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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, with the UN joining calls for governments to take action to support the most vulnerable. 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 Belgium recently announced its intention to introduce one. The UK also recently introduced an 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 was not a proposal for an EU-wide tax, rather a statement in support of such measures, should Member States decide to use them.

Since then, as energy prices continue to increase, several EU Member States have called on the Commission to intervene in the electricity market to tackle high costs. At the beginning of September, the Commission President Ursula von der Leyen confirmed that the EU executive is considering introducing a cap on the price of inframarginal electricity generation technologies. The idea is to cap the high profits certain technologies are currently benefiting from, notably renewables, hydropower and nuclear, by applying a levy to profits made in excess of the cap. The Commission would like to see the revenues generated from such a measure redistributed to citizens and businesses most impacted by high prices.

Note these are just plans for now – no proposal has been published so far. Energy ministers from the EU 27 countries are scheduled to meet on 9 September to discuss possible measures, which the Commission could then publish as early as next week.

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 the tax being passed on 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.

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. Indeed, several market players have filed appeals with the Italian administrative court, expecting that the Italian Constitutional Court would ultimately annul the new charge, which many believe does not properly capture extra-profits triggered by the current market conditions and is therefore potentially open to challenge on the basis of unconstitutionality.

The Italian administrative court will decide in early November whether to request that the Italian Constitutional Court rules on the matter. In the meantime, the Italian government has taken measures to crackdown on those who have decided not to pay, by increasing the administrative tax penalties to 60 per cent.

The tax revenues for the first instalment of the Italian windfall profits tax were significantly lower than forecast, despite the intentions of the Italian PM Mario Draghi and the fact that ENI S.p.A. (the State-controlled Oil & Gas multinational) has publicly declared that it would pay approx. €1.4bn.

In the upcoming days, the new decree currently under discussion may introduce further changes to the regime (including an increase in the rate of tax, currently set at 25 per cent).

The Spanish Government's new windfall tax proposal for companies in the energy sector

On 15 September 2021, the Spanish Government passed Royal Decree-Law 17/2021 (**RD 17/2021**) introducing a mechanism, currently in force until 31 December 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 mechanism 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. It 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.

In addition, the Spanish Government published a note clarifying that the owners of facilities that meet all the following requirements are not subject to this mechanism: (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.

As a result of negotiations between Portugal, Spain and the European Commission, the Spanish Government 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 and will be in force for 12 months but despite this gas cap, electricity prices in Spain continue to climb.

Finally, the Spanish Government, in July, submitted a draft law proposal developing a new temporary tax on the main companies in the gas, oil and electricity sectors (with a carve out for (i) companies below a €1bn threshold in 2019, and (ii) companies with energy revenues below 50 per cent of total revenues in 2017, 2018 and 2019). This would be a temporary measure for 2023 and 2024 and the tax would be equal to 1.2 per cent of the aggregate turnover of in-scope companies. Sanctions and measures are anticipated to avoid the levy being passed on to consumers and no carve out is envisaged for those in the renewables sector.

The UK Energy Profits Levy: a ring-fenced regime

On 26 May 2022, the UK Government announced a new "energy profits levy" charged on profits from UK oil and gas extraction activities. That legislation was formally enacted in July, with the levy applying (retrospectively) from 26 May 2022. This 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 also introduces a new "investment allowance" which, together with other reliefs already available, enables taxpayers to obtain relief of up to 91.25 pence in the pound where they reinvest profits in the UK oil and gas sector.

The new levy is, however, limited to the oil and gas sector, and the newly appointed Prime Minister, Liz Truss, suggested during the election process that she would not introduce any further windfall taxes on energy companies. The latest indications are that she will instead announce plans to freeze energy prices for two years at a cost of an estimated £100bn although it remains unclear how this would be funded.

Belgium announces new windfall profit contribution

The Belgian government recently announced the introduction of a windfall profit contribution on the energy sector. The design of such contribution has been widely discussed over the summer with various proposals being made by political parties, including the Belgian Minister of Energy's proposal to levy a one-off 25 per cent tax on excess profits inspired by the Italian Windfall Tax.

However, the government in the end decided not to introduce a new type of tax but to work with the model used for the nuclear tax, officially called the "repartition contribution" (repartitiebijdrage/contribution de répartition). The design of this nuclear tax has evolved over the years but is essentially a 38 per cent tax on the profit margin from the exploitation of the (four youngest) nuclear power stations (with a minimum amount and a reduction mechanism to take into account the contribution capacity and the risks associated with the size of the production facilities of each taxpayer).

According to public statements the current nuclear tax would generate around €785m for the 2023 budget, due to the high electricity prices. Certain public statements by government representatives indicate that the broadened windfall profit contribution would be expected to generate around €1.5bn. The additional revenue would be used to finance the various measures that will be introduced to relieve end users (private customers and businesses).

The details of the Belgian windfall profit contribution for the broader energy sector are expected to be determined by the end of September with the assistance of an expert group, although will then be subject to the usual legislative process in the Belgian parliament.

Based on public statements and previous experience with the nuclear tax, the key features of the Belgian windfall profit contribution could include:

- Applicability to all (large) market participants required to have a license from one of Belgium's energy regulators. The contribution would be technology neutral and apply to electricity, oil and natural gas market participants alike (including renewables);
- The contribution may be levied as a percentage of the gross profit margin of market participants (it is not yet clear whether the rate would be different from the current 38 per cent rate of the nuclear tax and if yes whether the nuclear tax rate would then be aligned). In terms of determining "excess profits", it is suggested that they may be benchmarked against the February 2022 market prices (applied to the subsequent physical sales volumes);
- The intention seems to be to make it a permanent contribution rather than a one-off contribution;
- A prohibition on shifting the cost of the windfall profit contribution to end-customers; and
- In line with the nuclear tax, it may be expected that the contribution would be deductible for income tax purposes. The latter design element may be included to distinguish the contribution from regular corporate income tax and could somewhat help the government's case if the contribution would be challenged on grounds of double taxation on the same profit (regular corporate income tax + windfall profit contribution).

There is little doubt that some taxpayers may challenge the validity of such a windfall profit contribution, among others on the grounds of unconstitutionality (see also below). The decision to follow the model of the nuclear tax was expressly motivated by the fact that the nuclear tax was already unsuccessfully challenged in various courts including the Belgian Constitutional Court. However, it should be noted that the nuclear tax that was previously submitted to the judgment of the Constitutional Court had different features to the one that is expected to be used as the basis for the windfall profit contribution for the broader energy sector. By way of contrast, the Constitutional Court has previously found certain sector-specific contributions on the oil and gas sector to be compatible with the constitution.

Germany: from windfall profits to "skimming off" inframarginal profits

In Germany, political discussions around the introduction of a windfall profit tax are still ongoing and have recently shifted. As the Federal Government could not come to an agreement regarding the introduction of a windfall profit tax ("Übergewinnsteuer"), it is now pushing the idea of "skimming off" profits from inframarginal technologies as these have significantly risen due to high market clearing selling prices (so called merit order principle). Through this mechanism, the Federal Government aspires to reduce electricity prices for private households and small and medium enterprises (SMEs) and provide financial assistance by determining a guaranteed fixed price for basic consumption (which is still to be determined).

The proposal under discussion is not strictly a tax, but involves skimming off inframarginal profits. The Federal Government coalition committee agreed in early September that it would propose a solution inspired by the German renewable energy levy (EEG-Umlage), through which private sector participants (the distribution network operators) set up and administer an account to which inframarginal profits are transferred. Whilst the obligation to transfer is imposed by the State, the Government is explicitly seeking a solution outside the federal budget and leaving it to private sector operators to distribute the profits to private households and SMEs.

Inframarginal profits are to be defined as the difference between the market clearing selling price and the actual offering price. For this purpose, a cap is likely to be set for the profits on the energy spot market. Many details, for instance on the precise criteria of the cap, are still to be discussed. The Federal Government coalition committee underlined that the final regulatory course should be set at a European level – but simultaneously announced it will follow a national approach if the desired outcome is not achieved at an EU level. The Federal Government might also take it even further, as it would welcome the European Commission developing measures to skim off inframarginal profits of companies outside the energy market.

Politically, the measures are linked to reducing electricity prices for private households and providing financial assistance by guaranteeing a fixed price for "basic electricity consumption" (which is still to be determined). The Federal Government announced that it will discuss a similar model for SMEs. Furthermore, electricity grid charges are to be subsidised and lowered, using the skimmed off inframarginal profits.

If introduced, the redistribution of inframarginal profits raises various legal concerns. Inter alia, despite being designed as an inframarginal profit transfer to an account administered by private actors, the redistribution scheme might be considered a circumvention of specific constitutional rules for the introduction of special levies. Also, it is not clear how the price cap defining the margin between the acceptable and the actual price (the inframarginal profit) can be set up in a legally sound manner, nor how a distribution of the inframarginal profits to customers can be rendered in an effective way.

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. In August, an initial proposal was put forward by the Austrian workers' association and union group which mirrors the Italian windfall tax as far as scope is concerned (i.e. companies in the business of production/distribution/trade of electricity, methane gas, natural gas, as well as other gases, crude oil or petroleum) but suggests taxation of windfall profits that are assessed by comparing current year EBITDA with reference EBITDA calculated separately for each entity (i.e. no group or consolidated view).

The resulting difference would be the taxable basis (the "windfall profit"). Depending on the amount of the windfall profit, a tax rate of 60 per cent or 90 per cent could apply. Further, and in order to promote investments into renewable energy sources, deduction for payments related to such investments from the taxable basis would be allowed ("super depreciation"). Payments under the windfall profit tax would then be deductible for corporate or personal income tax purposes. The proposal is that this would apply until at least 2024.

It is yet to be seen how this proposal will be received by the political parties. So far, no official proposal from any Austrian ministry has surfaced. It might very well be that Austria intends to wait for a uniform approach to be adopted at an EU level.

United States – a proposal on the table?

In the US, various Senators, including Senate Finance Chair Ron Wyden, have proposed legislation that would double the tax rate of large oil and gas companies' excess profits. According to the Senate Finance Committee press release, the bill would apply a 21 per cent additional tax on the excess profits of oil and gas companies with more than $1bn in annual revenue. Excess profits are calculated by subtracting a normal return (10 per cent return on expenses) from current profits.

The proposal applies to profit margins rather than oil prices, with the idea being that companies making "normal profits" based on their expenses would not pay any additional tax.

In addition to the excess profits tax, the proposed "Taxing Big Oil Profiteers Act" would also impose an excise tax on stock buybacks and end the use of the "last in, first out" accounting method by large oil and gas companies which means they can deduct the newer, more expensive inventory, rather than the older, less expensive inventory.

However, given the current political climate it seems increasingly unlikely that these proposals would gain any traction in Congress.

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 many jurisdictions, the implementation of sector-specific windfall profit taxes could face challenges from a constitutional perspective, including under the right to equal treatment.

Windfall profit taxes are, by nature, specific to a defined group of taxpayers and a defined type of profits. Taxpayers subject to the windfall profit tax may consider that they are treated unequally compared to taxpayers that are not subject to the tax or that benefit from an exemption. Any unequal treatment would have to be justified by a valid public-interest justification and not go further than is required to achieve the stated objectives of the relevant legislator.

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.

In some cases, taxpayers may consider that they have not generated windfall profits and are nevertheless required to pay a windfall profit tax. This touches upon a delicate aspect of such taxes, which is that they are motivated by the desire to tax windfall profits resulting from an external factor (energy crisis in combination with the marginal cost pricing on the electricity market) but are usually not designed to exclusively capture such windfall profits. For these taxpayers, the windfall profit tax could appear as a (double) tax on regular profits, sometimes at a disproportionately high rate that could raise questions under the right to property (Article 1 of Protocol No. 1 to the European Convention on Human Rights).

For instance, market players operating on a hedged basis, to protect themselves against price fluctuations, may have passed the financial benefit to counterparties. Or energy providers that have concluded (long term) supply contracts as a result of which they do not (fully) benefit from the increased energy prices. In such cases it is the purchaser of that energy who generates the windfall profit, often large energy companies (who may however also have ‘lost’ part of that benefit to their customers under fixed price contracts) but also large industrial end users. On the other hand, gas-fired power plants may in some cases have been able to benefit from a windfall profit by trading gas acquired under old contracts rather than using it to generate electricity. In some instances, market players may challenge the fact that they are today faced with a separate tax on windfall profits but cannot offset losses incurred in recent years. In the case of windfall profit taxes that are introduced on a permanent basis the question may arise whether they should include a mechanism to carry back or forward losses.

In Germany, the implementation of a new sector-specific windfall profit tax would also be faced with the fact that 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.

Compatibility with the 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 for those within the European Union.

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 listed on the next page, or your usual Freshfields contact.

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