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SPECIAL REPORT

McDonald's State Aid Investigation: What the European Commission Got Wrong

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In this article, the authors summarize the European Commission's state aid investigation of McDonald's, analyze the tax treatment of U.S. branches under Luxembourg domestic tax law and tax treaty law, and conclude that no state aid has been granted to McDonald's.

On June 7 the European Commission released the nonconfidential version of its decision to investigate whether a tax ruling from the Luxembourg tax authorities to McDonald's Corp. entailed state aid. In the letter, dated December 3, 2015, the commission said its preliminary view was that Luxembourg had granted a selective advantage to McDonald's by misapplying the Luxembourg-U.S. tax treaty.

This article summarizes the McDonald's case, analyzes the tax treatment of U.S. branches under Luxembourg tax and treaty law, and concludes that no state aid was granted to McDonald's.

I. Introduction

Since June 2013 the commission has been investigating the tax ruling practices of Ireland, the Netherlands, and Luxembourg with a view to detect potential state aid concerns. In December 2014 those investigations had been extended to the ruling systems of all EU member states. As part of the investigations, the commission reviewed tax rulings granted to members of several, mostly U.S.-based, multinational enterprises.

In October 2015 the commission decided that tax rulings the Netherlands gave to Starbucks Corp. and that Luxembourg granted to Fiat Automobiles SPA included illegal selective tax advantages in breach of EU state aid rules. In January 2016 the commission decided that the Belgium's excess profit ruling system is illegal, resulting in taxes of approximately €700 million to be recovered from 35 multinational companies. Likewise, in August 2016, the commission took the decision regarding the tax ruling Ireland granted to Apple and concluded that Ireland granted undue tax benefits of up to €13 billion to Apple. The commission also has ongoing state aid investigations into Luxembourg rulings granted to Amazon.com Inc.

In all those cases, the commission challenged the taxpayers' 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 disagree with the taxpayers. It is even possible that the commission considers its transfer pricing position so superior that by comparison it sees the taxpayers' and tax authorities' positions as state aid.[1]

By contrast, in the McDonald's case, the commission had to analyze the practical application of what we consider a clear tax treaty provision, which provides less room for interpretation.

[1] We question whether the CJEU will uphold that position.

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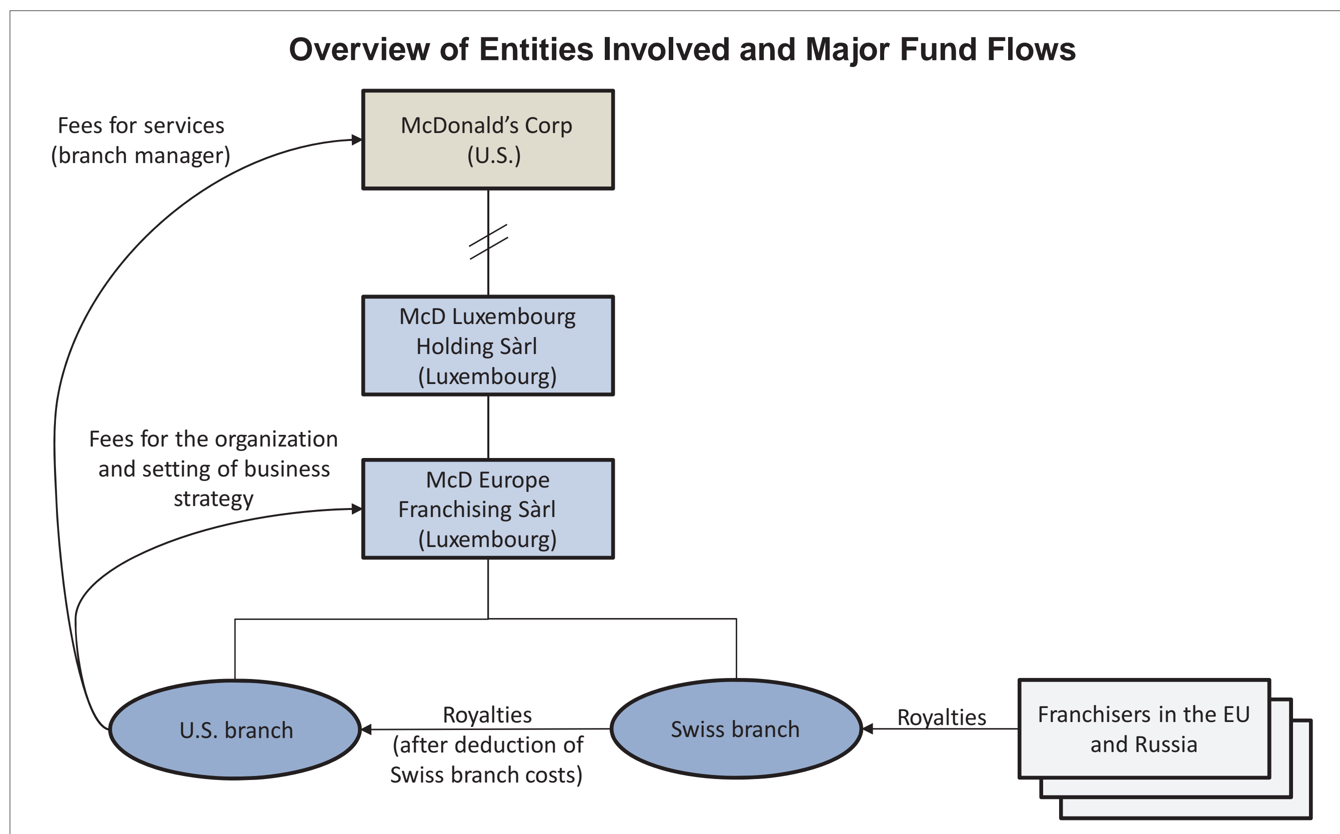

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II. Overview of the Investigation

The McDonald's group is a large U.S. MNE headed by McDonalds's Corp. Outside the United States, McDonald's Corp. and its U.S. affiliate, McDonald's International Property Co., license the right to develop and operate McDonald's restaurants on a market-by-market basis to entities that in most major markets are direct and indirect subsidiaries of McDonald's Corp.

McD Europe Franchising Sàrl (McD Europe) has two branches, one in the United States and one in Switzerland. To centralize the oversight and management of the European franchise rights in McD Europe, the Swiss branch entered into a buy-in agreement and a qualified cost-sharing arrangement with McDonald's Corp. and McDonald's International Property Co.

Under the buy-in agreement, McD Europe bought into some existing and future developed franchise rights owned by McDonald's Corp. and McDonald's International Property Co. As a result, McD Europe acquired beneficial ownership of several franchise rights intangibles. McD Europe later allocated those franchise rights as well as the related obligations to its U.S. branch.

The U.S. branch maintained operations in the United States and was controlled by a manager there who oversaw specific activities associated with the franchise rights. McDonald's Corp. provided that manager part time under a service agreement in return for a cost-plus charge as determined therein.

The Swiss branch had its registered office in Geneva and licensed the franchise rights to franchisers in various European countries. It further provided management, support, development, and other similar or related services associated with the franchise rights. The U.S. branch remunerated the Swiss branch for those services on a cost-plus basis.

The Swiss branch received royalty income from the franchisers that was paid on to the U.S. branch, to which the franchise rights intangibles were allocated. The remuneration of the services rendered by the Swiss branch was reflected in a decrease of the amount of royalties the Swiss branch paid the U.S. branch.

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

III. Luxembourg Tax Treatment

McD Europe is a Luxembourg resident company subject to Luxembourg corporate income tax on its worldwide income.[2] The income attributable to its U.S. branch is in principle part of the taxable income of McD Europe. However, the Luxembourg-U.S. tax

[2]Article 159(1) of the Luxembourg Income Tax Law (LITL).

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treaty allocates to the United States an unlimited primary taxing right over profits attributable to the U.S. branch as the host state of the permanent establishment. Luxembourg has adopted the exemption method to avoid double taxation.

McD Europe's tax treatment was detailed in two Luxembourg tax rulings from March and September 2009.

A. Existence of a PE

The first question to consider is whether the U.S. branch of McD Europe constitutes a PE under the treaty. The analysis should be performed first according to the clear wording of the treaty and then according to the domestic law of the state whose tax is at stake if further interpretation is needed.

According to the treaty, a PE is "a fixed place of business through which the business of an enterprise is wholly or partly carried on." Under Luxembourg domestic tax law, a PE is "every fixed place of equipment or business facility which serves for the operation of an established business."[3] Those concepts broadly align.

The franchising activities performed by McD Europe through a fixed place of business in the United States should be classified as a PE under both Luxembourg's domestic tax law and tax treaty law. Whether or not a PE exists under U.S. domestic tax law has no bearing on the Luxembourg analysis and resulting tax treatment of the U.S. branch.

All activities performed by a Luxembourg company are deemed commercial by default.[4] Therefore, even mere asset management by a Luxembourg company would be treated as commercial income subject to Luxembourg corporate income and municipal business taxes. In a cross-border context, any activity performed by a Luxembourg company through a fixed place of business in a treaty country should give rise to a PE under domestic tax law and Luxembourg's interpretation of tax treaty law.[5]

The same principles apply to foreign companies operating through a fixed place of business in Luxembourg.[6] In those circumstances, a PE would exist in Luxembourg.

The PE definition in tax treaties has also been discussed as part of the OECD's base erosion and profit-shifting project. The final BEPS action 7 report addresses the concern that multinationals artificially avoid establishing a PE through a perceived abuse of the PE threshold in the OECD model tax convention. It provides a new PE definition that lowers the threshold that must be exceeded for a PE to exist.

B. Allocation of Taxing Rights Under the Treaty

While McD Europe is generally subject to corporate income tax on its worldwide income, income derived through the U.S. branch is tax exempt under treaty article 25(2). Further, profits attributable to the U.S. branch are not subject to Luxembourg municipal business tax (based on domestic tax law), and the assets allocated to it are exempt from Luxembourg net wealth tax (based on the treaty). As mentioned, Luxembourg uses the exemption method for foreign PEs, a standard present in virtually all its tax treaties.

The treaty does not provide any conditions for the application of the exemption method, so Luxembourg must exempt from tax income derived from the U.S. branch irrespective of whether the United States exercises its own right to tax.[7]

While the primary purpose of tax treaties is to avoid double taxation, the strict allocation of taxing rights generally avoids even potential double taxation. When countries include special provisions such as a subject-to-tax clause, the MNE's residence state might deny the application of the exemption method when a PE's host state does not tax the profits attributable thereto.[8]

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[3]Para. 16(1) of the Steueranpassungsgesetz (Tax Adaptation Law); *see* Hoor, "The Concept of Permanent Establishments," 54(4) *Eur. Tax'n* 119 (Apr. 2014).

[4]LITL article 162(3).

[5]Absent a more specific treaty definition, under treaty article 3(2), Luxembourg should apply its internal law definition of a PE and the business of an enterprise.

[6]LITL article 156, no. 1.

[7]The treaty provides for an unconditional exemption of profits attributable to a U.S. branch. Thus, Luxembourg has no taxing authority over those profits.

[8]For example, Germany included in some treaties subject-to-tax clauses under which the application of the exemption method (instead of the credit method) is conditioned on the effective taxation in the source state. In the absence of source-state taxation, Germany may tax the income and avoid double taxation through the credit method. It follows that in the absence of a special provision, a contracting state may not simply reject the application of the exemption method. If the contracting states want to ensure that the tax treaty does not lead to double non-taxation, that cannot rely on interpretation and must instead amend the treaty. *See* Hoor, "The OECD Model Convention: A Comprehensive Technical Analysis," *Legitech* 28 (2015); Michael Lang, "Double Non-Taxation — General Report," 89a *Cahiers de Droit Fiscal International* 83 (2004); Manfred Mössner, *Steuerrecht international tätiger Unternehmen — Handbuch der Besteuerung von Auslandsaktivitäten inländischer Unternehmen und von Inlandsaktivitäten ausländischer Unternehmen* 199 (2005); Anna Scapa and Lare Henie, "Avoidance of Double Non-Taxation Under the OECD Model Tax Convention," *Intertax* 267 (2005); and Ingo Jankowiak, *Doppelte Nichtbesteuerung im Internationalen Steuerrecht* 34 (2009). The profits attributable to the U.S. branch may still be considered when determining the tax rate applied to the income of the Luxembourg head office (so-called reserve for progression). Also, as a further example, the Netherlands-U.S. tax treaty has been amended through protocol to allow for the exemption in the Netherlands of profits attributable to a U.S. branch provided that they are effectively subject to tax in the United States.

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Likewise, the application of the exemption method does not depend on whether the treaty partner jurisdiction recognizes the PE (or equivalent). That means that whether a PE of a Luxembourg company exists in a foreign jurisdiction must be determined based on only domestic tax law and tax treaty law. The tax treatment in the foreign jurisdiction does not affect the Luxembourg analysis.[9]

In light of the above, Luxembourg must exempt income derived from assets allocated to a U.S. branch. That treatment is in line with the functionally separate entity approach, the international standard for the attribution of profits to PEs.

Any income attributed to the Luxembourg head office would be taxable in Luxembourg at an aggregate rate of 29.22 percent (2016 rates in the municipality of Luxembourg City). Equally, any assets allocated to the head office would be subject to net wealth tax of 0.5 percent.

C. Profit Attribution to Foreign PEs

Income a Luxembourg tax resident earns from activities carried out through a foreign PE is part of the taxpayer's worldwide income subject to tax in Luxembourg.[10] The determination of the amount of income derived from a foreign PE is necessary for:

- determining the amount of income that is tax exempt under an applicable tax treaty (for a foreign PE in a tax treaty jurisdiction); or
- computing the amount of foreign taxes that may be creditable or deductible for Luxembourg tax purposes (for a foreign PE in a non-treaty jurisdiction).

The functionally separate entity approach should be followed.[11]

For Luxembourg accounting purposes, the financial statements of the Luxembourg enterprise should include the assets and liabilities allocated to the foreign PE, as well as the income and expenses attributable to it. However, for Luxembourg tax purposes, the profit attributable to the foreign PE should be determined using separate branch accounts, which should reflect the assets and liabilities that form part of the business property of the foreign PE as well as the related income and expenses.[12] In some circumstances, services rendered by a Luxembourg head office to the foreign PE may give rise to deemed income in accordance with the arm's-length principle and the authorized OECD approach.[13]

D. Coherence With OECD Principles

Article 7(1) and (2) of the OECD model tax convention embodies the so-called functionally separate entity approach, which is the application of the arm's-length principle in article 9 of the OECD model for the attribution of profits to a PE.[14] It seeks to attribute to a PE the profits that it would have earned at arm's length were it a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions.

Given that article 9 of the OECD model covers transactions between legally separate associated enterprises, a PE should be hypothesized as a separate enterprise even though it is not a separate legal person.[15] The OECD provided significant guidance on the application of the functionally separate entity approach in a July 2010 report on attributing profits to PEs.

OECD model article 7(2) requires that the profits attributable to a PE be determined as if the PE were a separate enterprise. Therefore, profits may be attributed to a PE even if the enterprise as a whole incurs losses.

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[9]When transactions or activities of Luxembourg tax residents have a cross-border dimension, the interpretation and application of Luxembourg tax law generally does not depend on the interpretation or tax treatment in a foreign jurisdiction. Consider the classification of foreign entities for Luxembourg tax purposes. The characteristics of the foreign entities are first analyzed and then compared to Luxembourg vehicles (treated as either tax-opaque or -transparent entities). In that analysis, the classification of an entity in its state of residence and its tax treatment are of secondary importance. *See* Hoor, ''Classification of Foreign Entities for Luxembourg Tax Purposes: Methodology and Tax Consequences,'' 52(4) *Eur. Tax'n* 135 (Apr. 2012).

[10]LITL articles 2(2) (individuals) and 159(2) (companies).

[11]*See* Hoor, ''The Tax Treatment of Permanent Establishments,'' 54(7) *Eur. Tax'n J.* 292 (July 2014).

[12]LITL article 18(1).

[13]*See* OECD ''2010 Report on the Attribution of Profits to Permanent Establishments'' (July 22, 2010). *See also* Paul Chambers and Keith O'Donnell, ''Luxembourg Branch Report,'' in ''The Attribution of Profits to Permanent Establishments,'' 91b *Cahiers de Droit Fiscal International* 460 (2006); and Hoor, *supra* note 11, at 287.

[14]The arm's-length principle is well entrenched in Luxembourg domestic tax law. *See* Hoor, ''Luxembourg Reshapes Its Transfer Pricing Landscape,'' 55(4) *Eur. Tax'n* 131 (Apr. 2015).

[15]There can be no legally binding contracts between a PE and other parts of the enterprise, there can be no separate ownership of assets by the PE or by its head office, no payments can be made between the PE and its head office (the funds paid legally belong at all times to the same person), and no profit can be realized on any dealings between a PE and its head office. Thus, hypothesizing a PE as a separate enterprise is a fiction only for tax purposes. As such, the OECD transfer pricing guidelines cannot be applied to PEs directly, but by analogy only. *See* article 7, para. 21 of the OECD model commentary. *See also* Philip Baker and Richard S. Collier, ''The Attribution of Profits to Permanent Establishments — General Report,'' 91b *Cahiers de Droit Fiscal International* 26 (2006) (in essence, profits attributable to a PE should be determined under the fiction that the PE is a separate enterprise, independent from the rest of the related enterprise). *See also* Josine van Wanrooij, ''Comments on the Proposed Article 7 of the OECD Model Convention,'' *Intertax* 300 (2009).

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Conversely, losses may be attributed to a PE if the enterprise as a whole has made profits.[16]

The attribution of profits to PEs under the functionally separate enterprise approach has two steps:

- it requires a functional and factual analysis to identify the economically significant activities and responsibilities undertaken through the PE;[17] and
- the pricing of any transactions with associated enterprises attributed to the PE in accordance with the OECD's transfer pricing guidelines, which are applied by analogy to dealings between the PE and the other parts of the entire enterprise by reference to the functions performed, assets used, and risks assumed by the hypothesized enterprises.[18]

Article 7(2) of the OECD model tax convention remains in line with the arm's-length principle in model article 9 insofar as intra-entity transactions are treated as arm's-length transactions by attributing to the transferring part of the enterprise the profit it would have made were it transacting with an independent enterprise under market conditions. Accordingly, a PE should be treated the same as a subsidiary for attributing profits under model article 7(2).[19]

Based on the above, the tax treatment of PEs under Luxembourg domestic tax law is consistent with the OECD guidance on the attribution of profits to PEs. Further, the functionally separate enterprise approach is consistent with the wording of the treaty, and Luxembourg doctrine on the attribution of profits to PEs in a tax treaty context supports the independent enterprise theory.

E. U.S. Tax Treatment

Income derived by a Luxembourg company through a U.S. branch is not always taxable in the United States; under IRC section 871(b), it must be effectively connected with a U.S. trade or business to be taxable.

Therefore, if the activities performed by a Luxembourg company through a U.S. branch do not rise to the level of a U.S. trade or business, the U.S. branch should not be subject to tax in the United States.[20] Accordingly, in practice there may be cases, such as McDonald's, in which a PE is considered to exist from a Luxembourg tax perspective (and under tax treaty law), but no taxable presence exists from a U.S. tax perspective. Hence, in those circumstances, the taxing rights allocated by the applicable tax treaty to the United States are not exercised under U.S. internal law.

F. Tax Ruling Practice

As in most of the EU, Luxembourg tax law provides for the ability to obtain tax rulings from the Luxembourg tax authorities.[21] It was common for taxpayers to seek advance certainty on the tax treatment of their business activities and investments structured in Luxembourg.

Contributing to that practice is that Luxembourg tax law, related guidance, and doctrine tends to be less detailed than that of larger jurisdictions. Further, there is only limited Luxembourg case law that could help interpret Luxembourg tax law.[22] However, international investors and multinational groups need legal certainty on the tax treatment of their investments, and tax rulings have been an important tool for managing tax risks.

Tax rulings are generally prepared by a tax adviser and comprise a detailed description of the relevant facts and circumstances as well as a strong technical analysis of the Luxembourg tax implications. When the Luxembourg tax authorities agree with the analysis, they will confirm the tax treatment through the ruling, which is binding on the tax authorities based on the principle of good faith.

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[16] *See* article 7, paras. 11 and 17 of the OECD model commentary.

[17] The functional and factual analysis takes into account the functions performed, assets used, and risks assumed. It determines the functions undertaken by the PE and their relation to the functions of the enterprise as a whole and to the functions of the enterprise associated with the PE. *See* article 7, para. 21 of the OECD model commentary. *See also* Baker and Collier, *supra* note 15.

[18] The traditional transaction methods or transactional profit methods should be applied. The comparability analysis is primarily based on five factors: characteristics of property and services, functional analysis, contractual terms, economic circumstances, and contractual terms. *See* Chapter I, paras. 1.39, 1.42, 1.52, 1.55, and 1.59 of the OECD transfer pricing guidelines. The same factors should apply to ensure comparability between a PE's dealings with other parts of the same enterprise and in uncontrolled transactions, with the difference that the contractual terms factor can be applied only by analogy — those transactions are not legally binding because an enterprise cannot enter into transactions with itself. *See* article 7, para. 22 of the OECD model commentary; van Wanrooij, *supra* note 15, at 302; Baker and Collier, ''2008 OECD Model: Changes to the Commentary on Article 7 and the Attribution of Profits to Permanent Establishments,'' *Bull. Int'l Tax'n* 200 (May/June 2009); Hoor, ''Etablissements Stables — Concept et Traitement Fiscal Selon le Droit Fiscal Interne et les Conventions Fiscales en Vagueur,'' *Legitech* 52 (June 2015); and Hoor, ''Etablissements Stables,'' *Legitech* 44 (2015).

[19] *See* Hoor, ''The OECD Model Tax Convention — A Comprehensive Technical Analysis,'' *Legitech* 122 (2010).

[20] If a foreign company performs financing activities through a Luxembourg finance branch, a PE should be recognized from a Luxembourg tax perspective. The Luxembourg domestic PE concept is much broader than the PE definition in the OECD model.

[21] Twenty-two of the 28 EU member states have a tax ruling system.

[22] To the extent German case law relates to a tax concept or provision that can also be found in Luxembourg tax law, it may in some cases be possible to refer to the jurisprudence of the German Federal Tax Court.

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The Luxembourg tax authorities can grant only rulings consistent with Luxembourg tax law. Rulings that are not in line with Luxembourg tax law would by definition not bind the authorities. Further, if the facts and circumstances change or deviate from those described in a tax ruling, the confirmation is not binding on the tax authorities. It follows that the tax rulings obtained by McD Europe can provide assurance only insofar as their confirmations represent a correct application of Luxembourg tax law and the treaty.

G. The Planned Treaty Protocol

On June 22 the United States and Luxembourg agreed to changes to the treaty to stop double nontaxation resulting from the countries' different interpretations of the PE concept. Under the amended treaty rules, the United States will be allowed under certain conditions to deny tax treaty benefits and to levy U.S. withholding tax in accordance with U.S. internal tax law on interest, royalty, and dividend payments from U.S. sources to a Luxembourg company if the income is not taxed in Luxembourg (because it is attributable to a PE in the United States or a third country).[23]

The planned changes are in line with the wording of the 2016 U.S. model treaty. Further, a draft law was submitted to the Luxembourg parliament anticipating the upcoming amendment to the treaty.[24]

During discussions, questions were raised regarding whether Luxembourg could or should tax the PE income once it became aware that the United States would not and whether the United States could directly apply a withholding tax. The conclusion seems to have been reached — rightly, in our opinion — that short of a change to the treaty, neither state could unilaterally reclaim taxing rights.

The draft law regarding the future protocol has an unusual retroactivity provision, which suggests that the contracting states were keen to rapidly reach a solution and concluded that specific legislative action was required. That makes sense for Luxembourg, because its attempt to tax the PE income would have been tantamount to a unilateral treaty revocation.

IV. State Aid Considerations

A. Opening Comments

State aid has recently acquired a high profile following the political storm over a perceived bias in the targeting of U.S. multinationals by the EU commission.

To anyone not versed in EU law, EU state aid proceedings in tax matters can indeed be hard to understand. While it is not our purpose to examine that topic in detail, a few of the more unusual features help illustrate the difficulty:

- 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 that is part of the same enterprise.
- The proceedings take place between the EU commission and the member state, meaning the taxpayer that can end up footing the bill is not fully represented.[25]
- When a member state appeals a state aid finding in tax matters, it finds itself in the unusual position of contesting its obligation to collect taxes.

B. The Concept of State Aid

Under article 107(1) of the Treaty on the Functioning of the European Union (TFEU), 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 incompatible with the internal market if it affects trade between member states.

According to the settled case law of 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 fulfilled. Hence, for a measure to be illegal state aid, it must:

- be granted by state resources;
- confer an advantage to undertakings;
- be selective; and

[23]However, taking the example of a Luxembourg resident company with U.S.-source income, the denial of treaty benefits by the United States will be possible only if (i) the income considered attributable to the foreign PE is taxed at a combined aggregate effective tax rate lower than the lesser of either 15 percent or 60 percent of the Luxembourg statutory rate; or (ii) under Luxembourg tax law, the income is attributable to a PE in a third country that does not have a comprehensive tax treaty with the United States, unless Luxembourg includes the PE income in the tax basis of the Luxembourg head office. Even if one of those conditions applies, the competent authorities may still decide via a mutual agreement that treaty benefits should be granted. A possible justification would be the existence of tax losses, for example.

[24]According to the draft law, the changes to the treaty will apply retroactively from the publication of the Luxembourg law in the official gazette, although the relevant protocol is still in negotiation (and will also include additional provisions). That means that if the Luxembourg legislative process can be finalized this summer, the change to the tax treaty (by means of a protocol) will apply retroactively from then, without regard to when the protocol is finally signed.

[25]*See* O'Donnell and Anne Muller, "State Aid and Tax Law: Enter the Taxpayer," in *State Aid and Tax Law* 201 (2013).

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- affect trade between member states and distort or threaten to distort competition.[26]

State aid cases in tax matters usually fail because it cannot be shown that an advantage granted to an undertaking was not selective.

C. State Aid Procedure

The commission's state aid investigations into tax rulings follow a two-step approach. It first asks member states for a description of its tax ruling practices and relevant documents, together with a list of all tax rulings issued during a specific period (mainly 2010-2013). 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 illegal state aid has been granted, the commission may decide to open a formal investigation that allows it to collect information from all interested parties, including the taxpayer, other member states, and potential competitors. If it does, the decision to initiate the procedure is sent to the relevant member state. At the end of the formal investigation, for which there is no legal deadline, the commission adopts a final decision. A negative decision in the context of aid that has already been paid out requires the member state to recover the aid with interest from the beneficiary. There is a limitation period of 10 years for recovery.

The commission has decided to open a full investigation into the McDonald's rulings. If the commission finds that there was illegal state aid, Luxembourg might be able to appeal to the CJEU.

D. 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 administration, an organ of the Luxembourg state, the first condition for a finding of potential state aid should be met.

Moreover, McD Europe is part of the McDonald's group, a globally active U.S. MNE that operates in numerous EU member 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 has been granted to McD Europe. The royalty income realized by McD Europe through its U.S. branch has been exempt from taxation in Luxembourg in accordance with the treaty, which is in line with the Luxembourg tax treatment analyzed in Section III. Therefore, it is at least questionable whether an advantage has been granted to McD Europe.

The commission argues, however, that Luxembourg misapplied the treaty and should have subjected McD Europe to tax on its worldwide income. Following that argumentation, the decisive question is whether the tax rulings granted by the Luxembourg tax authorities to McDonald's confer a selective advantage inconsistent with the common tax regime.

3. Selectivity

According to CJEU case law, TFEU article 107(1) requires determining whether within a particular legal system a measure constitutes an advantage for some undertakings over others in a comparable legal and factual situation.[27] For that purpose, the CJEU developed a three-step analysis to determine whether a particular tax measure is selective:

- identification of the referent legal system;
- assessment of whether the measure derogates from that common regime by differentiating between economic operators that, in 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. Referent system. The measure in question — that is, the treaty's exemption method — is part of Luxembourg's overall corporate income tax system and cannot be dissociated from it. Luxembourg's corporate income tax system should therefore be regarded as the referent system for assessing the measure.

b. Comparability test. The next step asks whether the tax rulings granted by the Luxembourg tax authorities to McD Europe entailed an advantage inconsistent with Luxembourg corporate income tax law. In other words, the question is whether the tax treatment of McD Europe is more beneficial than that of other Luxembourg undertakings that are factually and legally similar.

McD Europe is a Luxembourg resident company and should be subject to tax on its worldwide income unless a tax treaty provides otherwise. Consequently, refraining from worldwide taxation without that treatment being mandated by a tax treaty would create an advantage in light of that general principle.

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[26] *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 (2013).

[27] *See, e.g.*, *British Aggregates v. Commission*, C-387/06P (CJEU 2008), para. 82; *Spain v. Commission*, C-409/00 (CJEU 2003), para. 47; and *Portuguese Republic v. Commission*, C-88/03 (CJEU 2006), para. 54. *See also* Micheau and de la Brousse, *supra* note 26, at 168.

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However, the commission is wrong that the Luxembourg tax authorities misapplied the treaty. The application of the exemption method to royalty income realized via the U.S. branch is consistent with Luxembourg tax law and the treaty. The same tax treatment would have applied in the absence of a tax ruling or for other taxpayers in the same factual circumstances (with or without a tax ruling).

As mentioned, when negotiating the new protocol to the treaty, both states seem to have concluded that the only way to correct an anomaly was by legislative rather than administrative action.

c. Justification test. According to the CJEU, a measure found to be selective on the basis of the comparability test can still 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 McDonald's, this test is irrelevant.

E. What the European Commission Got Wrong

The commission has concluded that all conditions of the state aid concept are met and that the tax rulings, particularly the one from September 2009, provide a selective advantage to the McDonald's group. However, the commission's analysis is erroneous in several respects.

The first tax ruling from March 2009 stated that the U.S. branch constituted a PE whose profits were subject to U.S. tax. Further, it stated that those profits were exempt from corporate income tax in Luxembourg under the treaty and on the condition that McD Europe annually provided proof that those profits were declared and subject to tax in the United States.

However, that is not a requirement for the application of the treaty's exemption method, and it is unclear why that wording was included in the ruling. Wrong statements in a tax ruling cannot affect the correct application of the treaty. Because the first tax ruling imposed excessive restrictions on the taxpayer, filing a revised request for a tax ruling was appropriate. In September 2009 a revised request was sent to the Luxembourg tax authorities. That time, the tax adviser said that because the activities of the U.S. branch fell under the definition of a PE under Luxembourg tax law, ''Luxembourg would expect that the income may be taxed in the US because it may be treated as a PE from a Luxembourg tax perspective. There is, however, no requirement that the other contracting state (US) effectively taxes this income.''

The tax adviser further argued that because treaty article 25(2)(a) exempted income that may be taxed in the United States from Luxembourg corporate income tax, there was ''no reference that effective taxation should occur.'' The Luxembourg tax authorities confirmed that interpretation of the treaty.

The commission acknowledged that tax treaties are intended to avoid double taxation and do not oblige contracting states to effectively impose taxes. Thus, it said the requirement of ''may be taxed'' in article 25(2) of the treaty should not be read as a requirement to be effectively taxed.

However, the commission still found the revised tax ruling to contradict both the provisions of the treaty and Luxembourg law that transposes that treaty into national law and as its guiding principle requires worldwide taxation of profits. It assumed that the tax ruling resulted in a lower tax liability for McD Europe, which would amount to state aid. Overall, the income is not taxed in the United States and is tax exempt in Luxembourg.

The commission argued that the application of the exemption method would be inconsistent with article 25 of the treaty. It said that in accordance with article 7 (on business profits), the United States may only tax the income attributable to the U.S. branch if a PE exists to which the income can be attributed. Otherwise, those profits are taxable only in Luxembourg.

In general, it is correct that the United States may not tax the income in the absence of a PE. However, the decisive question is whether the U.S. branch exceeds the PE threshold in treaty article 5. If the conditions of the PE definition in the treaty are met, the United States has an unlimited primary right to tax the profits attributable to the PE. Luxembourg must exempt the income in accordance with treaty article 25(2). Whether a PE is found to exist under U.S. domestic tax law or the profits are effectively taxed in the United States is irrelevant for the mechanism of the treaty.

However, in its analysis, the commission relied exclusively on the existence of a PE under U.S. domestic tax law, concluding there was no possibility that those profits may be taxed by the United States. Therefore, the commission said the Luxembourg tax authorities should not have agreed to apply the exemption method. It specifically referred to paragraph 32.6 of the OECD commentaries, according to which:

> the phrase ''in accordance with the provisions of this Convention, may be taxed'' must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the Source State considers that the provisions of this Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus, the State of residence is not required by paragraph 1 to exempt the item of income, a result which is

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consistent with the basic function of Article 23 which is to eliminate double taxation.

At first glance, that guidance seems to provide a sound argument for the commission, but it is wrong for two reasons. Paragraph 32.6, added in 2000 to the commentaries to model article 23, addresses double nontaxation arising from conflicts of qualification. However, it does not apply in this case because it does not apply when the source state (the United States) does not tax because of the absence of a taxing right in its domestic law. That does not mean that the United States would not consider a PE to exist in accordance with the treaty. Instead, if the United States would not tax the income as a result of applying the treaty, Luxembourg would not have to exempt the income, according to the OECD. It is still unsettled whether a significant change in the commentaries such as the introduction of paragraph 32.6 could even apply to treaties concluded before its introduction.[28]

V. Conclusion

In the McDonald's case, the commission concluded that Luxembourg granted illegal state aid to McD Europe. That is, however, the result of a confusion of the definition of PE under U.S. internal law and the treaty.

Regarding whether the profits attributable to the U.S. branch may be taxed in the United States, it is relevant to determine whether the U.S. branch constitutes a PE under article 5(1) of the treaty. If so, Luxembourg must apply the exemption method irrespective of whether the United States recognizes a PE under its internal tax law or effectively taxes that income. Thus, the Luxembourg tax treatment in the rulings was consistent with the provisions of the treaty, meaning no selective advantage was granted to McD Europe.

The commission's aggressive investigations of tax rulings granted to members of U.S. MNEs has not passed unnoticed in the U.S. Indeed, when reviewing the list of multinationals involved, one cannot deny that most of them are prominent U.S. groups with strongly identifiable brands. On August 24, 2016, the U.S. Department of the Treasury released a white paper entitled ''The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings,'' in which concerns were expressed that the EU commission is applying new approaches that are inconsistent with international norms. The white paper further states that additional taxes levied abroad would be fully creditable against the companies' U.S. tax liability. It is evident that the current practice of the European Commission may create severe political tensions between the U.S. and Europe.

Apart from the reputational risks at play, the investigations create significant legal uncertainty for businesses operating in Europe. When state aid has been found to have been granted by a member state to a taxpayer, the taxpayer must repay the entire amount of tax savings. In those circumstances, member states may still challenge the commission's decision before the CJEU.

Ultimately, the European Commission opened a formal state aid investigation in regard to the McDonald's case, but no final decision has yet been taken. It remains to be seen whether the commission will take a more reasoned stance during its further inquiries into McDonald's and give proper consideration to some of the points on recognition of PEs in internal law, rather than relying on treaty law, as referred to in its initial decision. ◆

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[28] *See* Lang, ''2008 OECD Model: Conflicts of Qualification and Double Non-Taxation,'' 63(5) *European Tax'n* 204 (May/June 2009); Alexander Rust, ''The New Approach to Qualification Conflicts Has Its Limits,'' 57(2) *European Tax'n* 45 (Feb. 2003); Jean Schaffner, *Droit Fiscal International* (2014); and Alain Steichen and Jean-Pierre Winandy in: 89a *IFA Report* 523-524 (2004), Luxembourg chapter.

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