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ATOZ TAX ALERT

EU Commission finds no illegal State Aid in the McDonald's Case

20 September 2018

On 19 September 2018, the EU Commission announced its decision in the McDonald's State Aid investigations. According to a press release[1], the 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-United States 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 US tax laws and not special treatment by Luxembourg. Therefore, Luxembourg did not break EU State Aid rules.

The decision of the EU Commission is consistent with the analysis of ATOZ that was detailed in a comprehensive publication at the time the State Aid investigations were launched.[2]

Overview of the McDonald's case

The McDonald's group is a large US multinational which is headed by McDonald's corporation, a company listed on the New York Stock Exchange (NYSE).

Outside of the United States, McDonald's Corporation and its US affiliate, McDonald's International Property Company, licenses 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.

McD Europe Franchising S.à r.l. ("McD Europe"), a Luxembourg Company, has two branches, one in the US ("US Branch") and a second branch in Switzerland ("Swiss Branch"). In order to centralise 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.

[1] The text of the decision has not yet been published.
[2] See the report.

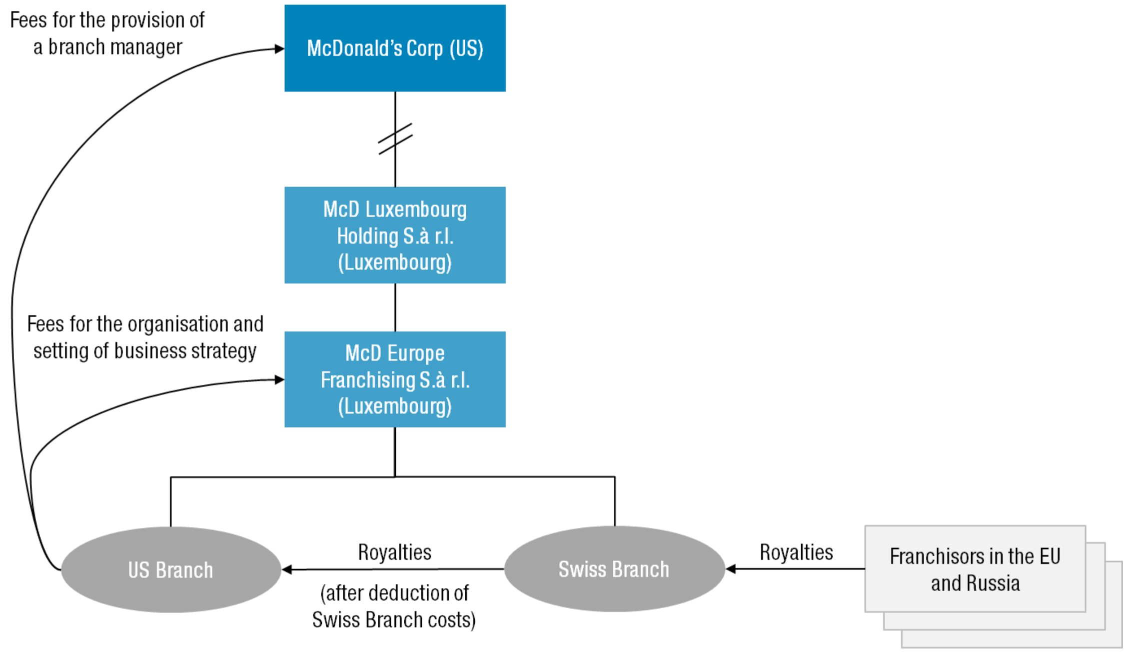
According to the buy-in agreement, McD Europe buys-in to certain pre-existing and to be developed franchise rights owned by McDonald's Corporation and McDonald's International Property Company. As a result, McD Europe acquired the beneficial ownership of a number of franchise rights intangibles. Subsequently,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

The US Branch maintains operations within the US and is controlled by a branch manager located in the US who oversees certain activities associated with the franchise rights. The branch manager is provided by 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 franchisors in various European countries. It also provides management, support, development and other similar or related services associated with the franchise rights. The US Branch remunerates the Swiss Branch for these services on a cost-plus basis.

The Swiss Branch receives royalty income from the franchisors which is then on-paid to the US Branch to 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 US Branch of McD Europe.

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



Tax treatment in Luxembourg and the US

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 US Branch is, in principle, part of the taxable income of McD Europe.

However, the tax treaty concluded between the US and Luxembourg allocates an unlimited primary taxing right over profits attributable to the US Branch to the US, as the US is considered as the host state of the permanent establishment ("PE"). In this regard, under the US-Luxembourg double tax treaty, Luxembourg has to exempt income attributable to a US 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 US tax law, income derived by a Luxembourg company through a US branch is not automatically taxable in the US. Instead, for the income to be taxable, it needs to be "effectively connected with a US trade or business".

Therefore, to the extent the activities performed by a Luxembourg company through a US branch do not fall within the scope of "US trade or business", the US branch should not be subject to tax in the US. 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), but no taxable presence is considered from a US tax perspective. Hence, in these circumstances, the taxing rights allocated to the US by the applicable tax treaty are not exercised under US internal law.

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

Conclusion

In the McDonalds case, the interaction between Luxembourg and US tax law as well as the applicable tax treaty have resulted in the non-taxation of the income attributable to the US branch.

The decision of the EU 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 EU 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.

Can we help? Do you have further questions?

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