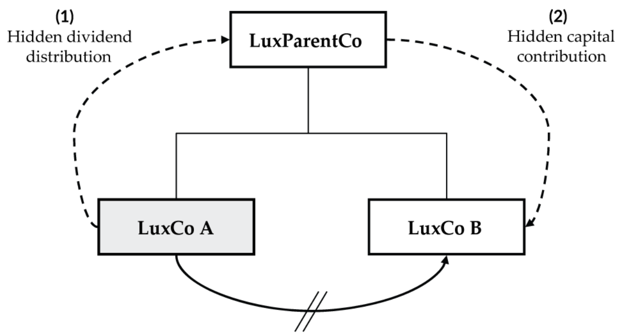


Advantages may also be shifted between sister companies and are deemed motivated by the relationship with the common shareholder. Therefore, for Luxembourg tax purposes, the advantage is deemed granted to the common shareholder that subsequently shifts the advantage to the beneficiary sister company.

While the advantage shifted to the common shareholder should be classified as a hidden dividend distribution, the advantage shifted to the beneficiary company may qualify as a hidden capital contribution.

Consider an example. LuxCo A waives a €1.6 million loan receivable by a Luxembourg sister company (LuxCo B). The FMV of the loan corresponds to its nominal value. For Luxembourg tax purposes, the advantage of €1.6 million granted by LuxCo A to LuxCo B is deemed shifted via the common shareholder (LuxParentCo). While the advantage granted by LuxCo A to LuxParentCo should be classified as a hidden dividend distribution, the advantage granted by LuxParentCo to LuxCo B should be classified as a hidden capital contribution. (See Figure 7.)

Figure 7. Advantages Shifted Between Sister Companies



d. Cross-Border Situations

Again, hidden capital contributions might occur in cross-border situations. In those cases, the Luxembourg tax treatment of the Luxembourg parties does not differ from the general tax consequences analyzed above. Luxembourg tax consequences do not depend on the foreign tax treatment of the parties involved.

3. Tax Adjustments Under LITL Article 56

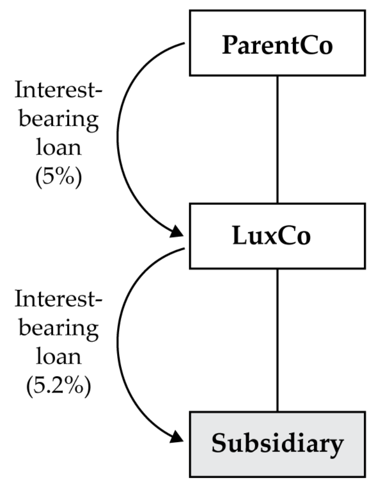
LITL article 56 (as applicable before 2015) allowed the Luxembourg tax authorities to perform tax adjustments where advantages had been shifted in a cross-border context. More precisely, the taxable income of a Luxembourg resident taxpayer that was affected by a "special economic relationship" with a nonresident taxpayer could have been adjusted by a tax official appointed by the tax director. Given that LITL article 56 was phrased broadly, both upward and downward adjustments could be based thereon.

In January 2015 a new version of article 56 formally introduced the arm's-length principle into Luxembourg tax law. The scope of the provision is limited to transactions between associated enterprises and does not apply to transactions between individual shareholders and a Luxembourg company. In a tax treaty context, tax adjustments made under new article 56 are generally permitted under article 9(1) of the OECD Model Convention on Income and Capital.

New article 56 serves as a legal basis for performing upward and downward adjustments in accordance with the arm's-length principle. In other words, when a Luxembourg company shifts an advantage to another group company, the Luxembourg tax authorities should increase the company's taxable income. Conversely, when a Luxembourg company receives an advantage from an associated company, the taxable income of the Luxembourg company must be reduced by a downward adjustment so as to reflect arm's-length conditions. Article 56 applies to both cross-border and domestic transactions.

Consider an example. LuxCo, which performs financing activities, receives from ParentCo a loan bearing interest at a rate of 5 percent. It grants to its subsidiary a loan of the same amount, which bears interest at a rate of 5.2 percent. (See Figure 8.)

Figure 8. Financing Activities



Assuming that the Luxembourg tax authorities can reasonably evidence that the arm's-length margin should be 30 basis points instead of 20, they can increase LuxCo's taxable income under LITL article 56.

Consider another example. LuxCo receives from ParentCo an interest-free loan to finance LuxCo's business activities. LuxCo substantiates in a transfer pricing study that the arm's-length interest rate would be 4.5 percent. (See Figure 9.)

Figure 9. Downward Adjustment

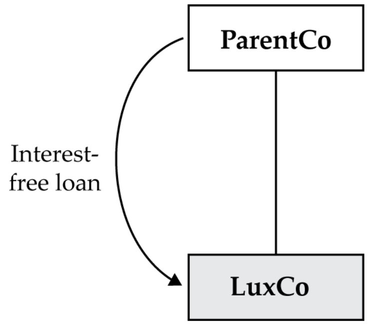
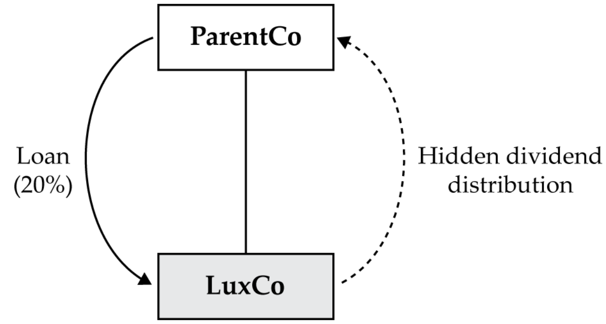


Figure 10. Excessive Interest Rate



In this case, a downward adjustment amounting to the arm's-length interest expenses should be performed when determining the taxable income in LuxCo's corporate tax returns. Whether the deemed interest expenses are deductible for Luxembourg tax purposes depends on the tax treatment of the income derived from the assets financed by the interest-free loan (for example, interest expenses incurred on tax-exempt income is not deductible) and may be limited under the interest limitation rules of LITL article 168-*bis*.

4. Hierarchy of Norms

LITL article 56 and the concepts of hidden dividend distribution and hidden capital contribution operate independently and may apply concurrently. In case of an overlap, however, the concepts of hidden dividend distribution and hidden capital contribution should take precedence over article 56. That is because the only tax consequence of article 56 is an adjustment of a company's taxable income (to restate arm's-length conditions), whereas the concepts of hidden dividend distributions and hidden capital contributions may require additional tax adjustments at both the company and shareholder levels. If article 56 applied, additional tax adjustments would be required in accordance with the concepts of hidden dividend distribution and hidden capital contribution. Accordingly, the article's scope should generally be limited to cases in which advantages shifted between related companies cannot be classified as a hidden dividend distribution or a hidden capital contribution.

Consider an example. LuxCo receives from ParentCo a loan bearing interest at a rate of 20 percent. The arm's-length interest rate is 8 percent. (See Figure 10.)

The advantage shifted by LuxCo to ParentCo in the form of excessive interest payments should be classified as a hidden dividend distribution of 12 percent (20% - 8% arm's-length interest). It follows that LuxCo's taxable income is increased by the amount of the excessive interest payments.[20] Moreover, the deemed dividend distribution — that is, the excessive part of the interest payment reclassified into a deemed dividend — is generally subject to Luxembourg withholding tax of 15 percent (unless a reduced or zero withholding tax rate applies). If ParentCo is tax resident in Luxembourg, the deemed dividend income would be taxable but may benefit from an exemption under the Luxembourg participation exemption regime.

D. Tax Treatment of Huhtamäki in Luxembourg

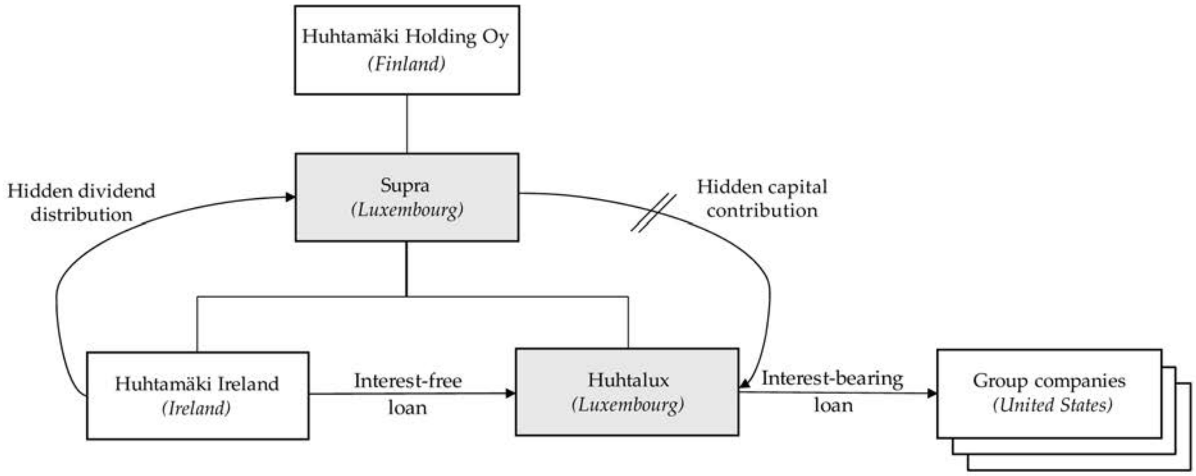
When analyzing the Luxembourg tax treatment of Huhtamäki, a distinction must be made between the period before 2015 and the period after.

Before 2015, transfer pricing adjustments could be performed based on the concepts of hidden dividend distributions and hidden capital contributions, as well as under LITL article 56.

The interest-free loan granted by Huhtamäki Ireland to Huhtalux is an advantage that in accordance with relevant case law, is motivated by the common shareholder and must be classified as a hidden dividend distribution from Huhtamäki Ireland to Supra. The value of the hidden dividend distribution corresponds to the arm's-

[20] LITL article 56 would result in the same tax adjustment.

Figure 11. The Huhtamäki Case



length interest income to be received by Huhtamäki Ireland, which is the difference between Huhtalux's interest income and an arm's-length finance margin.

If Huhtamäki Ireland were a Luxembourg company, its taxable income would have to be increased by the arm's-length interest income. At Supra's level, deemed dividend income corresponding to the amount of the arm's-length interest income of Huhtamäki Ireland would have to be considered in relation to the hidden dividend distribution. However, in this case, the deemed distribution benefited from an exemption under the Luxembourg participation exemption regime.

Assuming that the advantage granted in the form of an interest-free loan cannot be classified as a hidden capital contribution from Supra to Huhtalux, it is deemed consumed by Supra, which should recognize deemed expenses amounting to Huhtalux's arm's-length interest expenses for Luxembourg tax purposes. According to relevant case law, those expenses are not in direct economic relationship to the tax-exempt dividend income by Huhtamäki Ireland and should therefore be deductible at the level of Huhtalux.[21] The deduction of those expenses is not subject to any discretion by the Luxembourg tax authorities. (See Figure 11.)

Had Supra and Huhtalux formed a fiscal unity for Luxembourg tax purposes, Huhtalux's interest income would have been reduced by the deemed interest expenses incurred by Supra, resulting in the realization of an arm's-length finance margin. However, based on article 56 of the LITL (as applicable until 2014), the Luxembourg tax authorities had to accept the transfer pricing adjustment at the level of Huhtalux that benefited from an advantage that has been granted by a nonresident taxpayer as part of a special economic relationship. The same tax treatment would result from the diverging approach provided in Luxembourg doctrine, according to which any advantage may be classified as a hidden capital contribution. Hence, applying this logic, the arm's-length interest expenses would need to be recognized at the level of Huhtalux based on the concept of hidden capital contributions.

Since 2015, the new version of LITL article 56 provides for a legal basis to perform upward and downward adjustments whenever advantages are shifted between members of a group of companies. Further, the concepts of hidden dividend distributions and hidden capital contributions might apply.

As analyzed above, the interest-free loan granted by Huhtamäki Ireland results in a hidden dividend distribution to Supra. The deemed dividend income should be exempt at Supra's

[21]Because there is no (direct) economic relationship between the deemed expenses and the (partially) tax-exempt deemed dividend income, the provisions regarding expenses in connection with tax-exempt income (LITL articles 45(2) and 166(5) No. 1) should not apply. That is the case only when, for example, the interest-free loan is used to finance an asset that generates tax-exempt income. *See* Bundesfinanzhof Decision of Nov. 15, 1960, I 189/59 S, BStBl III 1961, at 80.

level, whereas the deemed expenses corresponding to the advantage granted by Huhtamäki Ireland to Huhtalux should generally be deductible for Luxembourg tax purposes. New article 56 also provides for a downward adjustment corresponding to the arm's-length interest expenses at Huhtalux's level.

However, the tax ruling issued by the Luxembourg tax authorities in 2013 provided only for a downward adjustment at the level of Huhtalux, the ultimate beneficiary of the advantage. The ruling is consistent with the new version of LITL article 56 that requires a downward adjustment to reflect arm's-length conditions.

IV. State Aid Considerations

The European Commission's state aid investigations have received a lot of media attention, given their well-known targets and the sometimes astronomical amounts of tax that could be collected by the member states in question.

The state aid proceedings involving tax matters have several unusual features. First, state aid is a competition law matter, not a tax law matter. That has wide-ranging consequences, including the potential recovery of state aid from a legal entity other than the one that benefited from the tax relief but is part of the same enterprise. Second, the proceedings take place between the European Commission and the member state. The taxpayer that can end up footing the bill is not fully represented.[22] Third, when a member state appeals a state aid finding in tax matters, it finds itself in the unusual position of vigorously contesting its obligation to collect taxes.

A. The Concept of State Aid

According to article 107(1) of the Treaty on the Functioning of the European Union, any aid granted by a member state or through state resources in any form whatsoever, including tax measures, that distorts or threatens to distort competition by favoring some undertakings or the provision of some goods is considered incompatible with the internal market if it affects trade between EU states.

According to the Court of Justice of the European Union, for a measure to be categorized as aid under TFEU article 107(1), all conditions in that provision must be met — that is, the measure must be granted by state resources, confer a selective advantage to undertakings, affect trade between member states, and distort or threaten to distort competition.[23]

State aid cases in tax matters usually fail because it cannot be shown that the advantage granted is selective.

B. State Aid Procedure

The state aid investigations into tax rulings follow a two-step approach. The commission first asks member states for a description of its tax ruling practice and relevant documents together with a list of all tax rulings issued during a particular period (mainly 2010 to 2013). It then selects tax rulings from that list for a case-by-case review as part of a nonpublic preliminary investigation.

When the preliminary investigation leads to the conclusion that state aid incompatible with the internal market has been granted, the commission may decide to open a formal investigation, which allows it to collect information from all interested parties (including the taxpayer, other member states involved, and potential competitors). The decision to initiate that procedure is sent to the relevant member state. There is no legal deadline to complete a formal investigation, at the end of which, the commission adopts a final decision.

When the commission takes a negative decision against aid that has already been paid out, it requires the member state to recover the aid with interest from the beneficiary. There is a limitation period of 10 years for recovery.

In Huhtamäki's case, the commission has decided to open a formal investigation. If it finds that there was state aid under TFEU article 107(1), Luxembourg could appeal the finding to the CJEU.

[22] *See* Keith O'Donnell and Anne Muller, "State Aid and Tax Law: Enter the Taxpayer," in *State Aid and Tax Law* 201 (2012).

[23] *See* Claire Micheau and Gauthier Charles de la Brousse, "Case Studies of Tax Issues on Selectivity: Analysis of the Patent Box Scheme and the Reduced Taxation of Foreign-Source Interest Income," in *State Aid and Tax Law* 167 (2012).

C. State Aid Assessment

1. Measure

The conditions of state-originated resources and affectation of trade and competition generally do not raise problems. Because the tax rulings were granted by the Luxembourg tax authorities, which is an organ of the Luxembourg state, the first condition for a finding of potential state aid should be met.

Moreover, Huhtalux is part of the Huhtamäki group, a Finnish multinational that operates in numerous EU states. Thus, any aid in its favor could distort or threaten to distort competition and has the potential to affect intra-EU trade. Accordingly, the fourth condition of the state aid concept should also be met.

2. Advantage

The next question is whether an advantage was granted to Huhtalux. The interest income realized by Huhtalux is taxable in Luxembourg as part of the company's worldwide income. The advantage shifted by Huhtamäki Ireland Ltd. to Huhtalux resulted in a downward adjustment in accordance with the arm's-length principle. That was and is consistent with Luxembourg tax law, even though the technical analysis slightly changed as of 2015 with the implementation of a new version of LITL article 56.

The European Commission argues, however, that Luxembourg exercised discretion when confirming the application of a downward adjustment. If one follows that argumentation, the decisive question is whether the tax rulings granted by the Luxembourg tax authorities to Huhtalux conferred a selective advantage, which is inconsistent with the common tax regime.

3. Selectivity

According to CJEU case law, TFEU article 107(1) requires a determination whether in the context of a particular legal system, a measure constitutes an advantage for some undertakings in comparison with others in a comparable legal and factual situation.[24] The CJEU developed a three-step analysis to determine whether a particular tax measure is selective:

- identification of the reference legal system;
- assessment of whether the measure derogates from that common regime in as much as it differentiates between economic operators that in the light of the objective assigned to the tax system, are in a comparable factual and legal situation (comparability test); and
- justification by the logic of the tax system (justification test).

a. Reference System

The measure in question — that is, the downward adjustment performed for transfer pricing purposes in accordance with LITL article 56 — is part of Luxembourg's overall corporate income tax system and cannot be dissociated from it. Thus, the Luxembourg corporate income tax system should be regarded as the reference system for the assessment of the measure.

b. Comparability Test

Next, one must analyze whether the tax rulings granted to Huhtalux entail an advantage inconsistent with Luxembourg corporate income tax law. In other words, the question is whether Huhtalux's tax treatment was more beneficial than that of other Luxembourg undertakings that are factually and legally similarly situated.

Huhtalux is a Luxembourg resident company and should be subject to tax on its worldwide income under Luxembourg tax law. Consequently, if Luxembourg tax law does not require accepting a downward adjustment for the interest-free loan granted by Huhtamäki Ireland, there would be an advantage.

However, as analyzed above, the European Commission is wrong in its conclusion that the Luxembourg tax authorities misapplied domestic tax law. As noted, the application of the downward adjustment is and was consistent with Luxembourg tax law despite technical nuances following the 2015 implementation of a new version of LITL article 56. The same tax treatment would have applied to other taxpayers in the same factual circumstances irrespective of the existence of a tax ruling.

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[24] *See, e.g.*, *British Aggregates v. Commission of the European Communities*, C-387/06P (CJEU 2008), at para. 82; *Spain v. Commission of the European Communities*, C-409/00 (CJEU 2003), at para. 47; and *Portugal v. Commission of the European Communities*, C-88/03 (CJEU 2006), at para. 54. *See also* Micheau and de la Brousse, *supra* note 23, at 168.

c. Justification Test

Finally, according to the CJEU, a measure found to be selective on the basis of the comparability test can still be found to fall outside the scope of the state aid rules if it is justified by the system's nature or general scheme. However, given that no selective advantage has been granted by Luxembourg to Huhtalux, this test is irrelevant.

V. Conclusion

The European Commission has opened an in-depth investigation to examine whether tax rulings granted by Luxembourg to Huhtamäki entailed a selective advantage that may amount to illegal state aid. While at the surface the case is about transfer pricing and the proper application of the arm's-length principle, at its core is whether a downward adjustment is consistent with Luxembourg tax law. The arm's-length character of the downward adjustment corresponding to the interest income of Huhtalux minus an arm's-length finance margin has neither been tested nor challenged by the commission.

While the technical analysis of the Huhtamäki case changed slightly following the implementation of a new version of LITL article 56 in 2015, the Luxembourg tax authorities did not exercise discretion in accepting a deduction for expenses that would have been incurred by Huhtalux under arm's-length conditions. Further, the downward adjustment is not conditional to a corresponding adjustment abroad.

The current state aid investigations create significant legal uncertainty for businesses operating in the EU. Where state aid has been found to be granted by a member state to a taxpayer, the entire amount of tax savings has to be paid by the taxpayer. However, in these circumstances, member states may still challenge the decision of the European Commission before the CJEU.

Ultimately, despite the European Commission opening a formal state aid investigation, no final decision has yet been reached. It remains to be seen whether the commission will take a more reasoned approach in its formal investigation and give proper consideration to Luxembourg tax law. ■