



## Windfall Profit Taxes – do they work?

### Introduction

Recent global circumstances have led to record oil and gas prices, putting pressure on governments around the world to take action to help households deal with rising costs. One option being considered and introduced by many countries across Europe is a tax on companies that have made unexpectedly high profits, in particular where these result from increases in energy prices – so-called “windfall profit taxes” or “windfall taxes”. Spain, Greece and Italy have already introduced windfall profit taxes and the UK also recently announced a new energy profits levy for businesses in the oil and gas sector. Others, such as Germany and Austria, are considering following suit. Whilst there appears to be considerable political momentum for introducing such measures, these types of innovative taxes can be flawed in their design, face constitutional challenges, potentially infringe state aid rules and could be incompatible with existing rules. In this briefing we consider some of the measures that have been introduced or which are currently being discussed in this area.

### The European Commission’s position

In early March 2022, the European Commission published its REPowerEU communication which aims to safeguard and secure energy supplies. To raise funds for new renewable energy products and mitigate high energy prices on consumers, the Commission called on Member States to consider temporary tax measures on windfall profits. In essence, the Commission’s view is that a tax, for a limited period, on electricity generators that do not depend on fossil fuels for their production but at the same time, due to the specific design of the electricity market, profit from heightened electricity prices and corresponding returns, would be justifiable. However, it is not a proposal for an EU-wide tax, rather a statement in support of such measures should Member States decide to use them.

### The Italian Windfall Tax: does it meet its policy objectives?

Italy has introduced a special contribution on extra profits realised by Italian energy industry players (the **Italian Windfall Tax**) to finance the reduction of energy prices for enterprises and consumers.

The tax, introduced by Article 37 of the Law Decree No. 21 of 21 March 2022 (converted by Law No. 51 of 20 May 2022), applies to the difference between (i) the added value (to be determined in accordance with Italian VAT rules) for the period from 1 October 2021 to 30 April 2022 and (ii) the added value for the period from 1 October 2020 to 30 April 2021 (the **Incremental Added Value**) and is levied at a rate of 25 per cent. As the tax is not deductible for income tax purposes it represents a real cost for relevant taxpayers, and is due on 30 June 2022 (40 per cent of the total amount due) and on 30 November 2022 (60 per cent of the total amount due).

The Italian Windfall Tax applies to companies that carry out the following activities in Italy: production of electricity, methane gas or extraction of natural gas, or the sale of electricity, methane gas and natural gas, or production, distribution, and trade of oil products. It also applies to companies importing electricity, natural gas, methane gas or oil products for subsequent sale, but does not apply to companies organising and managing platforms for the exchange of electricity, gas, environmental certificates and fuels. There are no exemptions for those in the renewables sector.

Whilst special measures have been included to prevent shifting of the tax to end-consumers, several concerns with the structure of the Italian Windfall Tax remain. Firstly, the tax basis is not designed in a way that exclusively captures the windfall profits generated by the spikes in energy and oil prices. Indeed, the Incremental Added Value could be influenced by a variety of factors (including M&A activities) which are not connected to price fluctuations.



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Secondly, to the extent that certain players operate on a hedged basis, to protect themselves against price fluctuations, the financial benefit associated with the price fluctuations may in fact have been passed to financial counterparties, thus diluting the profit remaining in the hands of the energy industry player. In such cases, the tax would not capture the exceptional profitability. Such distortions could potentially lead to the Italian Constitutional Court having grounds to scrutinise the provisions.

## **The Spanish Windfall Tax: will the design flaws be fixed?**

On 15 September 2021, the Spanish Government passed the Royal Decree-Law 17/2021 (**RD 17/2021**) introducing a mechanism, currently in force until 30 June 2022, for the temporary reduction in the remuneration of electricity production activity in order to reduce windfall profits (i.e., extra profits earned from non-emitting plants on the back of high gas and carbon prices) (the **Spanish Windfall Tax**).

The Spanish Windfall Tax requires electricity providers that fall within its scope to pay back to the Spanish electricity system an amount proportional to the increase in income obtained by these providers as a result of the incorporation of the natural gas price into electricity prices.

The Spanish Windfall Tax applies to non-emitting providers (i.e., owners of the electricity plants) in the Spanish peninsular territory, regardless of the specific sector in which they operate (wind, photovoltaic, hydro, etc.). However, the following facilities are expressly excluded from its scope: (i) facilities that have a specific regulated remuneration scheme (i.e. subsidised renewable assets); (ii) facilities in the electricity systems of non-peninsular territories; and (iii) facilities with net power equal to or less than 10 MW.

The Spanish Windfall Tax was originally intended to apply to energy providers regardless of the contracting method used (i.e., regardless of whether providers sold electricity on the daily market or through fixed-price contracts). However, this meant that the Government was penalising companies for profits they were not making, as the prices for such contracts were set before the price rise (through bilateral agreements at a fixed price). Therefore, the Spanish Government published a note clarifying that the owners of facilities that meet all the following requirements are not subject to the Spanish Windfall Tax: (i) the electricity produced is covered by a bilateral agreement(s) signed prior to the date of entry into force of RD-L 17/2021; (ii) the contracting instrument(s) are at a fixed price (i.e., they do not have a recognised delivery price indexed to the spot market price of electricity production); and (iii) the contracting instrument(s) are not intra-group contracts.

However, if new fixed contracts are signed or renewed with a fixed price higher than a certain amount, they would fall within the scope of the Spanish Windfall Tax.

The Spanish Windfall Tax is in force until 30 June 2022 and may be extended by the Government in the coming weeks. However, for the time being, it has had no real effect in solving the problem of rising wholesale power prices in Spain, as it has not achieved the revenue collection objective that the Spanish Government was looking for since most of the electricity sold in Spain (approx. 80-90 per cent) is not actually sold via the daily market, but is sold on fixed-price contracts signed prior to the application of this measure and therefore excluded from the Spanish Windfall Tax.

On the other hand, as a result of negotiations between Portugal, Spain and the European Commission, the Spanish Government has recently approved another measure to cap gas prices in order to benefit Spanish customers. This measure entered into force on 14 June 2022 following approval by the European Commission. The measure will be in force for 12 months but despite this gas cap, electricity prices in Spain continue to climb.

Finally, the Spanish Government has recently announced additional taxes for electricity companies for 2023. The details of these measures have not yet been published but according to the latest information available, it seems that the Government is considering an increase in Corporate Income Tax on electricity companies of 10 percentage points (the general tax rate is 25 per cent) or the introduction of a new specific tax for electricity companies.

## **The UK Energy Profits Levy: a ring-fenced regime, but what happens if you step outside the ring-fence?**

On 26 May 2022, the UK Government announced a new “energy profits levy” charged on profits from UK oil and gas extraction activities, with draft implementing legislation being published for consultation on 21 June 2022. Once that legislation has been formally enacted, the levy will apply (retrospectively) from 26 May 2022, and is intended to remain in force until the UK Government considers oil and gas prices have “return[ed] to historically more normal levels” (with a “sunset clause” expiring at the end of December 2025).

The levy is charged at a rate of 25 per cent, on broadly the same profits which are already subject to the UK’s oil and gas ring fence corporation tax and supplementary charge regime, taking the total effective tax rate on such profits to 65 per cent. However, the implementing legislation will also introduce a new “investment allowance” which, together with other reliefs already available, will enable taxpayers to obtain relief of up to 91.25 pence in the pound where they reinvest profits in the UK oil and gas sector.



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Although the new levy is, at present, limited to the oil and gas sector, the UK Government is currently considering whether to take additional steps in response to the “extraordinary profits” which it considers are being enjoyed in parts of the electricity generation sector. However, applying such a levy to businesses outside the ring-fence regime could be significantly more complicated than the existing proposals (which rely on the detailed rules which already exist as part of the ring-fence regime to identify those profits which are subject to the levy). It is also not clear whether, for example, companies that are involved in renewable energy generation would receive preferential treatment under any new levy (for example, enhanced investment allowances for investment into renewable energy projects), or might be excluded from the scope of any new levy altogether.

## German windfall profit discussions

Political discussions are ongoing regarding the introduction of a windfall profit tax in Germany. The state of Bremen has requested that the federal governance analyses the case for such tax and develops a more detailed proposal for draft legislation in June. This initiative is supported by several politicians, especially from the Social Democrat Party and the Green Party and is driven by the steep increase of the gas prices in Germany over recent weeks.

The Federal Ministry of Finance and – at least in part – the Federal Ministry of Economics have pushed back on these proposals so far, however. They consider such a tax could be counterproductive for Germany as an industrial nation trying to provide investment security for entrepreneurs. It therefore remains unclear whether the implementation of such a windfall profit tax has any realistic chance of success in the political arena. This is especially true as Germany already has relatively high business taxation rates compared to other jurisdictions. Plus, there is the potential for constitutional challenges, as to which, see below.

## Will Austria introduce a windfall profit tax?

In Austria, Chancellor Karl Nehammer, in May 2022, publicly expressed his initial sympathy for a windfall profit tax to be introduced in Austria, and the topic has remained on the political agenda ever since. The discussions in Germany may mean the Austrian debate gains even more traction. However, despite much discussion, it is still far from clear what such a tax would look like.

From what has surfaced so far, the tax is likely to target what is perceived as excess corporate profits that may be attributed to increases in energy prices, although how such excess profits would be calculated is as yet unknown. It can be expected that any proposal would reflect the European Commission’s proposals. But the Austrian government may well go beyond the scope proposed by the Commission. With current crises also resulting in increased profits in sectors other than electricity, the targets of these measures may not be limited to electricity generators but could extend to other alleged “crises winners” in various industries, such as oil and natural gas companies (as is the case in the UK and Italy).

## Constitutional and state aid challenges

It will be a matter of local law whether the introduction of new taxes would face fundamental legal barriers. In any case it is clear that such taxes must be designed equitably with a sound public-interest justification to withstand a constitutionality test.

For instance, in Germany, the implementation of a new sector-specific windfall profit tax could face two main challenges from a constitutional perspective:

- *Constitutional form of taxation:* The German constitution provides for an exhaustive catalogue of forms of taxation that a legislator is allowed to introduce. The “invention” of a completely new form of taxation or “blending” several forms of taxation into a new “hybrid” taxation regime is not allowed. This very strict framework for the introduction of new forms of taxation is to avoid uncertainties as regards legislative and administrative competencies or the allocation of tax revenues between different state levels in Germany. A new windfall profit tax would have to be in line with these principles. Previous attempts to circumvent this, such as the nuclear fuel tax which was found to be unconstitutional, show that the introduction of new sector-specific systems of additional profit taxation can lead to significant problems in this regard.
- *Unequal treatment of taxpayers:* The introduction of a new form of sector-specific taxation would lead to unequal treatment of taxpayers that must be justified by a valid reason to be in line with German constitutional law principles.



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This latter idea of unequal treatment could also lead to potential state aid issues. The European Commission itself has already indicated there could be state aid implications if such windfall profit taxes lead to selective advantages for specific undertakings (i.e., if they are excluded from such taxes while their competitors are hit). State aid concerns may therefore also need to be further explored.

## **Compatibility with Excise Duty Directive**

There has, as yet, been no broad discussion as to whether these new forms of windfall profit taxation for businesses in the energy sector could come into conflict with the harmonised system of excise duties on energy products. Art. 1 para. 2 of the Excise Duty Directive provides for strict restrictions on the implementation of new forms of indirect taxation on energy products. Based on the ECJ's prior judgments in this respect, it is the effect of the tax (and not its form) that is decisive when considering whether member states are bound by these rules when introducing new taxes materially related to sectors covered by the European Excise Duty system.

## **How can we help?**

We closely monitor all developments on an international and national level. Given the uncertainties as to when and how windfall profit taxes may be adopted in each country, being up to speed will be key to being able to react quickly to proposals that may be swiftly introduced. It may be helpful to have possible design flaws identified early on to either present arguments during the legislative process or contest inequitable design features before such tax measures are implemented.

Making use of our international network, we are already advising some clients on their strategic positioning vis-à-vis the potential adoption of windfall profit taxes. Individual strategies may depend on whether a company is likely to be in scope of such tax or whether its inclusion may be averted with the right line of arguments during the legislative process.

*If you have any questions about any of the issues raised in this briefing, please contact our team on the following page, or your usual Freshfields contact.*



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