UNIVERSITÀ DEGLI STUDI DI BERGAMO

Extraordinary tax policies for extraordinary times
Windfall Profit Taxation in Europe

Dott.ssa Anna Miotto

Dott.ssa Elena Briguglio

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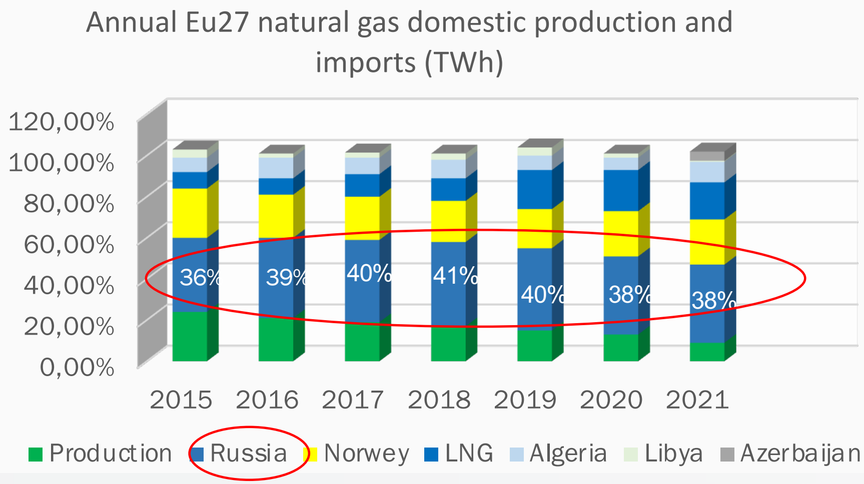
Abstract

- In March 2022 the European Commission raised for the first time the necessity to introduce a special tax to address the impressive profits made by oil and gas MultiNational Enterprises (MNEs) and the prices of **oil and electricity** that are spiraling out of control, as they are left to the offer / demand mechanism;
- Such a proposal was immediately endorsed by the European Parliament in a following resolution (May 2022) that urged the Commission to draft a **Regulation introducing a Windfall Tax, Europe-Wide**.
- The Commission delivered the proposal on September 14th and the Council had it **approved on 6 October 2022 (regulation 2022/1854)**.

The Impact of the War in Europe

The war in Ukraine is the third **asymmetric shock** that the EU has experienced in the last twenty years, after the economic-financial crisis of 2008 and the subsequent eurozone crisis and after the COVID-19 pandemic. An asymmetric shock is a sudden change in economic conditions that affects some EU countries more than others.



- Only **Russia constitutes more than 30%** of **Natural Gas** of all European consumption of , which becomes 50% of imports if we do not consider domestic production.
- The war caused an increase in gas and electricity bills which in the last quarter saw a **40% increase**.
- The first risk comes from **inflation** and the sustained rise in energy and commodity prices. The inflationary impulse of the conflict and the resulting tightening of sanctions by the West could continue to weigh on earnings growth.
- The second risk relates to the **potential impact of inflation on the economy** – including tighter financial conditions, higher energy prices and potential wage increases – and the resulting effects on economic growth.
- The final danger is related to a potential change in investors' appetite for risk and a consequent generalized **sell-off in the equity market**.

The Origin of the Windfall Profits (aka Extra-profits)

- Thanks to oil and gas, **energy companies** have made enormous profits (Eni spa, state-controlled company, earned about 20 billion euros between 2021 and 2022) for two reasons:
  - The **increase in demand** compared to offered as a result of the war in Ukraine which has caused gas prices to skyrocket;
  - Energy companies are selling at **very high prices** raw materials that were purchased well before the invasion of Ukraine. This leads to huge profits. This is allegedly a "market failure" case.
  - Are these earnings really "Extra profits"?
    - Yes, because the companies have mostly purchased gas with **long-term contracts** at already **fixed prices** (lower than today) and resell it at a **much higher price**. That **differential** is an unexpected gain, a profit that is a **surplus**.

The Windfall Tax:
the European Framework

- Council Regulation (EU) **2022/1854** of 6 October 2022;
  - **Art. 14**: **Surplus profits** generated by EU companies and PEs in the Oil and Gas Sectors shall be subject to a "Mandatory temporary solidarity contribution", unless Member States have already enacted equivalent national measures;
  - **Art. 15**: The tax shall be calculated on the taxable profits, as determined under national tax rules, in the fiscal year 2022 and/or the fiscal year 2023, exceeding by **20 % the average taxable profits** in the previous four fiscal years;
  - **Art. 16**: The tax rate shall be **at least 33 %**. The temporary solidarity contribution shall apply in addition to the regular taxes and levies applicable according to the national law of a Member State;
  - **Art. 17**: see the next slide.
  - **Art. 18**: The solidarity contribution applied by Member States in accordance with this Regulation shall be of a **temporary nature**. It shall only apply to surplus profits generated in the fiscal years referred to in Article 15

Why Taxing Windfall Profits

1. Measures for **energy consumers**, and in particular vulnerable households, to mitigate the effects of high energy prices;
2. Measures to help **reducing the energy consumption**, **promoting investments** by final energy consumers into renewables, energy efficiency investments or other decarbonisation technologies;
3. Measures to support companies in energy intensive industries, provided that they are made conditional upon **investments into renewable energies**, energy efficiency or other decarbonisation technologies;
4. Measures to develop the **energy autonomy**, in particular investments in line with the REPowerEU objectives set in the REPowerEU Plan and in the REPowerEU Joint European Action such as projects with a cross-border dimension;
5. In a spirit of solidarity between Member States, Member States may assign a share of the **proceeds of the temporary solidarity contribution** to the common financing of measures to reduce the harmful effects of the energy crisis, including support for protecting employment and the reskilling and upskilling of the workforce, or to promote investments in energy efficiency and renewable energy, including in cross-border projects, and in the Union renewable energy financing mechanism.

The Meaning of “Extra-Profits”

- **Excess over the normal profits** of the earnings actually received by non-marginal firms. The extra-profits often derive from **market situations** rather than from the merit of the entrepreneur (quasi-rent phenomenon).
- The extra-profits are therefore a **typical condition** of non (perfectly) competitive markets, where firms have the right to **determine prices** (price-setter firms) and leave the determination of quantity to the market. The fixed price is higher than the average cost of production, thus generating the monopoly rent.
- **Excessiveness** can be actually measured in many ways, but it is always **time sensitive**, and path dependent.
    - As the Global financial crisis in 2008 has clearly demonstrated, excessive profits by banks in the first decade of the century were by far offset with the immense losses coming after, and the Governments were urged to grant subsidies and incentives to the very same companies they overtaxed but some years before.
- The conclusion in this respect is that any judgment of excessiveness depends on the **timespan considered**, and the consistency of any tax with the ability to pay principle.

Who is the Taxpayer

- EU is targeting excessive profits only when they are originating from some selected sources. This is a sort of built-in discrimination whose consistency with the EU fundamental principles can be defended only according to the extraordinary situation of distress Europe is experiencing.
- Consequence: namely the necessity to define such a sector. ***Petroleum, natural gas, coal and refinery sectors****.*
  - Reference to “extractive business”;
  - All those who carry out activities of organization and management of platforms for the exchange of electricity, gas, environmental certificates (ETS) and fuels are excluded, as well as small and micro-enterprises engaged in the retail trade of automotive fuel;
  - There are many others that are **indirectly involved** and yet have seen their revenues increase impressively in the latest months
    - *This would be the case of the business which provides services or goods necessary to perform extractive activities, or to transfer the gas to other states either via ships or via pipelines. On the top of this there are all the companies providing maintenance to the infrastructure and providing consultancy.*
- The generic definition of the oil and gas sector shall <u>allow each member state to shape the windfall tax differently,</u> in order to expand or reduce the scope of the tax.

Continued: the permanent establishments

- Resident **companies and permanent establishments** are the taxpayers.
- What about the Group taxation ?
- The Regulation doesn't say more than companies and permanent establishment, so it’s supposed to leave to all the Member State the choose in order to tax all companies or only the permanent;
- Italy, in the first step of the Windfall Tax, in the Circular 22/2022 of the Italian Tax Authority, provided:
- *“… in case of a VAT group the windfall tax is charged on each of the companies members to a VAT group, provided they exercise one or more of the relevant activities”*.

Transfer Pricing and Windfall Profits Taxation?

- National taxes (i.e., income taxes) must expressly refer to the discipline of Transfer Pricing for this to be applicable (e.g. tax on production activities in the country of the case);
  - The Windfall Profits tax doesn’t mention Transfer Pricing.
    - Can we say it isn’t applicable?
- According to the purpose of the tax, solidarity contribution, it may be reasonable to extend its application.

A “New” Paradigm of Progressivity

- Windfall Tax is applied on the taxable profits (in Italy it is applied on the same tax base for direct taxes).
- Can now consider that companies taxation has become progressive ?
- Yes because: who has more is called to pay more.
- No because:
  - The Windfall Tax is charged for one year;
  - It Is introduced only for certain companies in a determined sector.
  - The tax is applied “*una tantum*” and due to the extra profits made in a special condition of the market. The same companies could lose a lot of profits in the years after (like banks in the financial crisis of 2008).

Conclusions

- **Is it possible to stabilize the Windfall Tax?**
  1. It is necessary to clearly define what is meant by extra profit;
  2. A precise tax base must be established;
  3. The applicability must be extended to all companies and not just to some;
  4. It is necessary to justify the tax.

- **Is it recommended to stabilize the Windfall Tax? It depends on …**
  1. The approach that countries have to the market;
  2. The rights and freedoms granted to companies;
  3. The social objective to be pursued;
  4. Whether the extra profits are seen as something extra, or if they are inherent in the business activity.

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Thanks for your attention

Anna.miotto@unibg.it

Elena.briguglio@unibg.it