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Can Selectivity Result from the Application of Non-Selective Rules?

The Case of Engie

*Phedon Nicolaides**

This paper identifies a significant shift in the approach for determining whether a tax measure is selective. The European Commission, in its decisions on tax rulings, has found that the selective nature of the rulings stemmed from the fact that they endorsed arrangements whose terms deviated from those that would have been agreed under normal conditions of competition. Unlike its other decisions on tax rulings, the Commission in the Engie case does not examine whether Engie benefitted from treatment that was not available to other companies. Instead, the Commission bases its finding of selectivity on the fact that Engie minimised its tax liability. This is an 'outcome-based' approached rather than a 'treatment-based' approach which requires comparison between companies in similar situations. Without a benchmark of comparison, an outcome-based approach is meaningless. In addition, the Commission breaks new ground by finding a selective advantage in favour of Engie in the non-enforcement by Luxembourg of anti-abuse rules. The Commission asserts that Luxembourg should have refused to issue the tax ruling.

Keywords: Selectivity; tax rulings; anti-abuse rules.

I. Introduction

In 2013 the European Commission launched a series of investigations in tax measures in several Member States that appeared to favour multinational companies. The investigations were widened to all Member States at the end of 2014 with requests for information on their 'tax rulings'.

Tax rulings are decisions of tax authorities that provide taxpayers with legal certainty and predictability on the application of tax rules to specific cases and are intended to avoid disputes between tax authorities and tax payers.

Most of the Commission's investigations of tax rulings concerned transactions between related companies. Because income from this kind of transactions may not reflect market conditions, tax authorities use variations of an OECD methodology to calculate a realistic amount of income. That is, the OECD methodology attempts to determine what the income would have been, had it be generated by transactions between independent companies, ie transactions that take place at an arm's length.

The Commission, in the investigations that it has closed so far, has mostly relied on the arm's length principle to conclude that advance tax rulings led to lower taxable income than otherwise and that the difference constituted State aid in the meaning of Article 107(1) TFEU. Given that aid from favourable tax treatment is operating aid, the Commission also found, as is normally the case with operating aid, that the State aid was incompatible with the internal market. Consequently, it ordered its recovery. The sums involved are considerable. Table 1 below lists the closed investigations and ongoing ones and the recoverable amounts, as initially calculated by the Commission.

Of the concluded investigations two cases stand out: McDonald's and Engie. The Commission deci-

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Table 1: Concluded and on-going Commission investigations

Commission final decision	Company	Member State	Result	Amount to be recovered
October 2015*	Fiat	Luxembourg	Negative	€23.1 million
October 2015*	Starbucks	Netherlands	Negative	€25.7 million
January 2016*	35 MNCs**	Belgium	Negative	€900 million
August 2016*	Apple	Ireland	Negative	€14.3 billion
October 2017*	Amazon	Luxembourg	Negative	€282.7 million
June 2018*	Engie	Luxembourg	Negative	€120 million
September 2018*	McDonald's	Luxembourg	No aid	---
December 2018	5 MNCs	Gibraltar	Negative	€100 million
On-going investigations				
	Controlled foreign companies (exemption of group financing)	UK		
	IKEA	Netherlands		
	Nike	Netherlands		
	Huhtamäki	Luxembourg		

* The corresponding Commission decisions are published in the Official Journal or on DG Competition's website. Links to the opening and final Commission decisions can be found at: <http://ec.europa.eu/competition/state_aid/tax_rulings/index_en.html> For information on the Gibraltar cases see: <http://europa.eu/rapid/press-release_IP-18-6889_en.htm>

** On 14 February 2019, the General Court annulled Commission decision 2016/1699 concerning advance tax rulings for 35 Belgian multinational companies [case T-131/16 *Belgium v European Commission* and T-263/16 *Magnetrol International v European Commission*] on the grounds that the rulings did not constitute a single scheme. The judgment is not relevant to the subject matter of this paper.

sion on McDonald's has found that no State aid was involved because of the unusual application of two tax systems. The operations of McDonald's were exempt on both the Luxembourg side and the US side. The two tax systems functioned independently and had their own definitions of taxable transactions. The relevant rules in both jurisdictions were enforced independently and in a non-discriminatory manner. For this reason, the Commission concluded that the rules were not selectively applied in favour of McDonald's.[1]

It is worth noting that in the Commission found that Luxembourg applied its rules objectively, even though it knew that McDonald's escaped taxation in the US. As the Commission explains,

> (113) Article 3(2) of the Luxembourg-US double taxation treaty considers that any undefined term in the Convention shall have the meaning that it has under the law of the State applying the Convention, ie Luxembourg in this case. ... contrary to what the Commission asserted in its Opening Decision, in the case of differences in interpretation or factual assessment between the contracting States, it is not decisive for the purposes of applying the double taxation treaty by Luxembourg whether the US Franchise Branch constitutes a permanent establishment under US domestic tax law and it is equally not decisive whether the Luxembourg tax authorities knew about the non-taxation of the business income in the US.

The Commission also examined whether Luxembourg treated similarly other companies that were in the same situation and found that

> (123) the assessment of 25 other tax rulings demonstrates that the Luxembourg tax authorities have followed a coherent interpretation of the double taxation treaty, applicable to all taxpayers in a comparable situation.

The Commission attached significance to the non-discriminatory application of the relevant rules, regardless of the outcome and the fact that McDonald's avoided taxation.

1 Commission decision SA.38945 is not yet published in the Official Journal. However, it has been posted on DG Competition's website. It can be accessed at: <http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38945>.

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By contrast, in the case of Engie, the Commission concluded that the independent application of two non-discriminatory rules of the Luxembourg tax law resulted in a selective advantage largely because they were combined within the same tax system. This, of course, immediately raises the important question of how selectivity can arise from the combination of non-discriminatory rules. In order to establish that a particular measure is selective, one has to define a (non-discriminatory) benchmark from which the measure in question deviates. But what is the non-discriminatory benchmark when the rules are already non-discriminatory? As will be seen later on, the Commission's answer is that the discrimination arose neither from the specific rules, nor from their application but from the *outcome* that they produced (ie the fact that the intra-group arrangements of Engie minimised its tax liability). Furthermore and unlike the McDonald's case, in Engie, the Commission did not consider whether the same rules could have been used or were actually used by other companies also to minimise their tax liability in order to rule out favourable treatment of Engie.

We can observe, therefore, a shift in the conception of selectivity from a comparison of the treatment of companies in a similar situation to a comparison of the outcome of the application of tax rules. The Court of Justice of the European Union has not endorsed such a meaning of selectivity.

The purpose of this paper is to analyse the unusual Commission decision on Engie, contrast it briefly to previous decisions on tax rulings, and consider its merits and whether it is soundly based on principles that emanate from the case law of the Court of Justice of the European Union.

The structure of the paper is as follows. The next section identifies the criterion or yardstick used by the Commission to determine the existence of State aid in transactions between related companies and places it in the context of the relevant EU case law. The Commission's interpretation stretches that case law. Section 3 summarises the main features of Commission decisions on tax rulings and in particular the nature of the intra-group transactions in order to understand the difference between other cases and the Engie case. Section 4 reviews the detailed reasoning of the Commission on Engie and focuses on its distinctive features in relation to previous decisions on tax rulings. Section 5 concludes with a summary of the main arguments of the paper.

Before proceeding, an explanation of how this paper relates to the existing literature is in order. During the past 4-5 years, a burgeoning literature has emerged that examines, and in many instances questions, the Commission's analysis of whether tax rulings constitute selective measures in the meaning of Article 107(1) TFEU.[2] Most of the literature has addressed two issues: the business and tax rationality of advance tax rulings and whether they derogate from the 'normal' system of taxation.

Any assessment of whether a tax measure constitutes State aid must establish that it is selective in the sense that it deviates from the normal tax rules or the 'reference system' of taxation or that it a priori excludes certain undertakings from those rules or system. Naturally, this paper also examines whether Engie benefited from a selective tax treatment. But its main contribution to the literature lies in its evaluation of the criterion that the Commission used to determine the existence of a selective advantage for Engie. In the absence of a methodology laid down in the case law of how to define the reference system, the Commission appears to identify the various components of the reference system in a rather ad hoc manner. In this sense, it does not follow its own approach, as explained in the Notice on the Notion of State aid, according to which the reference system is

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2 See, for example, the following papers and other references cited therein:
C Bobby, A Method inside the Madness: Understanding the European Union State aid and Taxation Rulings, *Chicago Journal of International Law*, 2017, vol.18(1), 186-215.
A Giraud and S Petit, Tax Rulings and State aid Qualification: Should Reality Matter? *European State aid Law Quarterly*, 2017, vol.16(2), 233-242.
M Lang, Tax Rulings and State aid Law, *British Tax Review*, 2015, no.3, 391-396.
R Luja, *EU State aid Law and National Tax Rulings*, Report for the European Parliament, 2015.
R Luja, *State aid benchmarking and tax rulings: Can we keep it simple?* in W Schön, I Richelle and E Traversa (eds), *State aid law and business taxation,* Max Planck Institute Studies In Tax Law and Public Finance, (Berlin & Heidelberg: Springer, 2016), 111-132.
C Micheau, *Tax Selectivity in European Law of State aid: Legal Assessment and Alternative Approaches*, 22 September 2014, University of Luxembourg Law Working Paper No. 2014-06.
P Nicolaides, New Limits to the Concept of Selectivity, *Journal of European Competition Law and Practice*, 2015, vol.6(5), 315-320.
P Nicolaides, State aid Law and Tax Rulings, *European State aid Law Quarterly*, 2016, vol.15(3), 416-427.
P Nicolaides and I E Rusu, The Concept of Selectivity, *European State aid Law Quarterly*, 2012, vol.11(4), 791-796.
L Panci, Selectivity in the Field of Corporate Taxation, *European State aid Law Quarterly*, 2018, vol.17(3), 353-367.
P Staviczky, De Facto Selectivity, *European State aid Law Quarterly*, 2015, vol.14(3), 332-337.
H Verhagen, State aid and Tax Rulings, *European Taxation*, 2017, July, pp.279-287.

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composed of a 'consistent set of rules' which are applied on the 'basis of objective criteria'.[3]

II. The Criterion for Identifying a Selective Advantage in Transactions between Related Companies

The Commission, in its various decisions on tax rulings, defines a criterion for identifying the existence of a selective advantage in intra-group transactions. The criterion is the price that would have been charged by a similar, but independent company to third parties for a comparable transaction. That price serves as a benchmark. If a related company charges less or more than the benchmark, then the Commission considers it not to reflect market prices or market conditions.

In establishing this benchmark, the Commission draws inspiration from the judgment in case C-182/03 *Belgium v Commission* (Forum 187). In that judgment, the Court of Justice states that

> (95) in order to decide whether a method of assessment of taxable income such as that laid down under the regime for coordination centres confers an advantage on them, it is necessary, as the Commission suggests at point 95 of the contested decision, to compare that regime with the ordinary tax system, based on the difference between profits and outgoings of an undertaking carrying on its activities in conditions of free competition.

The Court must have meant revenue instead of 'profits', since profits are derived by subtracting costs from gross revenue (indeed, this is confirmed by other language versions of the judgment which refer to 'revenue).

Since the Court refers to 'point' 95 (ie recital 95) of Commission decision 2013/757 on the Belgian coordination centres, it is necessary to clarify what that recital says before proceeding further. The Commission argues in recital 95 that a 'comparable' tax base to those of other companies must be defined for coordination centres. In other words, the Commission implicitly acknowledges that it needs a benchmark for comparison of coordination centres to ordinary companies. It then states that

> where – as is the case in Belgium – this comparable base is subject to the normal rate of corporation tax, the ultimate objective of establishing a comparable amount of tax has been achieved, and the application of the cost-plus method confers no advantages.

Although in paragraph 95 of its judgment, the Court refers to the difference between profit (revenue) and costs, in the very next paragraph it focuses on the cost side.

> (96) In that regard, the staff costs and the financial costs incurred in cash-flow management and financing are factors which make a major contribution to enabling the coordination centres to earn revenue, inasmuch as those centres provide services, particularly of a financial nature. Accordingly, the effect of the exclusion of those costs from the expenditure which serves to determine the taxable income of the centres is that the transfer prices do not resemble those which would be charged in conditions of free competition.
>
> (97) It follows that such an exclusion confers an economic advantage on the centres.

Therefore, what the Court says is that exclusion of certain costs results in prices that do not resemble prices charged in conditions of free competition, which must cover all costs. It must be noted, however, that the Court is dealing with the application of an alternative system of taxation: the cost-plus method. Perhaps this is the reason that it focuses on costs. Nonetheless, the Court does not examine how much profit should be included in the final prices charged by coordination centres to other companies, nor does it compare the amount of taxes paid by coordination centres and other companies. The important point is that the Court does not require equality of outcomes in the sense of the Commission's recital 95 that the cost-plus method must generate the same or similar amounts of tax revenue as the normal tax system.

This interpretation is supported by the observation of the Court in paragraph 98 of the same judgment that if the cost-plus method produces a higher tax burden, then that is the result that must be accepted. Symmetrically, if the cost-plus method produces a lower tax burden, then that too is the result that must be accepted. The Court explains that

3 Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, OJ C 262, 19 July 2016, 1-50.

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(98) contrary to what Forum 187 contends, that analysis cannot be called into question either by the fact that the inclusion of the financial charges could, in some cases, lead to a tax base that was unduly high or by the scale of the tax burden that might be imposed on the group, nor can it be called into question by the fact that a centre may be taxed when it has not made any profits. Each of those factors is a necessary incident of the cost-plus system.

In its various decisions and in particular in paragraphs 219-220 concerning Fiat, paragraphs 260-261 concerning Starbucks, paragraphs 147-148 concerning excess profits in Belgium, paragraphs 229-230 concerning Apple, and paragraphs 402-403 concerning Amazon, the Commission defines market-related benchmarks (as embodied in the arm's length principle).

Similarly, in its decision on Engie, the Commission attempts to establish such a market-related benchmark in its opening decision and refers to it in the first part of the final decision that describes the Luxembourg measure and the arrangements between Engie companies. However, it does not make any further mention of it, nor does it use it in the second part of the final decision that assesses the existence and compatibility of the aid.

This unexplained change is significant. Of course, the Commission is legally entitled to change its approach. After all, the purpose of the formal investigation procedure is to provide to the Commission new information. However, in the absence of a market-related benchmark for determining selectivity and having not found any specific rule or measure that discriminated in favour of Engie, the Commission focuses instead on the outcome of the funding arrangements within the Engie group, which minimised tax liability. As seen above, the Court of Justice in Forum 187 explicitly rejects what may be called an 'outcome-based' approach.

Indeed, this is the lesson to be drawn from Forum 187. In determining the existence of a selective advantage for a certain company, it is necessary to compare the treatment of that company to another which is in a similar situation. In Forum 187, which concerned the cost-plus method of taxation, the comparison was with a market-related benchmark. The outcome of the application of the relevant tax rules is not a valid benchmark. Just because a company pays little tax it does not follow that it enjoys a selective advantage. More importantly, an outcome-based approach is meaningless unless there is a benchmark of comparison. Without a benchmark of comparison, we do not know how 'little' is little tax. The valid benchmark is based on difference in treatment under the reference system.

III. The Nature of the Intra-group Transactions in the Cases that have been Concluded so far

This section describes the nature of the intra-group transactions in each of the cases investigated by the Commission. In most cases there were goods or services provided by one company to another. In the case of Engie what was provided was investment in the form of a loan that was later converted to equity. The Commission decision offers no indication that independent companies could not engage in a similar transaction. In fact, the Commission has not attempted to show that the arrangements implemented within the Engie group would not have been legally or economically possible between independent companies. It has only contended that they were superfluous or unnecessary.

Since each of the Commission decision reviewed in this section is very long, about 100 pages and sometimes more than a 100 pages, it is easy to get lost in details. For this reason and, above all, in order to facilitate comparison between the different cases, each case is summarised with the help of a table. In the tables below, the light red boxes indicate the nature of transactions between related companies.

With the exception of Engie, their common feature is that they involve transactions in goods or services. At first sight, the case of Fiat also appears to involve investment as in Engie. While in Fiat loans are supposed to be repaid with interest, in the case of Engie there is genuine investment with the investor assuming more risk right up front because the investment agreement does not fix a rate of interest, but rather provides for the loan, that is indexed to the performance of the business, to be converted into equity. Since equity holders ultimately assume all risks and therefore receive all residual profits or bear losses, it is a natural consequence of this arrangement that all residual profits generated from the operations covered by the loan are eventually converted into

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shares which are transferred to the investor. For the borrower it is sufficient that the loan provides operating capital that covers all its costs and does not require a remuneration in excess of its net income.

In decision 2016/2326,[4] the Commission finds that Fiat finance company based in Luxembourg obtained a selective advantage because the interest it earned on the loans it had granted to companies within the group was excessively low. The Commission considers that the rates of interest determined at an arm's should have been able to remunerate Fiat's capital and therefore they should have been set at higher rates.

Table 2: Fiat

Group
Finance company Luxembourg (1)
Loans from (1) to (2)↓ / interest from (2) to (1)
Manufacturing companies (2)

In decision 2017/502,[5] the Commission finds that Starbucks benefited from excessively high prices paid from the manufacturing to the trading company, which minimised the profits of the manufacturing company, and from excessively high royalties paid by the manufacturing company to the UK company, which again minimised the profits of the manufacturing company. Neither of the two pricing arrangements was consonant with the arm's length principle.

Table 3: Starbucks

Group				
UK transparent company (1)				
Royalties from (3) to (1)↑				
Coffee trading company (2)	Sale of coffee beans from (2) to (3)→	Manufacturing company (3)	Sale of roasted coffee from (3) to (4)→	Coffee shops (4)

In decision 2018/859,[6] the Commission provides extensive explanation of the arm's length principle and the OECD's guidance on transfer pricing. It finds that Amazon benefitted from excessively high royalties paid out within the group. The royalties were fixed at higher level than the level that would have been set at an arm's length.

Table 4: Amazon

Group (1)	
Payments for R&D from (2) to (1)↑	
Amazon SCS Luxembourg (holding company) (2)	
Royalties from (3) to (2)↑	
Operating company (3)	
Fees from (3) to (4)↓	Royalties from (5) to (3)↑
(4) Distribution companies	(5) Services & media companies

In decision 2017/1283,[7] the Commission finds that the profits allocated from the Apple operations company and the Apple sales company to the head office were excessively low. The profits would have been much higher had they been determined on the basis of the arm's length principle.

Table 5: Apple

Group (1)		
Payments for R&D from (2) to (1)↑		
Head office (2)		
Profits allocated from (3) & (4) to (2)↑		
Apple operations (3) and Apple sales (4)	Supplies from (3) & (4) to (5)→	Distributors (5)

4 OJ L 351, 22 December 2016.

5 OJ L 60, 29 March 2017.

6 OJ L 153, 15 June 2018.

7 OJ L 187, 19 July 2017.

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Although the Commission decision on Engie is examined in detail in the next section, for the sake of completeness, Table 6 provides a diagrammatic overview of that case too. It is just in this case there is no assessment of interest or dividend that would have been paid, had they been determined at an arm's length.

Table 6: Engie

	Holding company (1)	
Loan from (1) to (2) via intermediary↓	Intermediary company	Pay off of loan by (2) converted to shares received by (1) via intermediary↑
Subsidiary (2)		

IV. The Commission Decision on Engie

In its decision in case SA.44888,[8] the Commission concludes that Engie received incompatible State aid because it implemented intra-group financing arrangements that minimised its tax liability globally. Rather surprisingly this conclusion is not based on the same basic rationale as previous decisions which found that companies had benefited from favourable treatment of transactions which had not been carried out at an arm's length.

The case of Engie is different in two ways. First, the transactions which in this case were investments between related companies are not shown to be economically irrational for any of the parties involved in the sense that they would not be carried out by independent companies.

Second, the Commission finds that Engie also benefited from non-enforcement by the Luxembourg authorities of anti-abuse rules. This is the first time that the Commission contends that the non-enforcement of anti-abuse rules can confer an advantage in the meaning of Article 107(1) TFEU. Normally, anti-abuse rules are applied to foreign companies that exploit a country's domestic rules. The Commission applies the anti-abuse logic to transactions which are wholly internal in Luxembourg.[9]

1. The Facts of the Engie Case

The tax ruling received by Engie concerns a loan which is converted to equity when it is repaid. In this particular case, the amount of interest is linked to the performance of the borrower. The tax ruling confirms that the tax law of Luxembourg allows borrowing costs indexed on the borrower's performance, but not paid annually to the lender, to be deducted annually from the borrower's taxable base while the lender is not taxed until the loan is converted to equity due to the absence of annual payment. Upon conversion of the loan, the shares are passed to the ultimate holding free of tax by virtue of the standard participation exemption regime.

According to the participation exemption regime, in the case of share capital, dividends paid out are not deductible at the level of the paying company (ie the investee), while dividends received by investors remain untaxed. In the case of a plain loan, interest is deductible at the paying company (ie the borrower) and taxable at the lender's level. This means that debt funding is taxed on the side of the recipient of the interest (ie the lender who is the source of funds) while equity funding is taxed on the side of the payer of dividend (ie the investee who is the destination of funds).

Engie established in Luxembourg several companies, two pairs of which implemented funding arrangements that have been found by the Commission to constitute State aid. Because the these arrangements are largely identical, in order to avoid unnecessary and tedious repetition this paper refers only to those agreed between LNG Holding and its subsidiary LNG Supply.

The arrangements between the holding company and the subsidiary are as follows. The holding company transferred to the subsidiary assets. The subsidiary paid for the assets with a zero-coupon mandatorily convertible loan it received from an intermediary company which also belonged to Engie and was based in Luxembourg. The convertible loan is called ZORA in the Luxembourg tax practice. The loan paid no remuneration, but at the end of its life, it was converted into shares which represented the capital plus

8 The text of the Commission decision, which is not yet published in the Official Journal, can be accessed at: <http://ec.europa.eu/competition/state_aid/cases/266094/266094_2009354_271_2.pdf>.

9 Both Engie and Luxembourg have appealed against the Commission decision in cases T-525/18 and T-516/18, respectively.

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the profits or minus the losses of the company minus a certain percentage that corresponded to the economic margin realised by the borrower. The intermediary company financed the loan with funds from the holding company obtained in the context of a forward sale of the shares to be received upon conversion of the ZORA. When the intermediary company received the new shares from the subsidiary, it passed them on to the holding company by application of the forward sale.

For tax purposes, the subsidiary deducted every year an accrued amount (the so-called ZORA accretion) that it was eventually paid to the intermediary when the loan was converted into shares. The provision was treated as an expense and therefore reduced the subsidiary's taxable income. The subsidiary paid tax only on a residual margin based on an economic analysis.

When the holding company received the shares issued upon conversion, they were not included in its taxable income, nor when the shares were cancelled or sold because income from equity was not taxed at the level of the recipient in Luxembourg (ie the investor). The tax compliance of these arrangements was confirmed by the tax authorities in an advance tax ruling.

After the Commission looked into this arrangements it concluded that they enabled Engie to minimise its tax liability. This is true. From a wider economic or social perspective it may also be considered as a regrettable result. However, in this context, the only relevant question is whether they constituted State aid. The Court of Justice repeats in its every ruling on State aid that a public measure must be assessed whether it constitutes State aid on the basis of its effects, not on the basis of its intentions, objectives, motives of public authorities or any other consideration of wider social benefits or harm (see, for example, C-487/06 P *British Aggregates v Commission*).

2. The Reference Tax System

This section focuses on the reasoning of the Commission in seeking to prove that Engie enjoyed a selective advantage.

The Commission, first, recalls the three-step approach of the Court of Justice in determining whether a measure is selective (paragraph 167 of the decision). The first step identifies the 'reference system'. Paragraph 169 lays down a definition of what constitutes a reference system. This definition is systematically inserted in Commission decisions, yet so far it does not appear to have been explicitly confirmed by EU courts (with one implicit exception in the very recent judgment on Sigma Alimentos Exterior (see below)). This is also revealed by the fact that the definition in the Commission decision cites paragraphs 133 & 134 of the Commission's own Notice on the Notion of State aid rather than a court ruling.

In its judgment of 15 November 2018, in case T-239/11 *Sigma Alimentos Exterior v Commission*, the General Court did refer to the Notice on the Notion of State aid as a source of inspiration on how to establish the reference system (see paragraph 117 of that judgment). However, the General Court did not appear to endorse, apply or elaborate on the Commission's definition. Hence, there is still no real guidance from EU courts on a systematic approach, similar to the three-step test of selectivity, for establishing the reference system.

Although there is no definition of the reference system in the case law, the Court of Justice appears to advocate a wide, inclusive approach. In its judgment in case C-6/12 *P Oy*, it states in paragraphs 19-20:

> The Court has held that in order to classify a domestic tax measure as 'selective', it is necessary to begin by identifying and examining the common or 'normal' tax regime applicable in the Member State concerned. ... In that regard, it must be stated that such classification presupposes not only familiarity with the content of the provisions of relevant law but also requires examination of their scope on the basis of administrative and judicial practice and of information relating to the ambit ratione personae of those provisions.

In its Engie decision, the Commission states that

> (169) a reference system is composed of a consistent set of rules that apply on the basis of objective criteria to all undertakings falling within its scope as defined by its objective. Those rules define not only the scope of the system, but also the conditions under which the system applies, the rights and obligations of undertakings subject to it and the technicalities of the functioning of the system. In the case of taxes, the reference system is based on such elements as the tax base, the taxable persons, the taxable event and the tax rates.

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This is a nice definition which in practice it means that the reference system is any tax or any rule that the Commission considers that it actually applies or potentially can apply to one or more undertakings. This is because there appears to be no Commission decision on tax rulings or any other kind of measure which, after stating the definition, identifies the tax or rules that apply in each particular case through an explicit explanation of why or how the identified tax or rules form a 'consistent set'. Nor, can be found in a Commission decision an explicit listing of the 'objective criteria' on the basis of which tax rates or rules are applied.

The Commission's decision on Engie is no exception. In paragraph 170 of its decision, the Commission signals its intention to show that the measure that benefits Engie is a derogation from two reference systems. In the section that follows immediately afterwards (section 6.2.1), the Commission argues that certain tax rules apply to Engie without returning to the fundamental elements of its definition such as the existence of a consistent set of rules or objective criteria. This criticism does not mean that the Commission's findings are necessarily wrong. Rather, its ad hoc approach can lead the Commission astray if it ignores other components of the system that should be taken into account or if it uses the overall 'objective' of the tax system, which is to tax, to assert that tax payers may not legally try to avoid tax [which contradicts the fact that tax systems do allow tax payers to use available rules to reduce their tax liability].

For example, in paragraph 184 of the decision, the Commission responds to the argument put forward by Luxembourg and Engie that the same arrangements were available to any tax payer in Luxembourg. The Commission rejects it on the grounds that it would be contrary to

> the basic principle – common to every Member State – that income taxes should be levied according a taxpayer's ability to pay. Moreover, it would put at risk the capacity by the State to mobilise the necessary resources to finance its budget, thus rendering ineffective its tax system.

These two counter-arguments – ability to pay and financing of the national budget – which sound reasonable are, however, advanced without any explanation of how they form part of the reference tax system and constitute a reinterpretation by the Commission of the objective of the tax system.

The consequence of not relying on a systematic approach to define the reference system is also evident a couple of paragraphs further where the Commission states that it

> (187) does not agree that a reference system cannot be defined by reference to its objectives, such as the taxation of the profit of all companies subject to tax.

It appears to neglect that a tax system may contain multiple objectives and to ignore its own previous statement that some of those objectives may aim to modulate tax according to ability to pay.

More broadly, the aim of a tax system is not just to tax, but also to incentivise companies to direct resources where they generate benefits for society and to penalise companies when they engage in activities that harm society, human health or the environment. In fact, if the reference system had only one objective – ie to tax – then the third step in the three-step test of selectivity would be rendered ineffective. The third step is meaningful only because it implicitly recognises that a tax measure may have objectives other than just to tax (eg exemption of coal from taxes on fossil fuel when it is not used as a source of energy [eg coal used as input in the manufacturing of steel]).

This is an important point that needs to be elaborated further. The Commission cites quite prominently the judgment in case C-20/15 P *Commission v World Duty Free*. In that judgment the Court of Justice ruled that even though the tax treatment of the goodwill from acquisition of foreign companies by Spanish companies was an exception that was open to any Spanish company it still treated similar transactions in a dissimilar manner because the threshold for acquisition of foreign companies was lower than the threshold which applied to acquisitions of domestic companies.

If one follows the logic of the Commission that what needs to be taken into account is only the objective of the reference system to levy taxes, then in the *Spanish goodwill* case, the Court should have found that the acquisition of both domestic and foreign companies constituted a derogation from the reference system! But the Court did not do that. It, implicitly, recognised that a reference system could also include rules that reduced tax liability by, for example, allowing the depreciation of goodwill.

The Commission, in the Engie case, focuses on the fact that Engie's tax liability was minimised and ig-

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nores that that outcome may be the natural consequence of Engie making a non-standard use of standard rules available in the Luxembourg tax system.

The Commission defines the relevant system in paragraphs 171-179. It states that the reference system is the general system of corporate taxation because companies with a head office in Luxembourg are considered to be resident in Luxembourg for tax purposes (paragraph 173). Taxable profit is the difference between net assets at the end and beginning of the fiscal year (paragraph 174) which translates into accounting profit (paragraph 176). From the above, the Commission concludes that the purpose of corporate taxation is to tax the profit of resident companies.

Then the Commission proceeds in section 6.2.1.2 to demonstrate the existence of a derogation from the reference system.

3. Derogation from the Ordinary System of Taxation

In paragraphs 191-194, the Commission essentially argues that the Engie arrangements constitute a derogation from the reference system of taxation which aims to tax profits because LNG Holding and LNG Supply together minimise the amount of tax they pay. Naturally, this outcome is advantageous to Engie, but it does not automatically follow that the advantage is selective.

The Commission considers in paragraph 193 that 'under the ordinary taxation system, (the income of LNG Holding and LNG Supply) should be subject to taxation in Luxembourg. Therefore, the tax treatment granted on the basis of the contested tax ruling constitutes a derogation from the reference framework.' It repeats the same statement in paragraphs 196 & 197. Although Luxembourg's tax ruling merely confirms what is available under the relevant law it does not create a derogation from it. So Engie, even without the tax ruling, could have implemented its arrangement and would have arrived at the same or even a lesser amount of tax to be paid.

Before continuing further a comment is in order. In paragraph 195, the Commission rejects a claim by Luxembourg that a 'measure cannot constitute a selective advantage if it complies with national law, since in this case it would not constitute a derogation.' There are two issues in that quoted statement that need to be untangled. First, the Commission is right with respect to compliance with national law. State aid is in most cases granted in conformity with some national law or administrative decision. However, the alleged domestic legality is irrelevant in the eyes of State aid law. What matters is whether it falls within the scope of Article 107(1) TFEU. If it does, then aid granted without prior notification according to Article 108(3) TFEU is automatically is illegal under EU. Second, compliance with national law does not necessarily imply absence of selectivity. I suppose what Luxembourg meant was that a measure that was legally available to Engie was also legally available to any other company and, consequently, it could not constitute a derogation. Since it was not a derogation, it did not confer a selective advantage.

The problem with the conclusions of the Commission is that they do not specify from which rule of the reference system the arrangements between LNG Holding and LNG Supply constitute a derogation, apart from the claim that Engie should have paid tax because the purpose of the tax system was to tax. Indeed, those arrangements minimise the tax that would otherwise have been paid. But there is no rule in the Luxembourg system that prohibits companies from minimising their tax liability, as long as they respect the law. The Commission does not show that such a rule exists. The Commission contends that the Engie arrangements benefitted from a derogation because they minimised tax liability within a system that generally intends to tax profits. However, the decisive element here is that the system does not define the outcome of applying tax rules. In other words, it does not predetermine how much tax each resident company must pay.

In the landmark judgment in case C-78/08 *Paint Graphos*, the Court of Justice ruled that selectivity arose from the fact that no tax was paid given the objective of the reference system to tax profits. The Commission repeatedly returns to the idea that companies must pay tax. The problem for the Commission is that companies may also minimise their tax liability. Moreover, the reference system can indeed contain both tax raising (eg taxes) and tax reducing elements (eg discounts). A case in point is the very recent judgment of the General Court in case T-865/16 *Fútbol Club Barcelona v European Commission*. The General Court annulled Commission decision 2016/2391 that had found that Barcelona had benefited from lower taxation on the grounds that the

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Commission ignored to take into account that Barcelona was not eligible to use enhanced depreciation or discount options that were available to other football clubs.

In the case of Engie, the Commission asserts but does not prove why the difference of treatment accorded to the common borrower (deduction of interest at the borrower's level and taxation of interest at the lender's level), and common equity holder (no deduction at the investee's level, nor taxation at the investor's level) on the one hand, and to the convertible funding structure put in place by Engie, on the other, is selective. Indeed such different instruments are not in a legally and factually comparable situation. The Commission also fails to prove that the Luxembourg tax authorities accorded a different treatment than the one described in the tax ruling to companies other than those belonging to Engie. Nor, does it demonstrate that arrangements similar to those of Engie could not be agreed between independent companies. Indeed, it is telling that, unlike its other decisions on tax rulings, the Commission does not attempt to show that the Engie arrangements deviated from arrangements under normal conditions of competition between unrelated parties.

The Commission considers those arrangements to be selective because they lead to an outcome that is inconsistent with the purpose of the system which is to tax (an outcome-based approach). Therefore to be fair, the Commission does have a certain benchmark of comparison in mind. But the fundamental weakness in its argument is that it does not show that the minimisation of tax liability was an option that was not available to other companies in a similar situation as Engie. The judgment in case T-865/16 *Fútbol Club Barcelona v European Commission*, instructs us to make a global comparison by taking into account both favourable and unfavourable elements. Although Engie paid little tax, the amount of tax is not a sufficient benchmark of comparison on its own and therefore, such an outcome-based approach for determining selectivity is meaningless.

In the rest of the section on selectivity, the Commission argues that the Engie arrangements constituted a derogation in relation to a narrower reference system – that of the treatment of interest and dividends – and also in relation to the taxation of profit at group level. Since the same comments as above can be made in relation to the taxation of interest and dividends, the next sub-section examines only the views of the Commission on taxation of profits at group level.

4. Taxation at Group Level

The Commission proceeds to the next stage of its assessment by comparing intra-group financing transactions with those of Engie. In section 6.3.1. (paragraphs 245 to 257) it essentially repeats at length that interest is taxed at the level of the recipient and dividends are taxed at the level of the payer. No evidence is adduced that the Luxembourg tax system contains a rule that stipulates that group companies may not reduce their tax liability when they engage in intragroup financing or, even more importantly, that the combined tax base may not be reduced in comparison to what would have been, for example, had the companies been independent.

Nonetheless, the absence of such evidence does not prevent the Commission from stating as a matter of principle that

> (261) according to the Luxembourg corporate income tax system, the entire profit realised by companies must be subject to taxation and that, therefore, the payment of the remuneration for intragroup financing transactions between companies resident in Luxembourg cannot lead to a reduction of the combined tax base of the group in Luxembourg. Against that principle, the choice of one financing instrument over another does not make an undertaking less comparable.

In other words, the Commission does not accept that the tax base can be shrunk and tax liability can be minimised through non-standard financial arrangements. Nor, does it accept that borrowing costs do not have to be paid but, instead be converted to shares, creating in this way lower tax liability, first, at the level of the paying company and, then, at the level of the receiving company. It must be emphasised again that despite the Commission's assertions, the Luxembourg tax system does not prohibit the reduction of the tax base of group companies, nor does it stipulate that the tax base of a group of companies taken together must be similar to what could have been had they been taxed separately. The relevant issue is not whether Engie's tax liability is minimised, but whether the arrangement used by Engie is a derogation from the reference system.

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In order to prove that the tax treatment of Engie's arrangement constitutes a derogation from the reference system, the Commission in paragraph 271 quotes paragraph 71 of the *World Duty Free* judgment (C-20/15 P) as follows:

> According to the Court, the assessment of selectivity involves, 'ascertaining whether the exclusion of certain operators from the benefit of a tax advantage that arises from a measure derogating from an ordinary tax system constitutes discrimination with respect to those operators'.

Then it argues that

> (272) as established in Section 6.3.2, all groups engaging in intragroup financing transactions between companies resident in Luxembourg are in a legal and factual situation comparable to Engie in the light of the objectives of the system. However, such groups would not have access to the advantage granted to Engie since, as it has been established in Section 6.3.1, under the Luxembourg corporate income tax system, the payment of a remuneration in the framework of a financing transaction between two group entities resident in Luxembourg cannot result in a reduction of the combined tax base of the group in Luxembourg, and this irrespective of the type of financing instrument or contract used or of the level of the remuneration. Therefore, the measures at stake constitute a discrimination with respect to these operators.
>
> (273) Consequently, the advantage granted to Engie on the basis of the contested tax rulings is *prima facie* selective.

As pointed out above and contrary to what is stated in paragraph 272, section 6.3.1 of the decision does not establish that the 'payment of a remuneration ... cannot result in a reduction of the combined tax base'. Such a rule does not exist in the Luxembourg tax system which merely defines the treatment of specific transactions without laying down a general principle of symmetry of taxable treatment either among related or unrelated companies.

Above all, it is important to note that, as the Court of Justice required in the *World Duty Free* judgment, in order to prove selectivity it is necessary to prove '*exclusion* of certain operators' [emphasis added]. Nowhere in its decision does the Commission demonstrate that any other group of companies was excluded, de jure or de facto, from enjoying the benefits of an arrangement similar to that used by Engie or was prevented from establishing such an arrangement.

Lastly, in all the previous Commission decisions on tax rulings the companies involved had to request an advance tax ruling for purposes of legal certainty. They valued the assurances from tax authorities that their intra-group pricing agreements were allowable under the relevant tax rules. In the case of Engie, the intra-group arrangement was unusual but its two primary components on the treatment of interest and dividends were explicitly allowed by Luxembourg's law. Strictly speaking, since Engie was on safer ground, it had less need to request that tax ruling and, correspondingly, the Luxembourg tax authorities had less of a leeway to refuse it.

5. Anti-abuse Rules

For the first time in a decision concerning tax rulings, the Commission develops 'an alternative line of reasoning' according to which Luxembourg should have applied its anti-abuse rules to the facts presented by Engie in its request for an advance ruling in order to refuse to grant any assurances to Engie about its future tax treatment.

The Commission, first, explains that '(291) anti-abuse tax rules are the set of rules devised to avoid that taxpayers circumvent the main objective of the reference system, ie the taxation of corporate profit.' Then it adds that 'therefore, these rules must be understood as an inherent part of the reference system, as they ensure the internal consistency of the system and aim at achieving its fundamental objectives.'

It should be pointed out that, although the Commission starts with a definition of how the reference system should be identified, as already argued in sections 4.2 and 4.3 of this paper, it does not apply explicitly and a priori that definition to the Luxembourg tax regime in order to establish, in a consistent manner, all the rules that make up the reference system according to objective criteria. This is the case here too. The Commission broaches the alleged non-enforcement of Luxembourg's anti-abuse provisions with no other reasoning as to their link to the reference system apart from the assertion that those provisions must be regarded as part of the reference system.

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European countries have developed anti-abuse rules in order to combat artificial arrangements with no economic substance whose purpose is tax avoidance and to prevent multinational companies from exploiting the fact that they operate in different tax systems. In a European or international context, anti-abuse rules are intended to address practices which concern operations of foreign companies claiming a benefit in the domestic system or operations that combine activities inside and outside a certain tax system.[10]

What is puzzling about the Commission's argument that Luxembourg should have used its anti-abuse rules is that anti-abuse rules are normally invoked against corporate practices that are adopted unilaterally by companies. A tax ruling is issued only after tax authorities have examined a certain arrangement and have concluded that it complies with the relevant tax law. A tax ruling is also binding. Therefore, it makes no sense for tax authorities to use anti-abuse rules to reverse a tax ruling or even to refuse a tax ruling, given that they can simply not issue it in the first place.

The Commission decision indicates that Luxembourg's anti-abuse rules aim to prohibit tax evasion by abuse of forms or constructions which are legal under civil law.

> (292) If the legal form or the construction surrounding a transaction is not appropriate in terms of its substance, tax should be assessed in accordance with the substance of the transaction, as if it had been concluded in the appropriate legal form.

Paragraph 293 of the decision further indicates that anti-abuse provisions also cover rulings issued by the Luxembourg tax administration. The Commission interprets the relevant Luxembourg law as meaning that

> the Luxembourg tax authorities should not give binding decisions such as tax rulings in case the main reason for the taxpayer to seek such decision is to obtain a tax benefit. ... it is a mandatory requirement for the Luxembourg tax administration to rule out the existence of a potential abuse of law before granting a tax ruling.

The fact that Engie could have implemented the financing arrangement without any advance tax ruling does not receive any attention by the Commission. Nor, does the Commission consider whether it is possible in a tax system for a tax authority to exercise discretion and reverse its tax ruling which, after all, are binding.

Paragraphs 294-312 of the decision examine the four criteria that make up Luxembourg's anti-abuse provisions. Three of them are beyond the scope of this paper because they require knowledge of Luxembourg fiscal case law and practice. The fourth criterion, however, merits comment in this paper. It stipulates that in order for the anti-abuse provisions to apply there must be no economic reasons that justify the arrangements chosen by the taxpayer. If such economic reasons exist, then they are sufficient to prevent the application of those provisions.

The gist of the Commission's position on this issue is that the arrangements chosen by Engie are unnecessarily complex (paragraphs 306-310). Engie, allegedly, could achieve the same objectives through simpler debt or equity financing.

The comparison used by the Commission is the alternative arrangements that Engie itself could have deployed. But there is no attempt in the decision to quantify the risk, on the one hand, or flexibility, on the other, afforded by alternative arrangements and compare them to the arrangements actually chosen by Engie, as the Commission has done in its assessment of other tax rulings where it assessed the economic rationality of intra-group pricing or financing in comparison to prices or financing between third parties.

Nonetheless, the Commission concludes that '(311) by endorsing the tax ruling requests, the Luxembourg tax administration misapplied the law and granted an advantage to Engie' and that that advantage constitutes incompatible aid that has to be recovered.

V. Conclusions

In order to show that a tax measure is selective in the meaning of Article 107(1) TFEU, it is necessary to establish that it derogates from the reference tax sys-

10 For further information on how anti-abuse rules are used in conjunction with EU law see L De Broe and D Beckers, The General Anti-abuse Rule of the Anti-tax Avoidance Directive, *EC Tax Review*, 2017, vol. 26(3), 133-144. See also M Dahlberg and B Wiman (eds), *Cahiers de Droit Fiscal International*, chapter on Luxembourg, (Rotterdam: International Fiscal Association, 2013), 461-482.

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tem. Although every court judgment identifies the relevant reference system, there is no clear guidance in the case law on the procedure, methodology or approach for determining the reference system and its objective. In other words, there is no formula similar to the three-step test for demonstrating the selective nature of a tax measure.

The Commission, in its decisions on transfer pricing rulings, has found that the selective nature of those rulings stemmed from the fact that they endorsed arrangements that deviated from the arm's length principle. According to this principle, prices charged between related companies should resemble those charged by independent companies under conditions of free competition. The Commission derives this principle from the judgment in Forum 187. This paper has argued that in the Forum 187 case it is more likely that the Court of Justice meant that prices should cover all underlying costs rather than resemble prices that include a certain percentage of profit.

In the Engie case, the Commission defines the reference system in a rather haphazard manner and in relation to its overall objective which is to tax. It ignores other elements of the system and focuses on the amount of Engie's tax liability rather than on whether it benefitted from a favourable treatment. Unlike its other decisions on tax rulings and with the exception of the McDonald's case, the Commission in the Engie case does not attempt to establish the price or rate or interest or dividend that would have been charged or demanded by lenders or investors who are independent of the recipients of their funds. Instead, the Commission relies on broad statements which can be expressed succinctly in the supposed rule that groups of companies should pay tax or should be taxed as if they were a single undertaking. In the Commission's view, this rule can be derived from the fact that the Luxembourg tax laws aim to tax the profit of all resident companies. Because the intra-group financing arrangements adopted by Engie and the non-standard combination of standard tax rules result in minimisation of its tax liability, the Commission concludes that Engie derives a selective advantage without fully implementing all of the components of the three-step test and, especially, the comparison of undertakings in a comparable legal and factual situation.

There are, however, a logical omission and a leap of logic in the assessment of the Commission. First, the fact that the objective of Luxembourg is to tax profits is but one of possibly many other components of the reference system. It does not capture the totality of the reference system. Although the Commission states that the reference system is made up of a 'consistent set of rules that apply on the basis of objective criteria', it fails to identify those rules or those criteria. As a consequence, the Commission makes statements about the various components of the reference system, which appear to be arbitrary because they are not derived from a prior definition of all of the relevant features of the Luxembourg reference system.

The leap of logic is that because resident companies are subject to taxation they must necessarily pay some tax. But it does not follow from the concept of tax residence that companies may not legally reduce their tax. Minimisation of one's own tax liability is not prohibited by the reference system. Probably because the Commission could not establish what an independent lender would have charged, if it had to be repaid in the form of a dividend, as in the Engie intra-group financing arrangement, it attempts no quantification of the interest or dividend that would have been fixed had they been agreed among independent companies, like the approach adopted in other decisions on tax rulings.

The absence in the Commission decision of any comparison with similar companies is startling. There is not even a reference to other tax rulings either to point out to a derogation as in the case of Apple or to absence of derogation as in the case of McDonald's.

Because of the difficulty in finding a derogation in the way Engie applied the Luxembourg tax law, for the first time the Commission resorts to an 'alternative line of reasoning' that relies on the non-enforcement of Luxembourg's anti-abuse rules. According to this line of reasoning, Luxembourg should not have issued the tax ruling that allowed Engie to minimise its tax liability.

In conclusion, the Commission may be correct that multinational companies pay too little tax in relation to their ability to pay. This may be both morally wrong and harmful to the European economy. However, not all social and economic problems can be solved by mobilising the EU's State aid rules. The concept of State aid is 'objective' and cannot depend on our subjective preferences. The intra-group arrangements of multinational companies may be objectionable on other grounds but that does not make them selective in the meaning of Article 107(1) TFEU.

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