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Highlights & Insights on European Taxation

Please find below a selection of articles published this month (August 2024) in Highlights & Insights on European Taxation, plus one freely accessible article.

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Year 2024, no. 8

TABLE OF CONTENTS

INDIRECT TAXATION, CASE LAW

– ***C SPRL*** **(C-696/22)**. Chargeable event in insolvency proceedings. Continuous supply of services. Court of Justice

(comments by **Marilena Ene**) (*H&I* 2024/204)

– ***Adient*** **(C-533/22)**. No fixed establishment solely because two companies belong to the same group. Court of Justice

(comments by **Alexis Tsielepis**) (*H&I* 2024/201)

– ***Lear Corporation Hungary*** **(C-532/23)**. Delay VAT refund caused by application of national provision. Late payment interest. Court of Justice

(comments by **Tamas Feher**) (*H&I* 2024/197)

CUSTOMS AND EXCISE

– ***BP France*** **(C-624/22)**. EU law precludes legislation requiring a physical carbon-14 analysis for calculating incentive tax for incorporation of biofuels. Court of Justice

(comments by **Giorgio Emanuele Degani**) (*H&I* 2024/203)

STATE AID

– ***P*** **(C-451/21) and *P, Luxembourg v Commission and Engie*** **(C-454/21)**. Annulment of Commission's decision on tax rulings granted to Engie. Court of Justice

(comments by **Rita Szudoczky**) (*H&I* 2024/200)

MISCELLANEOUS

– ***Jurisdiction of the General Court in the following areas: common system of VAT, excise duties, the Customs Code, the tariff classification of goods under the Combined Nomenclature. Amendment of Protocol No 3 on Statute of CJEU***

(comments by the **Editorial Board**) (*H&I* 2024/212)

– ***Belgian Association of Tax Lawyers e.a*** **(C-623/22)**. Mandatory automatic exchange of information in relation to reportable cross-border arrangements. Right to respect for private life. Principles of equal treatment and non-discrimination. Principle of legality in criminal proceedings. Principle of legal certainty. Court of Justice

(comments by **Edwin Thomas**) (*H&I* 2024/198)

FREE ARTICLE

– ***P*** **(C-451/21) and *P, Luxembourg v Commission and Engie*** **(C-454/21)**. Annulment of

Commission's decision on tax rulings granted to Engie. Court of Justice

(comments by **Rita Szudoczky**) (*H&I* 2024/200)

The *Engie* case is part of the saga of State aid cases on tax rulings. Unlike the other cases, the issue in *Engie* is not transfer pricing rulings that deviate from the arm's length principle. Instead, the rulings concern a complex intra-group financing structure that the French headquartered group, Engie, implemented between its Luxembourg subsidiaries to finance a restructuring within the group. The structure resulted in a deduction/non-inclusion outcome leaving the profits earned in Luxembourg by the Engie subsidiaries almost untaxed.

More specifically, the structure scrutinized in the case involves a company in the Engie group (LNG Holding) transferring its business activity to a subsidiary (LNG Supply) whereby the latter finances that acquisition by a mandatorily convertible interest-free loan (ZORA) that it takes out from an intermediary company in the group (LNG Luxembourg). The loan is converted at its maturity into shares. The conversion takes into account the performance, either positive or negative, of LNG Supply during the term of the loan. Thus, at maturity, LNG Supply repays the loan by issuing shares which represent the nominal amount of the loan plus a 'premium' consisting of all the profits made by LNG Supply during the term of the loan (called 'ZORA accretions'). If losses are made during the term, those are also taken into account in the form of 'ZORA reductions'. From the premium, an amount is deducted that is the result of the application of a percentage corresponding to the tax on the profits agreed upon with the Luxembourg tax administration. In order to finance the loan that it issues to LNG Supply, LNG Luxembourg entered into a prepaid forward sale contract with LNG Holding, which is the sole shareholder not only of LNG Luxembourg but also of LNG Supply. LNG Holding paid, under the forward contract, an amount corresponding to the nominal amount of the ZORA. In return, LNG Luxembourg transferred to LNG Holding the rights to the shares that will be issued at the maturity of the ZORA, including the shares representing the value of the ZORA accretions.

The tax rulings at issue confirm that:

With regard to LNG Supply, the basis of assessment in a given financial year equals to a margin agreed with the Luxembourg tax administration corresponding to a fraction of the value of the gross assets shown on the company's balance sheet. The difference between the profit actually made in that financial year and the taxable margin constitutes the ZORA accretions for that year, which are considered to be deductible expenses related to the ZORA. Thus, from this aspect, ZORA is treated for tax purposes as a debt instrument.

As regards the intermediary company, LNG Luxembourg, it has the option of either keeping the nominal value of the ZORA in its accounts or increase that value by the ZORA accretions accrued during the period between taking out the ZORA and converting it. Upon conversion, if LNG Luxembourg increases the value with the ZORA accretions, it may choose to apply the tax neutrality regime provided for by Luxembourg law (Article 22bis of the Law on income tax, 'LIR'), which allows the capital gain corresponding to the ZORA accretions to remain untaxed.

With respect to LNG Holding, the payments received under the forward contract are recorded as financial fixed assets at cost price. Until the conversion, LNG Holding will not recognize any income from ZORA. Upon conversion, all income – including dividends and capital gains –

derived from LNG Holding's participation in its subsidiaries, including the shares in LNG Supply that LNG Luxembourg transfers to Holding after the conversion of ZORA, are exempt from income tax pursuant to Article 166 LIR. Thus, from this aspect, ZORA is treated as an equity instrument, as the income derived from it is entitled to participation exemption in the hands of the recipient.

In a decision of 20 June 2018, the Commission considered that the Luxembourg tax administration granted a selective advantage to LNG Holding by allowing the participation exemption to be applied to the income LNG Holding received in the form of ZORA accretions, which were previously deducted by LNG Supply. The Commission reasoned that the participation exemption is not applicable to income that previously, had not been taxed at the level of the distributing company. The tax ruling that allows such income to be exempted derogates from the Luxembourg provisions on the participation exemption and thus, constitutes State aid. Alternatively, the Commission put forward that Engie received a selective advantage due to the non-application of the Luxembourg general anti-abuse rule (Article 6 of the Law on tax adjustment). As the financing structure put in place by Engie was abusive in the meaning of that provision, the Luxembourg tax administration would have had to deny the tax ruling request by applying the general anti-abuse rule.

Luxembourg and Engie brought an action for annulment before the General Court against the Commission's State aid decision. The General Court, however, dismissed their action and fully endorsed the Commission's view expressed in the decision.

The Court of Justice of the European Union (CJ), in its judgment of 5 December 2023 (Joined Cases C-451/21 P and C-454/21 P, ECLI:EU:C:2023:948), disagreed with both the Commission and the General Court. Consequently, it set aside the General Court's judgment and annulled the Commission's decision.

The arguments in the case boiled down, as in most of the State aid cases on tax rulings, to the definition of the reference framework, which is a crucial element of the selectivity analysis. It is in relation to such reference framework that the existence of a selective advantage must be established. The Court of Justice, first, reiterated, referring to its *Fiat* judgment (CJ 8 November 2022, C.885/19 P and C-898/19 P *Fiat Chrysler Finance Europe v Commission*, ECLI:EU:C:2022:859) that the arguments of the applicants calling into question the identification of the reference framework are admissible because the latter is a question of law which can be reviewed by the CJ on appeal.

With regard to the substantive arguments, the dispute between the parties concerned the question whether, under Luxembourg law, the exemption of income from participations at the level of the parent company is made dependent on the taxation of distributed profit at the level of the subsidiary. In other words, whether there was a link of conditionality between Article 164 and Article 166 LIR. In this regard, the CJ emphasized that it is for the Member State to determine, in its own competence and having regard to its fiscal autonomy, the main characteristics of a tax, including the tax base, the taxable event and exemptions. All these elements constitute the reference system for the purpose of the selectivity analysis under State aid law. In the present case, the reference framework encompassed the participation exemption regime under Article 166 LIR. This provision did not make the grant of the exemption of income from participations formally dependent on the prior taxation of distributed profits. Luxembourg maintained that the wording of the provision determines its interpretation. Contrarily, the Commission and the General Court

departed from the literal interpretation of the provision, and they understood it as involving a conditionality.

The CJ pointed out that the Commission is, in principle, required to accept the interpretation of the relevant provisions of national law as put forward by the Member State provided that that interpretation is compatible with the wording of those provisions. 'The Commission may depart from that interpretation only if it is able to establish, on the basis of reliable and consistent evidence that has been the subject of that exchange of arguments, that another interpretation prevails in the case-law or the administrative practice of that Member State.' (para. 121). The CJ found that the Commission could not establish to the requisite legal standard that an interpretation prevailed in Luxembourg case law or administrative practice other than that put forward by Luxembourg in the proceedings. The General Court erred when it accepted that a 2018 letter by Luxembourg and a 1965 Council of State opinion were enough to substantiate the existence of an interpretation under Luxembourg law of Article 166 LIR that corresponded to the Commission's interpretation of the provision.

The Commission also argued that if the same income were exempted at the level of the parent company and deducted at the level of the subsidiary, it would escape all liability to tax in Luxembourg which would run counter to the objective of the Luxembourg corporate income tax system. Such interpretation of the relevant provisions cannot be upheld, according to the Commission, even if an express conditionality is absent in the law. In this regard, the CJ held that 'the Commission cannot establish a derogation from a reference framework merely by finding that a measure departs from a general objective of taxing all companies resident in the Member State concerned, without taking account of provisions of national law specifying the manner in which that objective is to be implemented' (para. 177).

Overall, according to the CJ, the General Court erred when it endorsed the Commission's interpretation of the Luxembourg participation exemption regime. Thus, the national law constituting the reference framework was erroneously interpreted by the Commission and the General Court.

With respect to the alternative reasoning of the Commission, in it the Commission found the tax rulings derogated from the reference framework, which includes the general anti-abuse rule under Luxembourg tax law, due to the Luxembourg tax authorities' non-application of the latter to the financing structures at hand. The General Court confirmed that the Commission could arrive at this finding without taking into account the national administrative or judicial practice relating to the Luxembourg anti-abuse provision, as the provision did not give rise to difficulties of interpretation.

The CJ decided to the contrary. In particular, the Commission could not conclude that the non-application of the anti-abuse provision by the Luxembourg tax administration led to the conferral of a selective advantage on Engie unless the non-application departs from the national case law or administrative practice on the provision. Otherwise, the Commission would itself define what does and does not constitute the correct interpretation of the Luxembourg anti-abuse rule, which would exceed the limits of the Commission's State aid powers conferred on it by the founding Treaties and would be incompatible with the fiscal autonomy of the Member States.

With the *Engie* judgment, the CJ sent another clear message to the Commission – along with its judgments in *Fiat* and *Amazon* (CJ 14 December 2023, C-457/21 P *Commission v Luxembourg,* ECLI:EU:C:2023:985) – that the State aid rules have their limits. Specifically, their

scope cannot be further stretched at the expense of the fiscal autonomy of the Member States to encompass tax rulings that might constitute (harmful) tax competition measures facilitating aggressive tax planning by MNEs without however being selective. Selectivity is to be established compared to a nationally defined reference system and not in relation to a fictitious, hypothetical or normative system defined by the Commission. The Commission cannot sidestep the reference to the Member State's own tax system when establishing selectivity by equating the reference system with the general objective of the corporate income tax, that is, the taxation of all companies resident in the Member States concerned. If such general and abstract objective constituted the reference system, any rule, application, non-application or misapplication of a rule or the absence of a rule that leads to non-taxation or lower taxation of taxpayers that are in an objectively comparable situation would qualify as State aid. Not only the definition but also the interpretation of the reference system – more precisely, the national tax rules constituting the reference system – is the competence of the Member States' authorities, and their interpretation cannot be substituted for by that of the Commission. These are now clear limits set by the Court of Justice with regard to the application of the State aid rules to tax measures. In view of these limits, the reasoning put forward by the Commission with regard to the selectivity of the *Engie* rulings cannot stand the ground and was rightly quashed by the Court. Nevertheless, the Court's reasoning left open several alternative routes through which the rulings issued by the Luxembourg tax authorities to the Engie group could be considered selective.

In particular:

The Commission could have argued the existence of an aid scheme under Luxembourg tax law instead of trying to establish the selectivity of the individual tax rulings issued to Engie. In fact, the combined effect of Article 164 and Article 166 LIR is (almost) non-taxation of positive results in the case of transaction financed by ZORA as opposed to those financed by (conventional) debt or equity. The reference system would be constituted by the Luxembourg tax rules concerning debt and/or equity financing under which income does not remain untaxed but is taxed either at the level of the payor or the payee. Taxpayers that use equity or debt financing are in an objectively comparable situation to those who use ZORA and therefore, their different treatment leads to selectivity. In this respect, Luxembourg argued that the financing system implemented by the Engie group was 'open to all' and that an application of the tax rules similar to that achieved by the Engie group could lawfully be achieved by other undertakings (see para. 93). Indeed, this can prove the non-selectivity of the Engie rulings. The argument cannot, however, immunize the scheme from the claim of selectivity. It has to be recalled that according to the European Courts` settled case law, selectivity can be established not only in the case of tax measures that make a distinction between undertakings in terms of their specific characteristics but between undertakings which choose to carry out certain transactions and other undertakings which choose not to do so (see GC, 5 November 2018, Case T-239/11 P *Sigma Alimentos Exterior v Commission*, ECLI:EU:T:2018:781, paras. 44 et seq.).

If the selectivity of the Luxembourg tax legislation, i.e., Article 164 and Article 166 LIR, cannot be established according to the reasoning above, it could be claimed that the practice of the Luxembourg tax administration in applying the provisions concerned constitutes an aid scheme. Thus, the consistent application of the exemption of income from participation at the level of the parent company when the corresponding income had not been taxed at the level of the distributing company benefits all those taxpayers that use ZORA financing. Such practice thus confers a selective advantage on all the undertakings making use of ZORA while the latter are in an objectively comparable situation to those that use debt or equity financing. The fact that the latter

could also implement a ZORA structure, does not make the practice general (i.e., non-selective) based on the case law cited in the point above.

Alternatively, it could be argued that an aid scheme is constituted by the administrative practice of the Luxembourg tax administration of consistently non-applying the Luxembourg general anti-abuse rule (Article 6 of the Law on Tax adjustment) to ZORA financing schemes although the conditions for applying that provision are satisfied in the case of those schemes. Such non-application of an anti-abuse provision is a derogation from what is laid down in the law although not in an individual case but consistently in a select group of cases (i.e., where ZORA financing is used), which benefits the taxpayers in this group that engage in a particular financing structure that should be qualified as abusive according to the letter of the law and according to the general judicial interpretation of the law. In this respect, the reasoning of the CJ in *Engie* imposes a heavy burden of proof on the Commission. In particular, the Commission would have to establish and prove to the requisite legal standard that Luxembourg courts interpret the Luxembourg anti-abuse provision and its conditions of application in a way that would require its application to ZORA structures and thus the tax administration's practice of not applying it thereto constitutes a derogation from the reference system.

Probably, the easiest and most straightforward way of establishing the selectivity of the individual rulings issued to Engie would be to argue that a selective advantage was granted to the subsidiary (LNG Supply) when the ruling endorsed that it is to be taxed on a fixed margin agreed with the Luxembourg tax authorities instead of on the actual income realized minus business expenses according to the normal rules of the Luxembourg corporate income tax. The CJ itself pointed out the potential selectivity of the ruling in this respect: '[t]hat being so, such a conclusion is without prejudice to an examination of the potentially selective nature of the tax rulings at issue in the light of the finding that the income of LNG Supply […] in each financial year concerned was, in return for the deduction of the ZORA accretions as expenses, taxed on the margin agreed with the Luxembourg tax authorities and not under the rules of ordinary tax law […]' (see para. 172). Why the Commission has not argued this obvious selectivity of the ruling from the outset, especially having regard to the settled case law on the selectivity of such measures (see CJ 22 June 2006, Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187 v Commission*, ECLI:EU:C:2006:416) is the mystery of the *Engie* case.

Even if one or all of the substantive arguments above could foster the selectivity of the Luxembourg tax treatment of ZORA financing, the question remains whether the Commission could start a State aid case anew based on them or would it be barred by any procedural rules or principles from doing so. Taking into account that the first three arguments concern the underlying Luxembourg tax legislation or administrative practice and not the rulings that were the subject-matter of the *Engie* case, those grounds could probably be invoked in a case challenging the aid scheme offered by Luxembourg.

Prof. Rita Szudoczky

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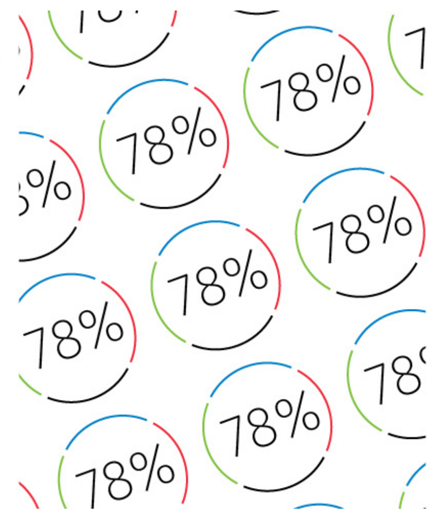

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