The European Commission has opened its state aid investigation into Luxembourg's tax breaks for holdings, a system that has been in place for almost a century, as George Metaxas reports

Changing of the old guard

Robert Harding

Recent changes in Luxembourg law have already heralded the end for 1929 holding companies. Tax benefits have been cancelled for newcomers, with existing 1929 holdings set to benefit from a 'grandfathering' clause until the end of 2010. It is therefore somewhat surprising that the EC has decided to escalate its investigation at this 11th-hour phase

Seventy-seven years sounds like a respectable age for a tax regime, but this is apparently not enough to spare it the pain of a European Union (EU) state aid investigation. On 8 February, 2006, the European EC (EC) opened such an investigation into Luxembourg tax laws that date back to 1929 and exempt certain holdings from corporate taxes.

So called '1929 holding companies' are one among several available vehicles that Luxembourg has created to attract financial institutions and holdings of multinationals, with considerable success. The financial services sector is reported to employ roughly 10% of Luxembourg's working population and the country still has approximately 12,000 holding companies, although their number has declined in recent years.

1929 holding companies are exempted from business taxes on earnings (dividends, interests and royalties) and payments (dividends and royalty fees). At least until recently, this tax-efficient solution was available to holdings of multinationals established in Luxembourg, provided these limited their activities to financing, licensing, management and coordination services.

As a general rule, EU state aid rules prohibit any form of aid granted by an EU member state or through state resources "in any form whatsoever" which distorts or threatens to distort competition by favouring certain companies. This so-called selectivity or specificity criterion can be fulfilled even if the state aid measure in question is drafted in general terms and can affect a substantial number of beneficiaries — as is usually the case with tax measures if, in reality, the resulting benefit is limited to an identifiable group.

It is a well-established principle, confirmed by the European Court of Justice, that national legislation providing corporate tax breaks may fall under the scope of the EC Treaty's state aid rules, if certain conditions are met. This can have far-reaching implications — approximately 25% of all state aid in the EU is reportedly granted through tax schemes.

On the level of legislation, direct taxation in the EU has generally remained subject to national policies. Several member states have consistently opposed any substantive EU harmonisation in this field and have insisted on maintaining their power to determine their fiscal policy independently.

Partly in reaction to this situation, some of the EC's decisions in the area of direct corporate taxation seem to be based on a broad interpretation of the concept of illegal state aid, thus effectively introducing limits to the member states' discretionary powers in this area.

The EC has the power to order the suspension and recovery of illegal new state aid. However, 'existing aid', which also includes state aid implemented by a member state before its EU accession, is subject to suspension but not to retroactive recovery. The EC's investigation of Luxembourg's 1929 tax regime has prompted concerns that its goal may be some form of retroactive taxation, back-fines or other penalties. Nevertheless, the legal basis, if any, for such an outcome is certainly not obvious in the case of an 'existing aid' such as the one involved here.

This conflict may come at a surprisingly late moment, but it did not come out of the blue. The EC first initiated a review of Luxembourg's 1929 legislation in December 2001. On 21 October, 2005, it proposed certain adjustments, but these were rejected by Luxembourg. The EC claims that it therefore had no choice but to initiate a formal investigation, on the grounds that the tax exemption under Luxembourg's 1929 exempt holdings regime "may constitute a disguised subsidy in favour of multinational companies based in Luxembourg and may distort the European financial market".

The EC's official announcement obscures the fact that, in recent times, Luxembourg's 1929 holding companies have lost their appeal as, for example, they have not benefited from any bilateral treaty benefits. On the contrary, other, more recently-created investment vehicles in Luxembourg, such as the *Societes de Participations Financieres* (SOPARFI) are better adjusted to the modern international investment environment.

More importantly, however, recent changes in Luxembourg law have already heralded the end for 1929 holding companies. Tax benefits have been cancelled for newcomers, with existing 1929 holdings set to benefit from a 'grandfathering' clause until the end of 2010. It is therefore somewhat surprising that the EC has decided to escalate its investigation at this 11th-hour phase. One possible explanation might be that it is easier for the EC to challenge a national tax measure that has lost its popularity and is already on its way out. This can help the EC send a confident public message, create a relatively easy legal precedent and move the goalposts in a disputed jurisdictional territory, such as the one of direct taxation.

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