No breach

International Tax | Large Corporate

01 October 2018

Bill Dodwell considers the recent EC state aid inquiry into rulings granted by Luxembourg to McDonalds

In December 2015, the European Commission announced it had opened an in-depth investigation into rulings granted by Luxembourg to McDonald’s. The case is interesting, as it follows complaints lodged with the Commission by trade unions and other campaigners, which produced a report making assertions about McDonald’s tax structure in Europe. Other investigations by the Commission seem to have come from their own enquiries.

McDonald’s Europe Franchising, a Luxembourg subsidiary of the group, had acquired the rights to royalties paid by franchisees operating restaurants in Europe and Russia to use the McDonald’s brand and associated services. The company’s Luxembourg head office was responsible for strategic decision-making. It also had two branches, a Swiss branch, which had a limited activity related to the franchising rights, and a US branch, which had minimal activities, and which received the royalties.

The Luxembourg tax authorities granted a ruling to the franchise company, under which the profits were exempted from Luxembourg tax. This was on the basis that under Luxembourg law the company had a taxable presence in the US and profits were allocated to the US branch. However, the authorities agreed that it did not need to prove its profits were subject to US tax. This was just as well, since the branch was not taxed in the US, as the company did not meet the US ‘trade or business’ threshold for a taxable presence.

Perhaps unsurprisingly, when faced with untaxed profits and a Luxembourg ruling, the European Commission decided to mount an in-depth state aid enquiry. The press release announcing the in-depth enquiry noted: ‘In particular, the Commission will assess whether Luxembourg authorities selectively derogated from the provisions of their national tax law and the Luxembourg-US Double Taxation Treaty and whether thereby the Luxembourg authorities gave McDonald’s an advantage not available to other companies in a comparable factual and legal situation. This investigation does not call into question the general tax regime of Luxembourg.’

Commissioner Margrethe Vestager, in charge of competition policy, added: ‘A tax ruling that agrees to McDonald’s paying no tax on their European royalties either in Luxembourg or in the US has to be looked at very carefully under EU state aid rules. The purpose of Double Taxation treaties between countries is to avoid double taxation – not to justify double non-taxation.’

On 19 September 2018, the European Commission announced it had finished its investigation and concluded that the state aid rules had not been breached in this case. The key finding was that Luxembourg had not misapplied its domestic law – which meant that similar opportunities were open to all.

Commissioner Vestager said: ‘The Commission investigated under EU State aid rules whether the double non-taxation of certain McDonald’s profits was the result of

Luxembourg misapplying its national laws and the Luxembourg-US Double Taxation Treaty, in favour of McDonald's. EU State aid rules prevent Member States from giving unfair advantages only to selected companies, including through illegal tax benefits. However, our in-depth investigation has shown that the reason for double non-taxation in this case is a mismatch between Luxembourg and US tax laws, and not a special treatment by Luxembourg. Therefore, Luxembourg did not break EU State aid rules.

Of course, the fact remains that McDonald's did not pay any taxes on these profits – and this is not how it should be from a tax fairness point of view. That's why I very much welcome that the Luxembourg Government is taking legislative steps to address the issue that arose in this case and avoid such situations in the future.'

The United States had in fact been putting pressure on Luxembourg to change its law since 2015, such that non-taxation of branches was brought to an end. The US was not willing to change its domestic definition of taxable presence, since this would have required primary legislation in the US and would have wider consequences for the US tax system. Equally, it was unable to amend its treaty with Luxembourg, due to the stand-off in the US Senate, where a single senator has prevented any tax treaties being ratified since 2010. The result was that the Luxembourg authorities were asked to stop giving branch rulings for US branches – which was also challenging, without a change in Luxembourg law.

Draft legislation is now before the Luxembourg parliament to strengthen the conditions to determine the existence of a permanent establishment under Luxembourg law. In addition, Luxembourg would be able, under certain conditions, to require companies that claim to have a taxable presence abroad to submit confirmation that they are indeed subject to taxation in the other country.

Many multinationals and tax advisers will welcome the acceptance by the European Commission that state aid rules do not apply in this case. One of the unexplained issues with state aid enquiries is how an enquiry in one case might be applied to many others with similar structures.

It remains to be seen whether the approach taken by the Commission in this case could affect the investigation into the UK's controlled foreign companies' regime. No doubt the Treasury will hope to convince the Commission to close down that enquiry, too.