CLIENT ALERT

The European Commission Ordered Luxembourg to Recover €120 Million in Tax Benefits Granted to Engie

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With its decision dated 20 June 2018, the European Commission found that two Luxembourg tax rulings allowed entities of the Engie Group (previously GDF Suez) to avoid paying taxes on almost all of their profits for about a decade. The Commission considered this illegal and ordered Luxembourg to recover approximately €120 million in allegedly unpaid taxes from Engie.[1]

This Client Alert summarizes the relevant facts and discusses the key legal questions raised by this ruling. We conclude with some guidance on what companies can do to avoid costly liability under tax rulings.

1. Facts

Engie is a French multinational producer and distributor of gas and electricity. In 2008 and 2010, it received two tax rulings from the authorities in Luxembourg, which confirmed the validity of certain financing arrangements between entities within the Engie Group (i.e. Engie LNG Supply for the 2008 tax ruling, and Engie Treasury Management for the 2010 tax ruling).

[1] SA.44888, *Aid to GDF Suez* (opening decision at JOCE C/36/2017; Commission press release available at http://europa.eu/rapid/press-release_IP-18-4228_en.htm).

According to the Commission, in 2008, Engie put in place complex hybrid convertible loan structures between several Engie entities to finance Engie LNG Supply's acquisition of Engie's existing gas trading business in Luxembourg.

For this transaction, Engie LNG Supply received financing from Engie LNG Holding via an intermediary. From the perspective of Engie LNG Supply, this financing was treated as a debt, which made it possible to deduct significant amounts from its otherwise taxable profits, as if it owed interest under a loan. These deductions accounted for 99% of Engie LNG Supply's profits.

However, no payments were actually made to the intermediary or Engie LNG Holding. Instead, these profits were retained by Engie LNG Supply until Engie decided to convert the loan. At that moment, the intermediary received these retained profits in the form of shares, which were then passed on to Engie LNG Holding. Engie LNG Holding then cancelled these shares to receive the profits in cash.[2] As a result, Engie LNG Holding did not pay any taxes on any interest paid by Engie LNG Supply to Engie LNG Holding.

As a consequence, for about a decade, Engie's effective tax rate in Luxembourg was less than 0.3% on these profits, which were not taxed in any other country either. In 2010, Engie put in place the same structure between Engie Treasury Management and Compagnie Européenne de Financement (C.E.F), which was also endorsed by Luxembourg under a separate tax ruling.

2. Legal analysis

Article 107 TFEU[3] prohibits Member States from granting State aid without prior approval from the Commission. A finding of illegal State aid requires the Commission to prove that (i) a company received an advantage from State resources, (ii) which must have been selective (i.e. favored certain undertakings), (iii) which distorts or threatens to distort competition, and (iv) which has not been approved by the Commission or is otherwise considered existing aid (i.e. has been in existence for more than 10 years before the Commission starts its investigations). There also must be an effect on trade between Member States. However, this condition is typically considered met where a company is active in several Member States.[4]

Advantage from State resources

The tax rulings confirmed to Engie that the financing arrangements were legal under Luxembourg tax law. As a result, Engie, as a group, paid a significantly lower amount of taxes than it would have under its normal tax rate, which was qualified as an advantage. Even though Engie did not receive any payments from the State of Luxembourg, it is clearly

[2] Income from shares is exempt from taxation under standard Luxembourg tax law, as in many other countries.

[3] Treaty on the Functioning of the European Union.

[4] Exceptions may be available in extremely localized scenarios, but do not warrant further discussion here.

acknowledged that an advantage can be provided from State resources where the State does not collect money due otherwise. This is the case here, where Luxembourg decided to forgo claiming the regular tax.

Selectivity and distortion of competition

EU State aid law does not question the existence of tax rulings as such – which may be an important tool to ensure legal certainty for taxpayers – and the Commission confirmed that its decision did not generally call into question Luxembourg's tax system in this regard. However, in certain cases, tax rulings may lead to tax exemptions granted to selected companies, thereby distorting competition within the EU internal market.

The Commission considered that the two *tax rulings* gave rise to a more favorable treatment of Engie. However, this analysis is correct only on the presumption that the tax rulings actually changed the "normal" tax situation. In situations where a tax ruling merely restates the law, the benefit is not granted by the tax ruling but by the underlying tax law itself.

This requires careful review considering that tax rulings, by their nature, are in principle intended to be declaratory and not constitutive. Thus, one would expect a careful analysis of why the tax rulings at stake went beyond their normal declaratory nature and *actually changed* the existing legal situation. As in previous tax ruling cases, the Commission did not appear to discuss this (at least not in the press release), which could be a key point for any appeal.

If the tax rulings, in the present case, are in fact only declaratory in nature, then the next question is whether the underlying tax law is in and of itself selective, i.e. beneficial to a limited group of tax payers. Assuming the law applies to all companies in the same way, it is difficult to see how the tax law could be considered selective. In other words, if based on the text of the law every company can use a convertible loan structure, deduct interest from income and later convert, transfer and cash the resulting shares without paying taxes at that stage, and if the law does not allow for an element of discretion on the part of the tax authorities in assessing the situation, it is difficult to see how the law can be considered to apply selectively to the relevant companies.[5]

Does the advantage qualify as existing aid?

Aid is considered as existing aid if it has been approved by the EU Commission (which is not the case here), or if it has been in existence for more than 10 years. Existing aid can be changed only with a view to the future, but it is not possible

[5] In the 2016 *Spanish Goodwill* cases, the Court of Justice of the EU confirmed a rather loose approach to the notion of selectivity where discrimination relating to legal provisions is concerned (cases C-20/15P and C-21/15P, *Commission v. World Duty Free Group*, 21 December 2016).

to order a retroactive recovery.[6] This statute of limitations is tolled when the Commission starts an investigation. As a result, the 2008 and 2010 tax rulings do not qualify as existing aid.

However, if, as discussed above, the 2008 and 2010 tax rulings are *merely declaratory* and thus do not confer an advantage on Engie, the relevant measure would be the underlying tax law (assuming it applied selectively; see discussion above). Thus, if the Luxembourg tax law has existed for 10 years prior to the start of the investigation, then there is a possibility that the 10-year statute of limitations has run, thus making the law itself (including all measures that merely declare its content, i.e. proper tax rulings), existing aid.

Recovery

A finding of an illegal aid leads the Commission to require the Member State to recover the aid illegally granted, in order to remove the distortion of competition in the market. Aid has to be repaid immediately, considering that an appeal does not have suspensory effect. Companies can apply for interim measures, which are, however, rarely granted.

In this matter, the Commission applied the standard corporate tax rate in Luxembourg of approximately 29% to Engie and ordered Luxembourg to recover around €120 million in unpaid taxes from Engie, plus interest. This recovery order is apparently based on the 2008 tax ruling only. With respect to the 2010 tax ruling, it would seem that Engie Treasury Management's profits had not been transferred yet. Thus, the Commission warned Engie that it would pay close attention to the level of taxation of future transfers.

The Commission's decision sparked immediate response from both Luxembourg and Engie. Luxembourg confirmed that Engie has always been taxed in accordance with applicable tax rules at the time, without having received any favorable treatment, and reserved its right to appeal.[7] Likewise, Engie confirmed that it did not receive an advantage in the form of State aid from Luxembourg and announced that it will appeal the Commission's decision before the General Court of the EU.[8]

[6] See e.g. Aid C 48/01 - *Vizcaya Coordination Centres, Spain* (OJ L 31/2003); Aid C 47/01 - *Control and Coordination Centres, Germany* (OJ L 177/2003); Aid C 49/01 - *Coordination Centres, Luxembourg* (OJ L 170/2003); Aid C 15/02 - *Coordination Centres, Belgium* (OJ L 282/2003).

[7] Luxembourg Ministry of Finance, Press release of 20 June 2018, *Luxembourg comments on the Commission's decision in the ENGIE case*. https://gouvernement.lu/en/actualites/toutes_actualites/communiques/2018/06-juin/20-engie.html

[8] Engie, Press release of 20 June 2018, *ENGIE denies having received any State aid from Luxembourg*. https://www.engie.com/en/journalists/press-releases/denies-having-received-state-aid-luxembourg/

As a side note, in November 2017, Total bought Engie's LNG business, including Engie LNG Supply. In its merger clearance decision, the Commission acknowledged that the parties had factored in the consequences of a potential recovery decision in their contracts,[9] considering the potential transfer of liability to the buyer.

3. The Engie decision in perspective

Continued political activism in the field of intra-group tax arrangements

Since 2013, the Commission has increasingly investigated tax rulings issued by Member States. So far, the Commission has analysed more than 1,000 tax rulings from 22 EU countries, 600 of which came from the Lux Leaks documents released in 2014.

The Commission has pursued a limited number of highly prominent cases, including against Belgium (the so-called "excess profit" tax scheme regarding 35 multinationals), Ireland (Apple), Luxembourg (Fiat, Amazon) and The Netherlands (Starbucks). There are also at least two ongoing in-depth investigations into tax rulings, in Luxembourg regarding McDonald's, and in The Netherlands regarding Ikea. The Commission is also investigating a tax scheme regarding multinationals in the UK.

Most companies and Member States appealed the Commission's decisions, with appeals pending before the General Court (hearings are taking place in June-July 2018 in the *Fiat*, *Starbucks* and *excess profit* cases). However, as noted above, lodging an appeal does not suspend a Commission decision. Member States are legally required to take measures to recover aid, even while the appeal is pending. In fact, the Commission brought proceedings in 2017 against Ireland in order to enforce its recovery decision in the *Apple* case.[10]

The Commission's declared objective of fair taxation

In the Commission's view, profits must be allocated between different legal entities within a group so as to reflect economic reality. According to Commissioner Vestager, a company cannot have "*the best of both worlds*" when treating a particular transaction from a tax perspective, and the Commission's ultimate objective is that all companies, big or small, pay their fair share of taxes where profits are earned. Only then can companies compete on equal terms, and not at the expense of EU citizens and companies that pay their fair share of taxes.

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[9] Commission Decision of 11 April 2018, *Total/Engie (part of LNG business)*, Case M.8771, para. 73. http://ec.europa.eu/competition/mergers/cases/decisions/m8771_203_13.pdf

[10] Case C-678/17 - *Commission v Ireland*.

Beyond State aids, the EU introduced new legislation to promote fair taxation: new EU rules on automatic exchange of information on tax rulings entered into force in January 2017[11]; a new directive on mandatory transparency rules for intermediaries and taxpayers was introduced on 5 June 2018; and as of June 2018, tax advisors and taxpayers will have to report certain cross-border arrangements, etc.[12]

Recent changes to Luxembourg tax law

The Government of Luxembourg recently announced a change to its tax provisions in order to close loopholes which could lead to non-taxation of profits from intra-group arrangements. The new legislation will also seek to implement EU rules tackling cross-border tax avoidance.[13] Furthermore, Luxembourg will also make amendments to the definition of “taxable presence,” which is of concern in the *MacDonald’s* case.

What should companies do?

The Commission initially targeted taxation schemes based on transfer pricing. It is now actively pursuing other cases more generally where a Member State allegedly failed to apply its own tax laws correctly, thus granting a tax break to attract investment. That said, the Commission continues to emphasize that tax rulings remain a valid tool for the tax administrations of EU Member States as long as they do not provide companies with an advantage; the Commission’s investigations continue to be focused on a limited set of highly prominent cases.

Companies should critically review new and existing tax rulings, possibly with the help of an expert. Transfer pricing cases, for example, can be reviewed with a view to the “*arm’s length*” principle, as described, for example, in the OECD’s Guidelines.[14] Other arrangements should be reviewed against the general tax rate applying to a company. Where a tax ruling provides for very significant savings, companies should question the rationale and evaluate whether the situation might be “too good to be true”. An expert can then help make a further risk assessment.

The situation is somewhat complicated by the fact that it is generally difficult to obtain legal certainty on the validity of a tax ruling under the EU State aid rules. Reassurances given by Member States as to the legality of their actions will not

11 http://europa.eu/rapid/press-release_IP-16-4494_en.htm

12 More information on these transparency rules may be found here: http://www.consilium.europa.eu/fr/press/press-releases/2018/05/25/corporate-tax-avoidance-transparency-rules-adopted-for-tax-intermediaries/

13 EU Anti-Tax Avoidance 2016 Directive, fully applicable as from 1 January 2019.

14 https://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-enm On 21 June 2018, the OECD also published its *Revised Guidance on the Application of the Transactional Profit Split Method*. The full text of the report can be found here: http://www.oecd.org/tax/transfer-pricing/revised-guidance-on-the-application-of-the-transactional-profit-split-method-beps-action-10.pdf

protect companies against a recovery order (the State aid procedure is a procedure between the Member State and the Commission, and there does not exist a process under which companies can notify and clear tax rulings with the Commission directly).

Finally, Member States are generally unwilling to bring individual tax rulings to the attention of the Commission because they retain the sovereign right to set their own tax rules and a consultation with the Commission on a particular case may expose their entire tax system to review and thus cause more problems, rather than provide legal certainty.

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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