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INSIGHT: The Engie State Aid Decision—Another One Bites the Dust

BY OLIVER R. HOOR

Engie (formerly known as GDF Suez) is a partly state-owned, French multinational which operates in the fields of electricity generation and distribution, natural gas, nuclear and renewable energy.

On September 6, 2018, the European Commission released its decision of June 20, 2018 regarding the Engie state aid investigations. The Commission ruled that Luxembourg granted illegal state aid to Engie and should collect around 120 million euros ($136.5 million) of taxes from the company.

European Commission Investigations

The European Commission has been investigating the tax ruling practices of Ireland, the Netherlands and Luxembourg since June 2013, with a view to detecting potential state aid concerns. In December 2014, these investigations were extended to the ruling systems of all EU member states.

As part of these investigations, the European Commission reviewed tax rulings granted to members of several multinational groups in Ireland, the Netherlands, the U.K., Belgium and Luxembourg.

So far, the European Commission decided in six out of seven cases that illegal state aid was present. Only in the McDonald's case did the Commission finally conclude that the Luxembourg tax treatment did not entail a selective advantage and thus did not constitute illegal state aid.

In the Engie case, the European Commission challenged the tax treatment confirmed in two tax rulings obtained by the group in 2008 and 2010. The tax treatment described in these tax rulings did not entail any particular tax benefit but merely confirmed the general tax treatment under Luxembourg tax law which would have applied to other companies in the same situations in a very similar manner.

The recent state aid investigations of the European Commission seem to suggest that the tax treatment of business activities and intra-group transactions by certain member states is not legal. Nevertheless, member states have the sovereignty to design their own tax rules and state aid cannot be used to undermine this sovereignty.

However, the existence of loopholes that may result in situations where corporate income is not taxed at all, or is taxed at nominal rates, was the starting point of the Organization for Economic Co-operation and Development (''OECD'') Base Erosion and Profit Shifting (''BEPS'') Project. The OECD recognized that these loopholes are perfectly legal and need to be addressed by legal changes with global coherence.

The Engie Case at a Glance In 2008 and 2010, Engie implemented two financing platforms involving several Luxembourg companies. Among these entities are Engie LNG Supply (which buys, sells and trades liquefied natural gas and related products in Luxembourg) and

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Engie Treasury Management (which manages internal financing within the Engie Group) which have both been financed by a convertible loan granted by a Luxembourg sister company.

The convertible loans have been classified as a debt instrument and the provisions recorded in relation to these loans have been deductible for Luxembourg tax purposes. With regard to the financing activities performed by Engie Treasury Management, the latter realized an arm's length financing margin that remunerated the company for its functions performed, risks assumed and assets used in regard to its financing activities.

Likewise, Engie LNG Supply realized an arm's length remuneration for its trading activities (after the deduction of provisions recorded in relation to the convertible loans).

The decision of the European Commission did not challenge the arm's length nature of the remuneration realized by the two Luxembourg companies that are financed by the convertible loans. The decision of the Commission was merely based on the application of Luxembourg tax law, challenging the overall tax liability arising in Luxembourg at the level of the entities involved in the financing transactions.

The respective sister companies (granting the convertible loans to Engie LNG Supply and Engie Treasury Management, respectively) transferred their right to receive the shares under the convertible loans via a forward sale agreement to the parent company.

In this regard, the parent companies recognized a participation in the subsidiaries that were financed with convertible loans. This tax treatment is based on the economic approach which is a variation of the substance over form concept. The future capital gains realized by the parent company in regard to its subsidiary are tax exempt in accordance with the Luxembourg participation exemption regime.

Overall, the Engie financing structures resulted in the realization and taxation of an arm's length remuneration for the entities that are financed by the convertible loans, having regard to the functions performed, the risks assumed and the assets used.

Decision of the CJEU: a Critical Review

The Concept of State Aid According to Article 107(1) of the Treaty on the Functioning of the European Union ("TFEU"), any aid granted by a member state or through state resources in any form whatsoever, including tax measures, which distorts or threatens to distort competition by favoring certain undertakings or the provision of certain goods shall be incompatible with the internal market, in so far as it affects trade between member states.

According to the settled case law of the Court of Justice of the European Union ("CJEU"), for a measure to be categorized as aid within the meaning of Article 107(1) of the TFEU, all conditions set out in that provision must be fulfilled. Hence, for a measure to be categorized as state aid, the following cumulative conditions have to be met:

- the measure has to be granted by state resources;
- it has to confer an advantage to undertakings;
- the advantage has to be selective; and
- the measure has to affect trade between member states and to distort or threaten to distort competition.

State aid cases in tax matters usually fail because it cannot be evidenced that an advantage granted to an undertaking is of a selective nature.

Focusing on Selectivity According to CJEU case law, Article 107(1) of the TFEU requires a determination whether, within the context of a particular legal system, a measure constitutes an advantage for certain undertakings in comparison with others in a comparable legal and factual situation.

For that purpose, the CJEU developed the following three-step analysis to determine whether a tax measure is selective:

- identification of the reference legal system (e.g. the Luxembourg corporate tax system);
- assessment whether the measure derogates from that common regime in as much as it differentiates between economic operators who, in the light of the objective assigned to the tax system, are in a comparable factual and legal situation ("comparability test"). In other words, it must be analyzed whether the tax treatment of a taxpayer is more beneficial than that of other undertakings that are factually and legally in a similar situation; and
- according to the jurisprudence of the CJEU, a measure found to be selective on the basis of the "comparability test" can still be found to fall outside the scope of the state aid rules if it is justified by the nature or the general scheme of the tax system ("justification test").

Considerations Relating to the Engie Case The tax treatment of the two financing structures follows the treatment of the underlying transactions for accounting purposes. This is a general principle under Luxembourg tax law. The tax treatment follows the accounting treatment unless a specific tax provision or concept provides otherwise.

With regard to the tax treatment at the level of the parent company, the economic approach resulting in the recognition of a participation in the subsidiary owing the convertible loan is a special tax concept (i.e. the economic approach) that requires a different treatment for tax purposes. The application of the participation exemption regime to capital gains realized in relation to qualifying participations is a plain vanilla application of Luxembourg tax law.

Overall, the technical analysis of this financing structure is very robust, even though the European Commission may not like the overall outcome in terms of tax liability at the level of the entities involved. In the absence of a selective advantage being granted to Engie, there should not be illegal state aid present in the Engie case.

European Commission's New Approach to State Aid

The more recent decisions of the European Commission seem to depart from established CJEU case law and EU state aid law. Although the concepts of "advantage" and "selectivity" are distinct requirements under state aid law, the Commission appears to have collapsed both concepts, as it merely examines whether the measures under investigation entailed a "selective advantage" rather than analyzing both requirements separately.

Here, the Commission deviates from its previous practice, where it consistently assessed separately the existence of (i) an advantage, and (ii) the selective nature thereof. Furthermore, in previous state aid investigations, the Commission never challenged how a member state applied its own transfer pricing rules in granting a specific advance pricing agreement.

The new approach of the Commission has a significant impact in practice. In state aid cases concerning transfer pricing, it now suffices that the Commission disagrees with the application of the arm's length principle. Notably, the Commission does not challenge the transfer pricing laws of the countries involved or the fact that rulings have been granted.

Instead, it challenges that transfer prices agreed to in tax rulings (likely in respect of cases with complex factual circumstances) are not consistent with its own interpretation of the arm's length standard. This ignores that transfer pricing is not an exact science but requires the exercise of judgement, and that there is commonly not one single arm's length price but a range of arm's length prices which are all at arm's length.

Likewise, in state aid cases concerning the application of domestic tax law or tax treaty law, the Commission appears to consider an advantage to exist (and therefore state aid), whenever it does not like the overall outcome of an investment structure.

While, for example, in the McDonald's case it has been claimed that Luxembourg misapplied the tax treaty concluded between the U.S. and Luxembourg, in the Engie case the Commission maintains to have found an inconsistent tax treatment at the level of different entities in Luxembourg.

In all these cases, the Commission second guesses the tax officials and, arriving at a different conclusion, which the Commission seems to regard as an absolute truth, concludes that the local officials' decision amounts to a selective advantage, without any consideration of whether the same decision would have been taken in comparable circumstances.

The consequence is that any administrative decision in tax matters (which the Commission might in future disagree with) is subject to a 10-year period of uncertainty.

Going Forward

The current state aid investigations undermine the multilateral progress made towards developing transfer pricing norms and the implementation of the consensus reached on Base Erosion and Profit Shifting ("BEPS").

In the author's view, Luxembourg rightly believes that it was applying its tax laws in line with applicable administrative practice. All of this is in line with Luxembourg's national sovereignty.

Going forward, the Luxembourg legislator will implement the Anti-Tax Avoidance Directive and other BEPS measures that should be applicable as from 2019, contributing to a level playing field within the EU.

As mentioned in the Official Journal of the European Union of November 5, 2018 (2018/C 399/55 Case T-516/18: Action brought on 30 August 2018—Luxembourg v Commission), the Luxembourg government has filed a claim against the decision of the European Commission before the CJEU. The other EU member states concerned by previous state aid decision of the Commission similarly filed claims before the CJEU. Ultimately, it will be for the CJEU to create legal certainty in state aid cases that go back 10 years in time.

Planning Points

Multinational groups that implemented a financing structure similar to that investigated in the Engie state aid case should analyze potential structure alignments in order to avoid adverse tax consequences going forward and to ensure continued efficiency.

Potential structure alignments need to consider a number of different aspects in the post-BEPS era.

First, apart from existing anti-abuse provisions under domestic tax laws and tax treaties (general anti-abuse rules, beneficial ownership concept, etc.), a replacement structure has to anticipate tax law changes resulting from the OECD BEPS Project.

In an EU context, anti-BEPS measures will need to be implemented by EU member states as from 2019 in accordance with the EU Anti-Tax Avoidance Directives (ATAD/ATAD 2). In a tax treaty context, the principal purpose test ("PPT") will apply as from 2019 as a result of the multilateral instrument ("MLI").

Second, a financing structure has to consider post-BEPS transfer pricing principles provided in the 2017 revision of the OECD Transfer Pricing Guidelines.

Accordingly, a finance company needs to have, among other things, control over the risks in relation to the financing activities and the financial capacity to assume the risk in case it materializes.

Moreover, the OECD released a discussion draft in regard to transfer pricing aspects of financial transactions which is expected to complete the guidance provided in the OECD Transfer Pricing Guidelines, adding additional complexity from a transfer pricing perspective.

Third, the financing of operations must be consistent with the rationale and the substance of the overall group structure. As a tendency, more treasury functions should be transferred to finance companies which may range from the review of treasury activities to the actual performance of treasury functions.

Overall, the design of an optimal financing structure in the post-BEPS era needs to consider at the same time the tax rules applicable in all jurisdictions involved, transfer pricing rules and substance aspects, requiring a holistic approach that copes with the complexities discussed above.

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