AG Kokott Tries to Bring Clarity to the Selectivity Test for Individual Tax Rulings

A vicarious role of the Commission would violate the fiscal autonomy of the Member States and the legal certainty which is a general principle of law in tax matters.

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Abstract**

In an opinion of 4 May 2023 in Case C-454/21 P, Engie, Advocate General Kokott proposes a new standard of State aid review of individual tax measures such as the tax rulings, based on a manifestly erroneous application of tax law (favorable to the taxpayer) by the national tax administration. Considering that, in order to assess the selective nature of tax rulings, only national law must constitute the frame of reference and that in any event, only tax rulings that are manifestly erroneous with regard to national law can constitute a selective advantage, Advocate General Kokott has called on the Court to annul the Commission's decision finding that Luxembourg granted the Engie group unlawful State aid in the form of tax advantages, as well as the judgment of the General Court.

In a nutshell

With an opinion rendered on 4 May 2023 in the Engie case,1, the Advocate General Kokott of the Court of Justice recommended the Court to rule that the tax advantages obtained by the concerned companies of the Engie group in the Grand Duchy of Luxembourg through individual tax rulings were not selective within the meaning of Article 107(1) TFEU. More generally, the Advocate General found that the rules on State aid do not allow the Commission itself to replace the national tax authorities in the interpretation of the law (in this case, of a general provision on the prevention of abuse) by such authorities, in order to demonstrate the existence of a selective advantage, when verifying the correctness of individual tax rulings granted in advance to the taxpayer.

As a result, the Advocate General invited the Court to rule that Article 107(1) TFEU does not allow the Commission to derive, from a Member State tax system, the existence of any inherent principle of correspondence providing for the inclusion in the tax base of a parent company of the untaxed profits distributed by a subsidiary, if that national legislation exempts such profits. This article suggests that the opinion of the Advocate General tries to bring clarity to the Commission's practice to review individual rulings as selective fiscal aids. In particular, the standard of review of individual tax rulings should be understood as being equivalent to the one used for State aid review of general tax schemes. However, the author disagrees with the opinion of the Advocate General that the tax rulings in question were not selective, because that conclusion is at variance with the settled case law of the Union Courts and the practice of

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the Commission finding that preferential tax regimes unjustified by the nature and scheme of the tax system can be de facto discriminatory and therefore selective, although being general in form, by creating unjustified inconsistencies in the determination of the income base to tax. The article explains the reasons for this mixed judgment.

**Factual and procedural backgrounds**

The *Engie* case concerns the appeals brought by the concerned companies of the Engie group and the Grand Duchy of Luxembourg against the first instance judgment that upheld Decision (EU) 2019/421 (‘the contested decision’)\(^2\), by which the Commission had held that a number of individual tax rulings delivered since 2008 by Luxembourg’s authorities constituted State aid incompatible with the internal market and unlawfully granted to Engie, which Luxembourg was ordered to recover from the beneficiaries.

The rulings in question concerned the tax treatment of the convertible loans (‘the ZORA’) put in place between different Luxembourg companies of the Engie group to finance its restructuring, involving the transfer of the group’s treasury business from the group’s Luxembourg holding company (Ultimate holding) to an operating subsidiary (LNG Supply), controlled by an intermediate parent company (LNG Holding). The acquisition of the business by the subsidiary was financed by a loan provided by the ultimate holding through the intermediate holding, which was granted in exchange of an interest position in the subsidiary, convertible into shares. The value of the shares once converted would include the interest remuneration of the loan called the ZORA accretions. Upon conversion, the shares would be automatically transferred to the ultimate holding pursuant to a forward contract being the payout for the assets transferred.

Multiple tax rulings were sought by lender LNG Luxembourg and the subsidiary LNG Supply and obtained from the tax administration. The tax rulings provided that, for tax purposes, LNG Supply would be taxed only on a margin agreed with the Luxembourg tax authorities, corresponding to a percentage of the value of the assets of the business acquired by LNG Supply as proxy of its yearly profits and that could not be lower than what agreed. The difference between the actual profits made each year and the margin agreed with the Luxembourg tax authorities corresponded to the ZORA accretions, that were however non-taxable, even if not formally deducted as interest expense.

Always for tax purposes, the tax rulings afforded LNG Luxembourg the possibility, during the lifetime of the ZORA in question, not to record in its accounts any taxable income corresponding to the ZORA accretions upon conversion of the ZORA into shares of LNG Supply attributed to LNG Luxembourg by assuming that the latter company would apply the tax exemption of the capital gains realized from the attribution of shares in participated companies (‘the participation exemption’) under Luxembourg’s Impôt sur le Revenu (‘LIR’). Because of the tax rulings, the ZORA accretions were not to be taxed on the conversion date, even if their value was not subject to corresponding taxation at the level of LNG Supply. The Advocate General questioned whether the interest corresponding to the ZORA accretions could be considered as truly deducted since the subsidiary was subject to the margin taxation.\(^3\) The author considers that the finding that the accretions were in fact not taxed but rather deducted follows from the evidence that the margin taxation to which LNG Supply was subject did not correspond to ordinary taxation of its business income. The justification for this was that the cost of the treasury activities transferred to LNG Supply were to be net of the financing costs,

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\(^3\) Opinion, points 31-32 and 40-42.
determinable as a forfeit. As result, the Engie case is a de facto case of deduction without inclusion. Therefore, the rulings allowed combining reduced taxation and exemption of the ZORA accretions, which, although akin to interest paid on a loan, were not included in the tax base of the lender companies, because considered exempt gains from shareholdings.

After a preliminary investigation, on 19 September 2016, the Commission opened State aid review of the series of tax rulings in question, pursuant to Article 108(2) TFEU. At the end of the adversarial procedure with Luxembourg, the Commission concluded that its tax authorities had unduly exempted the ZORA accretions from taxation, and unlawfully conferred to the concerned companies of the Engie group State aid incompatible with Article 107(1) TFEU. For the Commission, the tax authorities should have disallowed the participation exemption and taxed the ZORA accretions instead, under a correspondence principle that was inherent in Luxembourg’s tax law, to comply with State aid rules. The contested decision ordered the retroactive recovery of the unpaid taxes on the gains corresponding to the ZORA accretions untaxed in the fiscal years in question.

With the judgment of 12 May 2021 in Cases T-516/18 and T-525/18 (‘the 2021 judgment’), the General Court upheld in full the contested decision. Engie and the Grand Duchy of Luxembourg appealed the 2021 judgment advancing a number of pleas, which alleged, in essence, that the General Court had made an incorrect interpretation of Article 107(1) TFEU in the context of the limited reference framework that a State aid investigation should have had when reviewing individual tax rulings.

The Advocate General Opinion

With the Opinion in review, the Advocate General advised the Court to uphold all the main pleas brought by the applicants who essentially claimed the Commission’s classification of the individual tax rulings in question did not grant any selective tax advantage within the meaning of Article 107(1) TFEU.

The author understands that in essence two points were made by the Advocate General to try bringing clarity about the methodology to be used in reviewing individual tax rulings for State aid purposes.

In the first place, the Advocate General addressed the question of the choice of the reference framework by the Commission to assess the selective nature of tax rulings in question. Engie and Luxembourg had claimed in essence that the Commission and the General Court had erred in law in concluding that the combination of the margin taxation of LNG Supply and the exclusion of the value of the shares exceeding the amount of the loan converted, under the participation exemption regime from the tax base of LNG Holding was State aid. The Advocate General sided with the applicants in considering that the rulings duly reflected the ordinary way of taxing companies in Luxembourg. Also, the Commission had created a fictional system of reference comprising a principle of correspondence between income deduction and inclusion, by replacing its own assessment of Luxembourg’s tax system to the one that the tax administration had exclusive competence to apply when they rendered the individual tax rulings in question.

On the question of the choice of the tax system of reference, the Advocate General held that the Commission had exceeded its power to review, under State aid rules, the individual interpretations made by the national tax administrations of the applicable rules of their tax

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6 Opinion, points 86-101.
systems and to determine if such interpretations were correct. The Advocate General considered that the Commission had incorrectly relied on its own assumption about the existence of an anti-abuse provision in Luxembourg law, the scope of which was merely presumed.

This meant that the Commission had the burden of finding the existence of a derogation from the rules of the system of reference, having exclusive regard to the Luxembourg’s stated rules. In so doing, the Commission should have relied on Luxembourg law and administrative practice as interpreted by the national tax authorities rather than taking itself the role of EU tax authority of last resort, not permitted under State aid rules.\(^7\)

In the second place, the Advocate General examined whether, in the case in question, State aid rules required the Luxemburg’s authorities to follow, as part of their national tax system, an inherent principle of correspondence prohibiting the tax exemption of the gains realized from shareholdings attributed, even if those gains had not already been subject to a corresponding taxation at the level of the subsidiary. The Advocate General notably held although one could derive the existence of a general anti-abuse provision in the national tax system of reference, the Commission had erred in finding one for the purposes establishing the existence of a selective advantage, and going against the interpretation of Luxembourg’s law by the national tax authorities. According to the Advocate General, only the Luxembourg legislator could have envisaged a principle of correspondence in the taxation of the convertible loan between the two companies of the same group. In assuming the existence of such a principle, the Commission had erred in considering the reference framework for the taxation of such loans in Luxembourg, unlawfully concluding that the rulings were derogatory. Consequently, the Commission had relied on an ideal tax system, ultimately non-existent in Luxembourg.\(^8\)

Since the Commission had not demonstrated the existence of any selective advantage unlawfully granted, the Advocate General advised the Court to annul the 2021 judgment and also suggested that it was not necessary to refer the case back to the General Court because it was clear that the contested Commission decision had to be annulled.

**Remarks**

The author shares the Advocate General’s view that the assessment of individual tax rulings cannot follow a preferential, less strict standard under State aid rules. In the author’s view, the Advocate General considered that the methodology that the Commission had to use when reviewing the selectivity of individual rulings was the same as the one applicable when examining general tax schemes. As noted by the Advocate General, tax rulings serve an important role in the day-to-day management of the tax rules by the national tax administrations, which the author would qualify as a general role proper of regimes or schemes. One can therefore understand the Advocate General’s view that it would be detrimental to the principle of legal certainty if the Commission could take the competence of reviewing individual tax assessments by possibly annulling single tax assessments found to be erroneous under State aid rules.\(^9\) In her words, only the most serious errors could justify State aid review.

With respect to the question of when an individual tax ruling does constitute prohibited State aid within the meaning of Article 107(1) TFEU, the answer seems to be that this is the case when the ruling reflects a general practice of the tax administration. This is because the individual rulings cannot be construed as single derogation from the reference system. The Advocate General refers to the standard of a ruling being gravely incorrect, as proving a real

\(^7\) Opinion, points 102-114.

\(^8\) Opinion, points 115-134.

\(^9\) Opinion, point 100.
deviation from the reference tax system, that departs from an assessment that the administration should make in any similar case submitted. Therefore, the author submits that the references to the “serious errors” or the “manifest derogation” are to be intended as concerning errors that the administration may repeat or that, in other words, are systemic rather than occasional, since only the former type of errors is not simple and fall outside the ordinary margins of assessment or discretion of tax administrators when implementing the tax system of reference.

Only in that sense, one can understand the argument of the Advocate General according to which the rules on State aid do not provide for a vicarious role for the Commission, as this would violate the fiscal autonomy of the Member States and the principle of legal certainty which is a general rule in tax matters. Indeed, in most reviews of State aid unlawfully granted or planned, the Commission challenges the Member State’s submission that consider the aid compatible or even not aid at all, and this also applies to the review of fiscal aid schemes. What the Advocate General then seems to say is that the Commission cannot take a vicarious role when examining individual tax rulings, unless it proves that these are errors that are systemic or scalable to a practice. This makes the author wonder about the effectiveness of the practice of conducting State aid reviews of individual rulings, when these are only reviewable as general practices or schemes.

For the author, a first takeaway of the opinion therefore concerns the standard of review of individual tax rulings. The Advocate General suggests that to avoid infringing the principle of legality of taxation which is part of the legal order of the European Union as a general principle of law and which requires that any obligation to pay a tax and all the essential elements defining its substantive features must be provided for by law in order to be foreseeable by the taxpayer. Hence, the review of individual rulings or assessments the selectivity criterion should be limited to what the Advocate General calls “plausibility check”, meaning that “only the manifest derogation in favour of the taxpayer”\(^\text{10}\) can constitute a selective advantage. In so doing, the Advocate General seems having singled out the Commission’s practice of investigating individual rulings, rather than general tax regimes, as the source of the insufficient reasoning of the Commission in proving the selective nature of the tax rulings in the case in question.

What is more, the Advocate General made such findings with reference to the recent Fiat Finance judgment,\(^\text{11}\) by which the Court annulled the Commission’s assessment of individual tax rulings as selective in the light of the rules on State aid, although mindful of the fact that such rulings are sometimes potentially harmful to competition.

A second takeaway of the opinion then concerns the question of how to establish, in a case such as Engie, the selectivity of a tax advantage resulting from an incoherent determination of tax bases of companies subject to income tax in Luxembourg that is awarded through tax individual rulings of the tax administration when these merely implement Luxembourg’s tax rules generally available to all taxpayers.

For the Advocate General, since the decision of whether to include or not the income in question in the tax base remained a matter for the national legislature, it was not for the Commission to decide whether a substantive correspondence (anti-abuse) clause existed and in what situations, but only for the Luxembourg’s tax administration. Since a clear income inclusion rule did not appear in Luxembourg’s statutory law, the Advocate General held that the rulings could not be proven to be selective, because the Luxembourg’s tax authorities did

\(^{10}\) Opinion, point 101.

\(^{11}\) Judgment of 8 November 2022, Fiat Chrysler Finance Europe v Commission, in Joined Cases C-885/19 P and C-898/19 P, EU:C:2022:859, paras 73-74 and 97;
nothing different but apply the general statutory law in an individual case. The author cannot agree with that conclusion.

It is true that, according to the settled case-law, for tax measures, selectivity has to be determined in several steps, and require in the first place to identify the ordinary tax system applicable (the ‘reference framework’). In doing that, the basis for determining the reference framework can only be the national legislator’s decision as to what it deems to be ‘normal’ taxation. For the Advocate General, fundamental taxation decisions, particularly the decisions about taxation techniques but also the objectives and principles of taxation, are therefore only for the Member State to make. This would entail that neither the Commission nor the Court can judge national tax law by some implicit or ideal tax system, and therefore the tax rulings in question are just the expression of the law. However, to be truly general the law must be consistently applied.

The author believes that the Advocate General may have tried to take an overly strict approach taken from the recent judgment in Fiat Finance, where the Court excluded the existence of an arm’s length principle inherent in the State aid prohibition enshrined in Article 107(1) TFEU, which was the base of the Commission decision in that case. In Fiat Finance, the Court held that even if the arm’s length principle is an internationally accepted standard for transfer pricing, it does not have any autonomous denotation in State aid rules that is directly applicable and that the Commission can impose on Member States, under the primacy of EU law.

However, the author suggests that it is precisely because of the standard based on the “manifest derogation” coined in the opinion that the Advocate General should have rather concluded that the tax rulings in Engie had a derogatory nature.

Unlike the presumed violation of the arm’s length principle in Fiat Finance which concerned individual pricing assessments made in Luxemburg’s tax rulings relating to the acceptable prices in intra-group transactions, the Engie case concerned the inherent coherence of the national law with itself. What was at stake in Engie is not the assessment of an acceptable transfer price but the question of whether including income in the tax bases of the concerned taxpayers. The margin taxation or reduced taxation of the income of the subsidiary, which is justified by the interest cost borne by it, creates an inconsistency when coupled with non-taxation. This, indirectly differentiates between taxpayers in comparable situations, because convertible loans may benefit from the inconsistency while non-convertible ones cannot.

The choice made by the tax authorities between taxation or exemption was merely a binary one. By providing an advance ruling exonerating income from taxation at the level of the lender even if not fully taxed at the level of the borrower, the Luxemburg’s tax authorities contravened the aim of Luxemburg’s tax system, which is to tax income equally, in all situations that are comparable. In Engie, there was no double taxation to avoid, and it was therefore clear that the tax administration should not have allowed the exempt income to go untaxed.

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13 Opinion of Advocate General Pikamäe in Ireland v Commission in Case C-898/19 P, EU:C:2021:1029, points 60 et seq.; see also Opinions of Advocate General Kokott in Fossil (Gibraltar) in Case C-705/20, EU:C:2022:181, point 57; in Commission v Poland in Case C-562/19 P, EU:C:2020:834, point 39; and in Commission v Hungary in Case C-596/19 P, EU:C:2020:835, point 43.

14 Opinion, point 73.
The conclusions of the Advocate General in the Engie case should be compared with the findings of the landmark Gibraltar judgment, where the Court held that, in examining a company tax system, the notion of selectivity is not necessarily limited to exemptions or derogations from the ordinary or statutory tax system, but it also includes situations which make the material scope of a tax system unreasonably narrow in practice by excluding from tax arrangements of undertakings which should reasonably be taxed.\textsuperscript{15} In Gibraltar, the Court has specifically expanded the notion of selective advantage when reviewing general tax measures to include not only the subjectively selective advantages but also the objective ones. It did so by determining the underlying objectives of a company tax system which is to apply to all undertakings in comparable situations and therefore could not tolerate unjustified exclusions from taxation. In Gibraltar, that comparison concerned the “offshore companies” as opposed to the companies with local employees and business premises.\textsuperscript{16} In setting that standard of selectivity, the Court went even beyond the mere objective comparability of undertakings to include a quasi-subjective element consisting in the tax system allowing the possibility of abuse. It held that consistency of Gibraltar’s tax system was excluded because:

\textit{“the fact that offshore companies [were] not taxed [was] not the random consequence of the regime at issue, but the inevitable consequence of the fact that the base of assessment [were] specifically designed so that the offshore companies, which by their nature have no employees and do not occupy business premises, have no tax base under the bases of assessment adopted by the [Gibraltar tax system].”}

It is impossible not to apply the above dicta of the Court, mutatis mutandis, to the present case and conclude that the fact that the gain deriving from the conversion of the ZORA loan into shares was not taxed under the tax rulings in question was not the random consequence of Articles 164 and 166 LIR but the consequence of the fact that the tax ruling system allow the companies of the same group arranging their intra-group loans as convertible to have no tax base under Luxembourg’s tax law, which is an unjustified exclusion.

Also, in Lico Leasing, the Court specifically held that the favourable tax treatment resulting from a combination of different tax measures in different stages of complex business arrangements, concerning different taxpayers could be considered selective.\textsuperscript{17} The situation in Lico Leasing seems strikingly comparable with the one of the corporate reorganisation in the case at issue, where the company reorganization was structured in different steps with the use of intragroup financial arrangements, the essence of which was to create a mismatch between the exemption of the ZORA accretions, realised by the parent companies as a result of the conversion of a loan into shares and the constructive deduction of the loan at the level of the subsidiary.

In that sense, even if the tax administration endorsed each of the rulings individually, as justified on the basis of the LIR, it is a fact that they all concerned companies of the same group involved in the same financing arrangement, and were sought from the same tax administration. Their nature as “manifest derogation” results clearly from the facts that the arrangements subject to the rulings were specifically designed to obtain a mismatch between non-taxation and exemption, resulting in a tax advantage in terms of lower tax burden for the companies of


\textsuperscript{16} Gibraltar, cit., paras 101 and 102.

the same Engie group which can be considered selective deviating from the coherence that Luxembourg’s tax system shall ensure.

There was no justification for that. The author submits that the conclusion of the Advocate General in the case in review, to consider the tax rulings as justified because the applicable law would not expressly require that income derived by a parent company from its subsidiary to its parent as tax exempt only if taxed at the level of the subsidiary,\(^{18}\) cannot follow from a sensible application of the tax law in Luxembourg.

As a matter of principle, similarly to what happens in any income tax system, the Luxembourg’s one is based on the principle of single taxation, according to which tax should not be imposed more than once but at least once on income, which was not for the tax authorities to disapply by allowing the double non-taxation of the same income for the same (substantive) taxpayer as a result of the de facto deduction without inclusion of the ZORA accretions.

It follows that on the point of the assessment of the selectivity of the Luxembourg’s tax ruling system, the Advocate General should not be followed, since concluding that Luxembourg is free to devise a system of rulings that denies correspondence between what is non-taxable on the one hand and taxable on the other would mean depriving its tax system of all coherence.

To think otherwise, would make it arbitrary to implement the standard based on a “manifest derogation” that the Advocate General has suggested, while that standard is already explained in Gibraltar and Lico Leasing.

**Conclusion**

In conclusion, on the one hand, the opinion of the Advocate General tries to bring clarity on the standard to use in order to review individual tax rulings and determines in the authors’ view that that standard is the same one that the case law has ruled to use to review general tax schemes. On the other hand, suggesting, as the Advocate General does, that the double non-taxation of income derived from transactions between companies of the same group is not State aid in the case in review would mean violating the standard so clearly set out by the Court in cases such as Gibraltar and Lico Leasing. According to that standard all unjustified misapplications of national tax rules, independent of the form, and therefore including those by means of a tax ruling practice allowing double non-taxation of income resulting from intragroup transactions, are qualifiable as a selective tax advantage and therefore constitute prohibited State aid.

Should the Court decide to follow the Advocate General and rule that no State aid is present in the case of lack of correspondence between non-taxation and exemption resulting from the de facto deduction without inclusion of the ZORA accretions, because not expressly prohibited in the tax system of reference, this would mark a serious setback for the future of State aid control of tax measures.

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\(^{18}\) Opinion, point 110.