Bloomberg Tax

Daily Tax Report®

NUMBER 0 NOVEMBER 19, 2018

European Union

INSIGHT: European Commission Finds no Illegal State Aid

BY OLIVER R. HOOR

According to a press release (the text of the decision has not yet been published), the European Commission has found that the non-taxation of certain McDonald's profits in Luxembourg did not constitute illegal state aid as it is in line with national tax laws and the Luxembourg–U.S. tax treaty.

The in-depth analysis of the Commission has shown that the reason for double non-taxation in this case is a mismatch between Luxembourg and U.S. tax laws, and not special treatment by Luxembourg. Therefore, Luxembourg did not break EU state aid rules.

The decision of the European Commission is consistent with the comprehensive analysis by ATOZ, detailed in a publication at the time the State Aid investigations were launched.

Overview of the McDonald's Case The McDonald's Group is a large U.S. multinational which is headed by the McDonald's Corporation, a company listed on the New York Stock Exchange.

Outside of the U.S., McDonald's Corporation and its U.S. affiliate, McDonald's International Property Company, license the right to develop and operate McDonald's restaurants on a market-by-market basis to entities, which, in most major markets, are either direct and indirect subsidiaries of McDonald's Corporation.

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McD Europe Franchising S.à r.l. ("McD Europe"), a Luxembourg Company, has two branches, one in the U.S. ("U.S. Branch") and a second branch in Switzerland ("Swiss Branch"). In order to centralize the oversight and management of the European franchise rights within McD Europe, the latter entered into a "buy-in agreement" and a "qualified cost sharing arrangement" with McDonald's Corporation and McDonald's International Property Company.

According to the buy-in agreement, McD Europe buys in to certain pre-existing and to-be-developed franchise rights owned by McDonald's Corporation and McDonald's International Property Company. As a result, McD Europe acquired the beneficial ownership of a number of franchise rights intangibles. Subsequently, McD Europe allocated these franchise rights as well as the related obligations to its U.S. Branch.

The U.S. Branch maintains operations within the U.S. and is controlled by a branch manager located in the U.S. who oversees certain activities associated with the franchise rights. The branch manager is provided by the McDonald's Corporation on a part-time basis under a service agreement in return for a cost-plus charge as determined in the agreement.

The Swiss Branch has its registered office in Geneva (Switzerland) and licenses the franchise rights to franchisers in various European countries. It also provides management, support, development and other similar or related services associated with the franchise rights. The U.S. Branch remunerates the Swiss Branch for these services on a cost-plus basis.

The Swiss Branch receives royalty income from the franchisers which is then on paid to the U.S. Branch to

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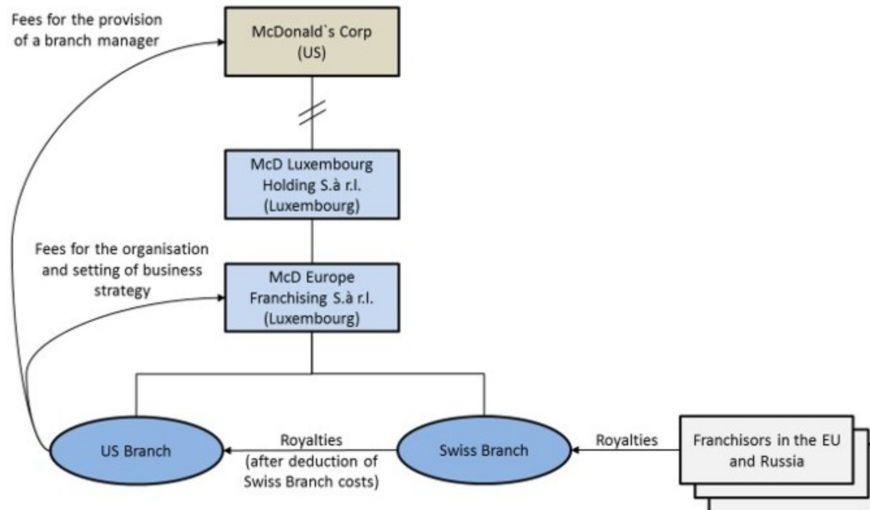
which the franchise rights intangibles have been allocated. The remuneration of the services rendered by the Swiss Branch is reflected in a decrease of the amount of royalties paid by the Swiss Branch to the U.S. Branch of McD Europe.

The chart illustrates the relevant entities of the McDonald's group and the major fund flows.

ing rights allocated to the U.S. by the applicable tax treaty are not exercised under U.S. internal law.

Consequently, the income realized by McD Europe through its U.S. branch was neither taxable in the U.S. nor in Luxembourg, where the exemption method in regard to business profits attributable to the PE in the U.S. was applied.



Tax Treatment in Luxembourg and the U.S. McD Europe is a Luxembourg resident company that is subject to Luxembourg corporate income tax on its worldwide income. The income which is attributable to the U.S. Branch is, in principle, part of the taxable income of McD Europe.

However, the tax treaty concluded between the U.S. and Luxembourg allocates an unlimited primary taxing right over profits attributable to the U.S. Branch to the U.S., as the U.S. is considered as the host state of the permanent establishment (''PE''). In this regard, under the Luxembourg–U.S. double tax treaty, Luxembourg has to exempt income attributable to a U.S. PE.

The tax treatment of McD Europe has been detailed in two tax rulings which were signed by the Luxembourg tax authorities in March and September 2009.

Under U.S. tax law, income derived by a Luxembourg company through a U.S. branch is not automatically taxable in the U.S. Instead, for the income to be taxable, it needs to be ''effectively connected with a U.S. trade or business.''

Therefore, to the extent the activities performed by a Luxembourg company through a U.S. branch do not fall within the scope of ''U.S. trade or business,'' the U.S. branch should not be subject to tax in the U.S.

Accordingly, there may be cases, such as the McDonald's case, where a PE is considered to exist from a Luxembourg tax perspective (and under tax treaty law), whereas no taxable presence is considered from a U.S. tax perspective. Hence, in these circumstances, the tax-

Decision of the European Commission In the McDonald's case, the interaction between Luxembourg and U.S. tax law as well as the applicable tax treaty has resulted in the non-taxation of the income attributable to the U.S. branch.

The decision of the European Commission confirms that the tax rulings granted by the Luxembourg tax authorities did not entail a selective tax benefit and merely provided certainty on the general tax treatment in these circumstances. The double non-taxation was not the result of an unfair advantage granted by the Luxembourg tax authorities. Instead, it was the outcome of the correct application of the tax rules in force.

This is quite remarkable, as in all previous decisions on state aid in tax matters, the European Commission has concluded that illegal state aid was present. In all these other cases, the countries concerned have reached out to the Court of Justice of the European Union (''CJEU'') to file a claim to challenge the Commission's decision. Ultimately, in these cases it will be up to the CJEU to provide legal certainty with regard to state aid investigations going back as far as 10 years.

Planning Points While the decision of the European Commission is positive, as it provides legal certainty for the past, branch structures as implemented by McDonald's will likely disappear over the next few years.

Overall, the management of licensing or financing activities through such branch structures relies on a deductibility of royalty or interest payments in the resident state of the companies that ultimately receive a li-

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cense or a loan and the non-taxation of the related income in the host state of the PE and the jurisdiction in which the head office is located.

In Europe, these hybrid PEs will be tackled through the EU Anti-Tax Avoidance Directive II (''ATAD II'') that needs to be implemented by EU member states by January 1, 2020. As a result, payments made by companies resident in EU member states may not be deductible for tax purposes unless these payments are taxable at the level of the recipient.

ATAD II follows the recommendations of the Organization for Economic Co-operation and Development on BEPS Action 2. Accordingly, it can be expected that other countries will implement similar rules targeting hybrid PEs.

In light of the above, multinational groups that still operate with hybrid PEs should carefully analyze the upcoming tax law changes, perform an impact analysis, and consider structure alignments aiming at optimizing the overall tax position in the post-BEPS tax environment.

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