Tax Competition and EU Law
Pinto, C.

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CHAPTER 3 - EC STATE AID RULES AND MEMBER STATES' (HARMFUL) TAX COMPETITIVE MEASURES

3.1 Introduction

This chapter focuses on the EC Treaty provisions on state aid and their application to the area of direct taxation. As emphasised above (see Chapter 2, especially at 2.3.4 and 2.3.5), these provisions are fundamental for the correct functioning of a common market without distortions of competition caused by Member States' behaviour in the form of selective aid to certain market agents or to certain sectors of the economy. Given the broad powers conferred on the Commission in case of their breach, the state aid rules constitute the most effective legal tool against harmful tax competition. As the majority of Member States' tax incentives are caught by these rules, it is important to analyse them at length as compared to the other Treaty provisions potentially applicable in this area (see in Chapter 2), also in the light of the recent initiatives undertaken by the Commission and its large scale investigation initiated in 2001 with regard on a number of such (harmful) tax incentives.

The analysis of the Treaty state aid rules as applicable in the direct tax area is no easy task. The main reason is that direct tax policy pursues a number of fundamental objectives, economic as well as social, which in some cases justify certain (special) tax measures even if in principle they do fall within their scope. This causes several interpretative issues in this respect and also explains why adopting a common approach to deal with harmful tax competition based on other Treaty provisions (e.g. Arts. 94 and 95(2) or Art. 96, see in Chapter 2) would be preferable to the piecemeal approach currently adopted by the Commission, which, although based on the systematic application of these rules to the various (harmful) tax incentives offered by Member States, may also lead to inconsistent treatment and ultimately to undesirable results.

This chapter first clarifies the concept of state aid and its significance in the EU by reference to the latest available data and policy trends in this area. A general analysis of the EC Treaty provisions on state aid follows, with regard to both their substantive and procedural aspects. It then specifically deals with fiscal state aid, referring to relevant Commission decisions and ECJ case law. The second part of the chapter will focus on the more recent developments on the application of the (fiscal) state aid rules.

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1 This chapter is based on my paper EC State aid rules and tax incentives: A U-turn in Commission Policy?, published in 38 European Taxation, 8/1999, p. 295 (Part I) and 38 European Taxation, 9/1999, p. 343 (Part II).
2 See, in general on this point, the article by the EU Competition Commissioner (and formerly the Commissioner of the Internal Market involved in the approval of the Code of Conduct, see Chapter 1 at 1.4.3 and Chapter 4, Section 4.2) M. Monti, How state aid affects tax competition, EC Tax Review, 4/1999, p. 208.
3 Please note that the analysis in this chapter is limited to the EC Treaty and does not cover the impact of other legal rules such as those laid down by the World Trade Organisation’s GATT (i.e. General Agreement on Trade and Tariffs), GATS (i.e. General Agreement on Trade and Services), and TRIPS (i.e. Agreement on Trade Related Aspects of Intellectual Property Rights), which are outside the scope of this research. For an analysis of state aid in the EU in the light of these provisions, see e.g. R. H. C. Luja, WTO agreements versus the EC fiscal aid regime: Impact on direct taxation, 27 Interfax, 6-7/1999, p. 207; R. H. C. Luja, Anti-tax-avoidance rules and fiscal trade incentives, 28 Interfax, 6-7/2000, p. 226; R. S. Avi-Yonah, Tax, trade, and harmful tax competition: Reflections on the FSC controversy, Worldwide Tax Daily, 2000, 29/11/2000, 243-18.
against harmful tax competition, starting with the Irish corporation tax case, followed
by the “Notice on the application of the state aid rules to measures relating to direct
business taxation” (hereinafter: “Notice” or “Notice on fiscal state aid”)\textsuperscript{4} and the
Guidelines on national regional aid (hereinafter: “Guidelines” or “Guidelines on
national regional aid”)\textsuperscript{5} released by the Commission in 1998, and concluding with the
Commission 2001 large scale investigation targeting Member States’ potentially
harmful tax regimes. The final synthesis contains some closing comments on the
Commission effort, as well as a critical outline of the main principles of fiscal state aid
inferred from its practice and documents and from the ECJ case law and their
appropriateness in the fight against harmful tax competition.

3.2 What is State aid?

3.2.1 Overview of the concept of state aid within the EU

In short, state aid within the meaning of EC law encompasses any transfer of public
resources from the government to a specific recipient or to several recipients. This
definition implies: (i) a cost or a loss of public funds to the government granting the
aid, and (ii) a corresponding accrual of wealth to its recipient(s). One might wonder
why state aid matters and why EU institutions need to monitor it. As already
mentioned (see Chapter 2, at 2.3.4 and 2.3.5), the main reason is that aids granted by
governments affect the forces of free competition inherent to open markets because
the firms, sectors, or regions benefiting from them are put in a comparative
advantage with respect to those not benefiting from them.

However, from an EU perspective a distinction also needs to be drawn between state
aids which distort trade and competition but nonetheless have an underlying
desirable justification from an economic and/or a social point of view and those
which lack such a characteristic. More specifically, aids granted to firms that invest in
a particularly depressed area of the country granting them may be considered
acceptable because the harm to the interplay of free competition is fully offset by the
benefits brought about by them, namely the likely development of the area
concerned, which is one of the EU fundamental objectives. The same goes for an aid
granted to a big firm in financial difficulty, because the need to preserve employment
may be important enough to justify the distortion of competition caused to the
detriment of the other firms involved in the same business. The situation is different,
however, where the aid granted in a depressed area is not linked to its handicaps and
unlikely to boos development or employment therein, or in the latter example where
the aid to the same big firm is not accompanied by a viable plan of financial
restructuring and by reasonable deadlines to implement it so as to restore free
competition as soon as possible. In these cases, aid must be considered undesirable
for the internal market as well as arbitrary, because State funds are likely to bring
about misallocation of economic resources and distortion of competition without a
counterbalancing interest deserving to be pursued at EU level.

\textsuperscript{4} The Notice was released on 11 November 1998 and was published in OJ C 384 of 10 December 1998, at 3. For a
thorough explanation of the Notice, see in Section 3.6.

\textsuperscript{5} The Guidelines were published in the OJ C 74 of 10 March 1998, at 9, are effective as from 1 January 2000. For a
thorough explanation of the Notice, see at 3.7.2.
The issue of state aid has been assuming an increasing importance in the EU over the years along with the increasing liberalisation of the common market: the more integrated the European economy and the less the alternative policy instruments available to the Member States to protect their domestic economy (i.e. mechanisms linked to exchange and interest rates), the more important a balanced control the granting of state aids becomes in order to preserve undistorted competition in the internal market. This is even more true in the direct tax area, which is the last effective policy tool likely to have a significant impact on the behaviour of the internal market actors (see Chapter 1, especially sections 1.1 and 1.2).

A key year in the history of state aid within the European Union is 1985, when the Commission pointed out the necessity of categorising the different kinds of aid systematically and of using an effective method to quantify the amounts of aid granted by Member States. The reason behind this need was the sharp increase of state aids in the previous decade and of disputes and cases brought before the Court of Justice. As a result, the Commission periodically started publishing analytical Surveys on State Aid containing extensive data on the aids granted by Member States in the different sectors of the economy broken down into categories based on their form, objective and beneficiaries. Another fundamental publication (also) dealing with state aid are the Reports on Competition Policy, released every year by the Commission and containing the main policy and legislative developments (also) in state aid matters, with references to most important ECJ cases.

3.2.2 Categorisation of state aids by form

State aid involves financial support granted by a government to a certain sector, enterprise or region through a direct or indirect transfer of resources. The practical mechanisms to which governments resort for this purpose may vary as there are countless forms available to them (see also Chapter 1, at 1.1.2). The ultimate choice depends mainly on their political and procedural expediency as well as on their perceived effectiveness. In this regard, a chief distinction is the one between aids accorded through subsidies and aids granted through tax expenditures. In short, the former are grants and awards directly transferred to the beneficiary(ies): they are included in the annual budget approved by a country’s parliament and thus are transparent and quantified (or quantifiable) in advance. The latter consist of a reduction of the tax burden achieved by way of special tax rules that deviate from a country’s general tax system: they are often implemented directly by governments and are therefore non-transparent and not easily quantifiable. With regard to the concrete forms of state aid, as it would be impossible to describe or even mention all

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7 The Commission Surveys on State Aid in the European Union constitute the richest and most comprehensive source of information in this area and are often relied on and referred to throughout this chapter. The first Survey was released in 1988 and covered the period 1981-1986, and has been updated every two years since. The latest survey released by the Commission is the Ninth Survey on State Aid in the European Union, COM (2001) 403 final, Brussels, 18/7/2001, covers the period 1995-1999, and is available at http://europa.eu.int/eur-lex/en/com/cnc/2001/com2001_0403en01.pdf.

of them it is convenient to group the similar ones together according to objective parameters. For this purpose, the categorisation used by the EU Commission in its annual *Surveys on State Aid* seems the most appropriate and will be followed. Four broad categories of aid have been singled out, mainly based on the distinction between subsidies and tax expenditures. The first category, broken down in two subcategories, contains: a) direct grants awarded by the government, which are included either in the budgetary law or in the social security legislation of that country; b) a number of tax incentives and other forms of relief granted via the tax system. Examples of measures falling into this category are interest subsidies, reductions in social security charges relating to new employment schemes or R&D activities (subcategory a)), and exemptions and tax credits (subcategory b)). The distortive element of state aids of this type, which results in strengthening the financial position of the recipient firms as compared to their competitors, is self-evident and needs not be commented on further.

The second group of state aid measures concerns state-owned companies, which receive capital injections in the form of equity participation by the government necessary to undertake a certain investment or to cover losses incurred in their business activity. It is often difficult to distinguish between legitimate injections granted pursuant to an independent economic decision taken by the government and supportive measures lacking a genuine economic basis and whose main effect is an unfair distortion of normal competition conditions. The criterion used by the Commission for this assessment is the so-called “private investor principle.” This requires a comparison of the governmental decision with the behaviour of a private investor in the same (or similar) situation: if the latter would have undertaken that same investment by acquiring an equity participation on the same conditions, then the measure adopted is not deemed to constitute state aid, and vice versa.9 The third category of state aid measures is also broken down into two subcategories. The first regards so-called ‘soft’ loans, i.e. loans granted at an interest rate lower than the market rate, and ‘participatory’ loans, whose favourable terms can be agreed upon in several ways between the beneficiary and a State, such as flexible repayment schedules or advances repayable only in case of positive results of the underlying business activity financed. The distortion in these cases lies in the low cost of borrowing enjoyed by the recipients as compared to the higher market cost borne by competing enterprises to finance their investments. The second subcategory encompasses various forms of tax deferral, which may be granted through several tax provisions concerning for instance the formation of tax-free provisions, accelerated depreciation, deferment of payments of taxes due and the like. In this case, the competitive advantage enjoyed by the benefited firms is the postponement to a later fiscal year of their tax liability, which leads to higher after-tax investment returns in terms of net present value.

The last group of aid measures includes State guarantees in favour of certain enterprises. Such guarantees may be provided either through transfer of grants directly to the recipients or through a commitment to repaying the underlying debt in

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case of their failure to do so. This form of aid is characterised by a low degree of transparency and is used mostly to help the rescue or restructuring of enterprises in financial distress. In these instances there is a need to balance the conflicting interests of preserving the free interplay of competition between favoured and non-favoured enterprises, on the one hand, and of trying to rescue companies with a high number of employees and an important influence on the economy of a certain country or a certain area, on the other hand, which the Commission has tried to balance in specific documents issued in this respect.10

3.2.3 Categorisation of state aids by objective

The categorisation of state aids by objective is meant to group together the various forms of aid based on their goals and is fundamental not only from a theoretical point of view, but also from a legal point of view, as will be seen below in this chapter (see section 3.3). Once again, the Commission’s classification laid down in its Surveys on State Aid in the EU will be relied upon for this purpose.

A first category is referred to as ‘sectoral’ aid and encompasses measures adopted by Member States for the purpose of stimulating investments or helping the development or the restructuring of certain sectors of the economy. Their main feature is that they are usually available for all of the enterprises engaged in the aided sector. Consequently, this kind of aid does not distort free competition within the sector concerned, but does affect competition between companies engaged in the benefited sector and those engaged in other sectors of the economy. Examples of sectoral aid are favourable measures granted to the agricultural, fishing, shipbuilding, coal, steel, transport, forestry, textile, synthetic fibres and motor vehicle sectors.11

A second category is constituted by ‘horizontal’ aid, whose object is to pursue specific goals of domestic and/or international policy. The chief characteristic of this aid is that it is available to all the enterprises with respect to a certain function of their business activity and is meant to stimulate certain activities regardless of the line of business the aided firms are engaged in. For instance, aids granted to boost employment, R&D activities, environmental protection and energy savings in production processes fall into this category.12 The threat to the normal interplay of free competition lies in that some enterprises may be able to take advantage of these measures more than their competitors because their activity relies to a larger extent on the aided business function. Examples are R&D incentive schemes, which benefit mainly the pharmaceutical industry, or companies engaged in the manufacture of innovative products and/or in the provision of highly specialised services. The same goes for employment incentives, which are likely to wind up favouring companies relying mostly on the labour factor in their economic activity, whereas capital-intensive companies may not be able to exploit the aid to the same extent.


11 The Commission has published several documents on sectoral aid. For their most recent version, see the Commission Competition web site: http://europa.eu.int/commission/dg04/aid/index.htm. See also European Commission, Competition law in the European Communities, Volume II A - Rules applicable to State aid, Brussels - Luxembourg 1999.

12 The Commission documents on horizontal aid are available in the same sources cited in the previous footnote.
The last category is that of ‘regional’ aid, which encompasses favourable schemes granted by States to boost the development or the employment of certain depressed areas within their territory. Regional aids are usually available for all of the enterprises operating in the area concerned irrespective of the business activity carried on, but may also be limited to certain sectors of the economy whose development is felt necessary to be encouraged in that area. This category of aid brings about discrimination between enterprises operating within the assisted area and those operating outside that area. In these cases there is the need to weigh the conflicting interests concerning the desirable goals of helping the development and/or employment in certain poor areas and, on the other hand, the need to avoid distortions of competition unrelated to the local handicaps (see also at 3.3.2 and in Section 3.7).

### 3.2.4 Significance of state aid in the EU and recent policy trends

The significance of state aid in the EU is shown by the latest data available on its amount as shown in the Commission *Ninth Survey on State Aid*. In the period 1997-1999, it appears that Member States spent on aggregate an overall € 90 billion, down from € 102 billion in the previous period 1995-1997, but still representing an astounding figure. The (rail) transport and the manufacturing sectors were the most favoured recipients of this aid, with € 32 and € 27.6 billion respectively. Furthermore, also the amount of aid as a percentage of GDP went down from 1.43 in the period 1995-1997 to 1.18 in the period 1997-1999, as did aid as a percentage of total government expenditure from 2.82 to 2.44.

As for the amount of aid broken down by form, the Commission *Ninth Survey on State aid* provides interesting figures concerning the distinction between budgetary expenditures and tax expenditures (i.e. fiscal state aid) handed out in the form of tax exemptions, credits, deferrals etc. (see at 3.2.2). While most Member States appear to prefer the more transparent budget expenditures to finance state aid (i.e. Austria and Spain entirely and Greece 99% of the aid), a minority of Member States prefer (i.e. Ireland with 60%) or substantially resort to (i.e. France with 47% and Italy and Denmark with over 30%) tax forgone to finance their aid. Another interesting finding is the prevailing amount of ‘regional’ aid, representing 56% of the total, versus ‘horizontal’ aid, equal to 34%, and aid to particular manufacturing sectors, accounting for 7%. In this latter respect, it is worth noting that the *Survey* specifically takes into account the Irish fiscal state aid in the form of the ‘manufacturing relief’ (see its explanation in Section 3.5), which is considered ‘sectoral’ aid as available to the whole manufacturing sector and represents a staggering 56% of the whole aid granted by Ireland.

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14 See the Commission *Ninth Survey on State aid*, cit., Table 2 at 22.

15 See the Commission *Ninth Survey on State aid*, cit., Table 3 at 23.

16 See the Commission *Ninth Survey on State aid*, cit., Table 21 at 50, and Figure 8 at 51.

17 See the Commission *Ninth Survey on State aid*, cit., Table 8 at 33.
These figures must also be evaluated from a state aid policy perspective pursued by the EU. The chief objective meant to rationalise the system is the reduction in the amount of state aid by Member States, both in its overall level and as a proportion of GDP. This is necessary to cause as little distortion to competition in the internal market as possible and ultimately to pursue the ambitious goal to make the EU the most competitive economy in the world by the year 2008. This policy is also consistent with the more general EU policy to justify government intervention only to the extent necessary to prevent or correct market failures and/or to encourage economic development and employment in depressed areas. Moreover, the reduction of the overall level of state aid is consistent with the EMU policy meant to get EMU States to maintain sound public finances so as to comply with the parameters of the 'Stability and Growth Pact' (see Chapter 2, section 2.5).

Another EU key policy goal in this area is modernisation, which is reflected in a number of new documents containing specific rules for horizontal, sectoral, and regional state aid issued by the Commission to keep up with the changed economic and social environment in the EU or to lay down consistent principles in areas previously not dealt with in any specific document. Linked to this is the objective of increased transparency in the administration and application of the Treaty state aid rules, which aims at facilitating the understanding of the state aid system and raising the awareness for the need of central control, at making readily available information on the Commission decisional process and the corresponding Member States' reaction, and ultimately at promoting exchange of information and experience in the state aid policies in various the Member States. A result of this objective was the creation of the State Aid Register, containing summary information on all state aid cases as well as relating Commission decisions where available, and of the State Aid Scoreboard, containing updated information on the levels of state aid in the last ten years and on domestic and EU policies in this area. Lastly, the EU state aid policy is geared towards an increased monitoring of the Commission decisions, mainly their application and enforcement by the addressees Member States, which reflects the powers of this body as the “guardian of the Treaty” (see also at 3.3.4).

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18 The recent policy trends are outlined in the Commission Ninth Survey on State aid, cit., at 18 ff., as well as in the latest Commission 2001 Competition Policy Report, cit., at 75 ff.
20 For instance, this is the case with regard to the three Regulations on training aid (Regulation (EC) No. 68/2001, OJ L 10 of 15/1/2001), on the codification of the de minimis rule (Regulation (EC) No. 69/2001, OJ L 10 of 15/1/2001, see also below at 3.3.1), and on the exemptions for aid to SMEs (Regulation (EC) No. 70/2001, OJ L 10 of 15/1/2001), adopted by the Council on the basis of Art. 89 of the Treaty (see at 3.3.3).
21 This is the case for instance of fiscal state aid, which was thoroughly addressed for the first time in the Commission Notice on fiscal state aid, cit., explained in detail in Section 3.6.
22 The State Aid Register is available at http://europa.eu.int/comm/competition/state_aid/register/ and features searches of state aid cases and pending proceedings based on the aid type, instrument, or sector of the economy, or on the Member State concerned.
23 The State Aid Scoreboard is also available on the Internet at the address http://europa.eu.int/comm/competition/state_aid/scoreboard/. The Scoreboard also features a forum on Member States' policies and their compliance with the State aid provisions, and in general the State aid policy in the internal market and the relationship between domestic aid granted by EU countries and other government expenditures. On the State aid Register and Scoreboard, see also R. Joels, Two new transparency instruments: the State Aid Register and the State Aid Scoreboard, Competition Policy Newsletters, October 2001, No. 3, p. 64.
3.3 EC Treaty rules on State aid

3.3.1 Basic substantive law on state aid: Art. 87(1)

The fundamental rules on the granting of state aid within the EU are contained in Arts. 87-89 of the EC Treaty. As explained above (in Chapter 2, especially at 2.2.1, 2.3.4 and 2.3.5, and above in Section 3.2), the state aid provisions are expression of the fundamental Treaty rules contained in Arts. 2 and 31(g), as they are meant to safeguard the correct functioning of the common market by ensuring free competition among enterprises and preventing Member States from distorting it with their behaviour. The basic substantive rules are contained in Art. 87 of the Treaty, whose first paragraph reads:

"Save as otherwise provided in this Treaty, any aid granted by a State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market."

As this provision is not comprehensive, its interpretation and practical application have been clarified over the years through instruments of secondary EC law and other Commission documents as well as the case law of the ECJ. The first step is to explain the meaning of the term "aid", which is not specified in Art. 87(1). The simplest definition is found in the Commission Surveys on State Aid, where this concept is defined as "any measure representing a cost or a loss of revenue to the public authorities and a benefit to the recipient." The merit of this definition lies in its conciseness and simplicity as well as in its all-catching character. In fact, it summarises the concept of aid as elaborated in a slightly more complex way by the ECJ, which refers to any advantage received by firms through a transfer of resources without payment and a corresponding expenditure or lack of revenue for the state concerned. From the wording of Art. 87(1), it follows that four conditions need to be met for a measure to be considered state aid within its scope:

i) An advantage conferred to a firm or firms,

ii) from state-originated resources,


25 See Case 61/79, Amministrazione delle Finanze dello Stato v. Denkavit Italiana Srl, [1980] ECR 1205, 1235; Case 82/77, Openbare Ministeries v. Jacobus Philippus van Tiggele, [1978] ECR 25, 52, and Case 9/70, Frans Graal v. Finanzamt Traunstein, [1970] ECR 825, 853. The ECJ has also repeatedly made clear that the concept of aid is broader than that of subsidy "because it embraces not only positive benefits" but also interventions which, in various forms, mitigate the charges that are normally included in the budget of an undertaking and which would "be similar in character and have the same effect" (see e.g. Case 30/59, De Gesamenlijke Steenkolenmijnen in Limburg v. High Authority, [1971] ECR 1, para. 19).
causing a distortion of competition and having an impact on intra-Community trade, and

having specific or selective character, i.e. concerning certain undertakings or the production of certain goods.

Firstly, a measure must confer an advantage on a specific undertaking or an unspecified group of undertakings fulfilling certain conditions. Such an advantage must consist of a certain relief from the charges normally applied to the benefited undertakings without a counterbalancing charge proportional to the alleviation granted.\(^{26}\) The advantage in question may be granted in “any form whatsoever”: therefore, all the different kinds of aids described above which fall in the two broad categories of subsidies and tax expenditures (see at 3.2.2) can constitute state aid.

The second criterion is that the advantage be granted out of resources directly or indirectly provided by the State. The origin of the transfer may be the central government or any local government, as well as any other public or private agency directly or indirectly controlled by the State.\(^{27}\) Sometimes, it may be hard to figure out whether in a given case this criterion is satisfied: for instance, the ECJ has held that lax behaviour of a state in enforcing its legislation is equivalent to a transfer of state resources (see also at 3.4.6).\(^{28}\)

The third test is composed of two sub-tests: an aid measure must (i) distort or threaten to distort competition, and (ii) affect EU trade between Member States. Sub-test (i) catches measures that confer an advantage on the recipient undertaking(s) vis-à-vis their competitors in such a way as to improve the recipient’s rate of return on his investment in relation to Community competitors not benefiting from such aid.\(^{29}\) Under the recent Regulation on \textit{de minimis} aid, this requirement is not deemed met and thus the aid falls outside the scope of Art. 87 where its amount does not exceed \(\mathbf{\text{€} 100,000}\) over a three-year period from the date of its first granting.\(^{30}\) With respect to sub-test (ii), in principle a measure is considered to affect intra-Community trade where part of the production of the benefiting firm(s) is exported to other Member States.\(^{31}\) However, the ECJ has ruled that even an advantage to a firm which does not export its products or which exports all of its products to non-Member States may be likely to affect EU trade and be caught by Art. 87(1): as this firm still enjoys a competitive advantage in its local market over non-subsidised EU firms seeking to penetrate the same market.\(^{32}\)


\(^{28}\) See Case NN 118/97, \textit{SNIA CE SA}, referred to in the \textit{Commission XXVII Report on Competition Policy}, 1997, SEC(98) 636 final, at 67. This criterion plays an important role in the fiscal area, as will be seen at 3.4.6.


The last criterion, specificity or selectivity, is the most difficult to be scrutinised when assessing the nature of a certain aid measure. It is implied from the wording of Art. 87(1), which requires that an aid favour “certain undertakings or the production of certain goods”: this means that the advantage conferred by the State must be specific or selective in some way, with respect to either the beneficiary (i.e. “sectoral” aid), or to the activity encouraged (i.e. “horizontal” aid), or to the territory assisted (i.e. “regional” aid). The reverse application of this criterion entails that general measures are outside the scope of Art. 87(1) of the EC Treaty.33

More in general, in order to assess the compatibility of an aid measure with the Treaty its effects rather than the causes or aims pursued by the Member State through its implementation must be evaluated. In other words, what counts to establish whether this measure falls within Art. 87(1) is the objective aspect of its conferring an advantage to one or more recipients on the basis of the actual effects on the internal market and not the subjective aspect linked to the State’s (policy) objectives, which are irrelevant at this stage.34 Based on this, if a state aid meets all the said four conditions, the basic rule contained in Art. 87(1) is its incompatibility with the Treaty. Incompatibility means that, as a matter of principle, such aid is in breach of EC law and must therefore be abolished by the Member State concerned or amended in such a way to be compatible with the Treaty.

3.3.2 Exemptions from the incompatibility principle and “regional” aid

The general principle of incompatibility contained in Art. 87(1) does not imply an absolute prohibition of all the aid measures implemented by the Member States. As aid may sometimes be desirable because it is inspired by social and/or economic policy objectives pursued by Member States that bring about positive effects in the EU, there may be in these cases a reasonable justification to tolerate it despite its ability to distort intra-Community trade. The need to balance these conflicting interests has led to the introduction in paragraphs 2 and 3 of Art. 87 of certain exemptions from the incompatibility principle laid down in paragraph 1. In all these cases not only the effects of the state aid measure must be taken into account (i.e. its objective consequences), but also the causes and aims underlying its introduction (i.e. the subjective aspect), which therefore is able to justify its granting. Art. 87(2) contains a set of automatic exemptions under which aids having the required features are always deemed to be compatible with the common market: they are referred to as ipso iure exemptions.35 This provision covers “aid having a social character”, “aid to make good the damage caused by natural disasters”, and “aid granted to the economy of certain areas of the Federal Republic of Germany affected

33 However, aid measures which, although failing to meet the specificity criterion, are considered general but nevertheless cause a distortion to the internal market might still be prohibited under Art. 96 (or 97) of the Treaty: see Chapter 2, section 2.4.
34 See e.g. Case 173/73, Italy v Commission (i.e. Italian textiles case), [1974] ECR 709, paras. 26-28, and Case C-241/94, France v Commission, [1996] ECR I-4551, paras. 19-20. This conclusion is true with regard to the general application of Art. 87 (1), whereas the policy goals pursued by a country through the granting of aid do bear relevance e.g. for the application of the exemptions contained in Art. 87 (3), or, in the fiscal state aid area, for the potential applicability of justifications (see at 3.3.2, 3.3.4, and 3.6.4).
35 See, for an explanation of the ipso iure exemptions and of the discretionary ones discussed infra in the text, Commission, Competition, cit., at 10 ff.
by the division of Germany”, stating that they “shall be considered to be compatible with the common market” (emphasis added). In these cases, eligible state aid measures are subject to a mere control by the Commission on the existence of the required characteristics, without any discretionary assessment left to this body. On the other hand, Art. 87(3) contains a set of exemptions that do not apply automatically, but require an analysis by the Commission involving extensive discretionary powers (on this, see at 3.3.4). This is reflected by the different wording of this paragraph, which covers state aid that “may be considered to be compatible with the common market” (emphasis added).

The discretionary exemptions relevant to the fiscal area are contained in subparagraphs (a) and (c) of Art. 87(3), which deal with “regional” aid measures. The practical application and interpretation of these exemptions has been left to the Commission, which has published several documents so as to provide legal certainty and to ensure transparency and equality of treatment for Member States and interested parties. Generally speaking, the Commission’s policy is to narrow the scope of these exemptions in accordance with the general rule of incompatibility in order to limit as much as possible the distortions to competition within the EU market, given their exceptional character. The most important policy documents in this respect has been the “Communication on the method of application of Art. 92(3)(a) and (c) [i.e. now Art. 87(3)(a) and (c)] to regional aid”, first released in 1988 (hereinafter: “1988 Communication”) and applicable up to the year 1999. With effect as from the year 2000, the Guidelines on national regional aid released in 1998 have replaced the 1988 Communication. This paragraph analyses the 1988 Communication due to its relevance on case law for over a decade and its influence on the 1998 Guidelines, which will be explained at length below (see Section 3.7, especially at 3.7.2).

Starting with Art. 87(3)(a), it covers “aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment.” In general, the Commission considers that “regional” aid is intended to promote or facilitate the economic development of certain areas where it is likely to bring about a lasting improvement in the conditions of the region involved. Consequently, where the effects of the aid measure are only be temporary and the structural situation of that region is not likely to be much more different from that prior to its granting, the aid in question will not meet this test and will be considered incompatible with the common market. As to the regions qualifying under this exemption, the 1988 Communication considers areas which suffer from a standard of living abnormally low and/or from serious underemployment to be those having a GDP/PPS ratio lower than 75% of the average EU index over the last three years.

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36 Para. 2 of Art. 87 will not be analysed further because its importance with respect to the fiscal area is very limited.


38 GDP is the Gross Domestic Product; PPS is the Purchasing Power Standard and is based on a comparison of the prices in the Member States on the same sample of products and services (see the 1988 Communication, I, 1, at 2). It is worth noting that the index of the area must be lower than 75% of the average standard of the EC, rather than that of the national average, as required for the application of the Art. 87 (3)(c) exemption (see below in the text).
The second exemption dealing with regional aid is contained in Art. 87(3)(c), which covers “aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.” By and large, the Commission considers that regional aid is not contrary to common interest where it can be shown that the region concerned suffers from difficulties that are relatively severe by Community standards. Furthermore, it must be apparent that without the aid the market forces would not eliminate these difficulties and that the granting of aid does not unduly distort competition in particular sectors. On top of that, the Commission requires that the aid be necessary to achieve one of the objectives set out in the Treaty and that a compensating benefit to the Community be present in the aid measure.

As for the specific method of assessment on whether the social and economic disparities of the region concerned are serious enough to consider acceptable regional aid, it is based on two stages relying on specific economic indicators contained in the 1988 Communication. Stage one requires that specific thresholds, set for each Member State in order to prove that there is a national disparity between the subsidised region and the rest of the country, be met by the aided area. The basic thresholds are:

- GDP/GVA of the region must be 85% or lower than national average;\(^{39}\) and/or
- structural unemployment of the region must be higher than 115% of national index.\(^{40}\)

Stage two of the Art. 87(3)(c) application method makes it possible to take into account further indicators that are potentially able to prove deep economic and social divergences existing between the regions concerned and the rest of the country.\(^{41}\) As a consequence, Member States can prove that a certain area, although not meeting the thresholds required by stage one, nevertheless needs to be aided due to its low development or high unemployment evidenced by these other factors.\(^{42}\)

Based on the above methods, the Commission regularly publishes a list of regions of each Member State qualifying under the exemptions laid down in Art. 87(3)(a) and (c), the latest having been published for the period 2000-2006.\(^{43}\)

3.3.3 Procedural rules for the granting of state aid: Art. 88 EC Treaty

The general substantive principle of incompatibility of state aids with the Treaty requires a careful scrutiny by the Commission as to whether such aids are caught by the ban of Art. 87(1) and, if so, whether they are covered by any of the Art. 87(2) exemptions or may be approved on the basis of paragraph (3) of Art. 87. The basic

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\(^{39}\) GDP stands for Gross Domestic Product; GVA stands for Gross Value Added.

\(^{40}\) It is worth noting that these thresholds are adjusted for each Member State so as to take into account the different needs and contingencies of specific areas within the countries concerned.

\(^{41}\) Some of the indicators listed in the 1988 Communication are: trend and structure of unemployment, development of employment, net migration, youth unemployment, GDP per employee, growth of investment, and political situation.

\(^{42}\) This is especially true where the stage-one thresholds have not been met for insignificant percentile differences or where there are special characteristics of the area not reflected in the economic parameters used in stage one.

\(^{43}\) The latest news on the final maps of areas entitled to receive aid under Arts. 87 (3)(a) and Art. 87(3)(c) under the 1998 Guidelines (see at 3.7.2) and also valid for the grants out of the Community “Structural Funds”, are contained in the Commission Reports on Competition Policy (see e.g. the 2000 Report cit., at 79), and the Commission Surveys on State Aid as well as on the Commission web site http://europa.eu.int/comm/competition/state_aid/regional/.
procedural rules for the granting of state aid are contained in Art. 88 of the Treaty. More detailed rules are laid down in the Regulation 659/1999, approved on the basis of Art. 89 of the Treaty to codify the Commission practice and the ECJ case law in this area.

A fundamental distinction must be made between "new" (or planned) aid and "existing" aid (see also Art. 1 of Regulation 659/1999). The former is governed by the rules contained in Art. 88(3), which states that "the Commission shall be informed ... of any plans to grant or alter aid" and that "the Member State concerned shall not put its proposed measures into effect". After the mandatory notification of the new aid by the Member State concerned, the Commission must review the planned measure and assess its compatibility with the Treaty within two months from the notification. The outcome is then laid down in a decision, which may be either positive (in which case the Member State may grant the aid), or negative. In the latter event the procedure provided for by Art. 88(2) will be initiated (see especially Arts. 2, 4 and 5 of the Regulation 659/1999 and below).

If a Member State fails to notify a new aid in accordance with Art. 88(3), this "non-notified" aid is unlawful or illegal. This means that if the Commission then finds that aid incompatible with the common market, the Member State concerned will be forced to recover the aid from the recipient(s), and, in addition, to require interest payments from the day the aid was handed out so as to restore the situation altered by its concession. Should the Commission consider the measure compatible with the common market, then the beneficiaries would be entitled to keep the benefits previously granted to them (see Arts. 10-15 of Regulation 659/1999.) Art. 88(3) is considered by the ECJ to have direct effect: this implies that in case of failure by a Member State to submit the required notification, any domestic court has the power to enforce directly this provision by declaring the aid in question unlawful and by taking the necessary remedies under national law. However, the substantive assessment on the compatibility of the aid with the Treaty under Art. 87 may only be carried out by the Commission, because this latter provision does not have direct effect and thus may not be applied by domestic courts.

As opposed to new aid, "existing" aid includes both measures that have already been approved by the Commission and those introduced before the ratification of the EC

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45 See Council Regulation (EC) No. 659/1999 of 22 March 1999 laying down detailed rules for the application of Art. 93 (i.e., now Art. 88) of the EC Treaty, OJ L 83, 27/03/1999, p. 1. As mentioned in the text, this regulation is based on Art. 89 (ex Art. 94) of the Treaty, which reads: "The Council, acting by a qualified majority on a proposal from the Commission and after consulting the European Parliament, may make any appropriate regulations for the application of Articles 87 and 88 and may in particular determine the conditions in which Article 88(3) shall apply and the categories of aid exempted from this procedure." This provision has recently also been used to approve the three regulations on the exemptions mentioned above (see at 3.2.4.)

46 See Art. 14 of Regulation 659/1999. It is worth noting that if there is a breach of the principle of legitimate expectations the Commission is not entitled to order the Member State concerned to recover the aid (with interest) from the recipient: see in detail at 3.3.4. As for the obligation to recover illegal aid in case of a subsequent sale of his company or assets benefiting from the aid by the recipient, there are different rules depending on whether there is a separate sale of the assets or of the business as a going concern: see the summary in the Commission *Report on Competition Policy*, 2000, cit., at 88.
Treaty. The applicable rules are contained in Art. 88(1), which stipulates that “the Commission shall, in co-operation with Member States, keep under constant review all systems of aid existing in those States” (see also Arts. 17-19 of Regulation 659/1999.) This monitoring power is conferred on the Commission in order to ensure that the aid measures previously approved are still compatible with the common market and are applied consistently by the Member State concerned, especially in cases in which the Commission approval had been made subject to the fulfilment of some conditions (see below). Where the Commission finds that an existing measure no longer satisfies the principles of Art. 87 EC Treaty, it may issue a recommendation containing proposals concerning the aid in question, and in case of non-compliance by the Member State it may undertake the procedure provided for by Art. 88(2).

Turning to this procedure, Art. 88(2) reads:

“if, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State ... is not compatible with the common market having regard to Art. 87,... it shall decide that the State concerned shall abolish or alter such aid ... and, if the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may refer the matter to the Court of Justice direct.”

The Art. 88(2) procedure is made up of several steps that depend on the outcome of the Commission’s assessment of the planned aid (see also Arts. 4 and 6-7 of Regulation 659/1999). As mentioned above, it may be initiated either upon notification of a new aid by a Member State under Art. 88(3) or upon a review of an existing aid by the Commission under Art. 88(1), which is started on its own initiative or as consequence of a denunciation by other Member States, private parties or indirect sources (e.g. news released by the press). The first step is a request for clarification to the Member State concerned to be forwarded within fifteen days from the notification or the review of the existing aid. After receiving this clarification, which the Member State must submit within twenty days, the Commission has a period of two months to decide whether to continue the procedure or to decide not to raise any objection to the aid measure. This phase of the Art. 88(2) procedure ends with the issuance of a “Notice” (i.e. an “invitation to submit comment”) published in the Official Journal. If the two-month period has elapsed and the Commission has not issued a notice, the Member State concerned is entitled to implement the aid measure because this behaviour is equated with a tacit approval by the Commission.

If the Commission finds prima facie the aid not compatible with the common market, it must issue a notice containing a detailed description of the measure concerned and the related grounds of incompatibility with EC law. Furthermore, it must invite the Member State concerned and the other interested parties to submit their observations and comments on that measure within a period of thirty days from the publication date. After that, the Commission starts a “formal investigation” or “administrative proceeding” concerning a more detailed assessment of the aid measure, which must be concluded within six months of the date of publication of the notice. This formal investigation culminates in a Commission decision, which is also published in the

47 On the rights of interested parties to intervene in the state aid procedure, see especially the Regulation 659/1999, Art. 20.
Official Journal. Such a decision may be positive (i.e. of compatibility of the measure with the EC Treaty), positive but subject to conditions, negative, or partly positive and partly negative. In response, the Member State concerned may either comply with its content or decide to seek its annulment before the ECJ under Art. 230 of the Treaty.

3.3.4 Commission discretion, legal nature of the Commission documents on state aid, and principle of legitimate expectations

An important issue that arises with respect to the Treaty state aid rules analysed so far regards the extent of the Commission’s discretion and powers and the related issue of the legal nature of the documents issued for the interpretation and application of such rules. As a matter of principle, the Commission has broad discretionary powers in the areas of both competition law and state aid by virtue of its role of guardian of the Treaty and of impartial and super partes body. This role stems from the Commission’s primary task to ensure the correct functioning of the internal market and the achievement of the fundamental objectives of the Treaty (see in Chapter 2, Sections 2.2. and 2.3).

From a legal point of view, in the state aid area Art. 88 (1) states that “the Commission ... shall propose to the latter (i.e. Member States) any appropriate measures required by the progressive development or by the functioning of the common market,” implying, in together with the other rules on the approval procedure (see at 3.3.3), that the Commission does enjoy discretion in the assessment of the aid character of a measure as well as in the application of the discretionary exemptions contained in Art. 87(3) of the Treaty.48 However, a distinction must be made between the application of Art. 87 (1), in which the Commission must exercise its discretion in accordance with the fundamental state aid principles laid down in the EC Treaty without arbitrarily derogating from them, and the application of the Art. 87 (3) exemptions, in which the Commission does enjoy wide discretionary powers.

This has been repeatedly confirmed by the ECJ,49 and this distinction has been clearly set out by the European Court of First Instance (hereinafter: “CFI”) in the more recent Ladbroke case:50

“It follows that the concept of aid is objective ... the characterisation of a measure as State aid ... cannot in principle justify the attribution of a broad discretion to the Commission, save for particular circumstances owing to the complex nature of the State intervention in question (Case 56/93 Belgium v Commission [1996] ECR I-723, paragraphs 10 and 11, and Case T-358/94 Air France v Commission [1996] ECR II-2109, paragraph 71). The relevance of the causes or aims of State measures falls to be appraised only in the context of determining - pursuant to Art. 92(3) [i.e. now Art. 87(3)] of the Treaty - whether such measures are

48 In this respect, it is important to point out again that there is a difference between subjective interpretation by the Commission of the term "aid" within the meaning of Art. 87(1) and discretionary power in the application of the Art. 87(3) exemptions. While the Commission's discretionary power dealt with in this paragraph specifically relates to the latter, the interpretation of the vague concept of aid is made by the Commission but is based on the judgements of, and subject to the supervision of, the ECJ.
With regard to the Art. 87 (3) (a) and (c) exemptions, in the landmark Philip Morris case\(^51\) the Court had already made clear that the Commission is entitled to a particularly wide discretion in assessing the effects and the objectives of a planned aid measure in a Community context, and this interpretation has always been followed since.

A related issue on the Commission discretion in the application of the state aid rules concerns its several documents on the concept of ‘sectoral’ and ‘horizontal’ aid as well as of ‘regional’ aid for the application of the Art. 87 (3) exemptions. These aim at making public its interpretation and methods of application of the EC state aid rules so as to ensure openness, transparency, objectivity and equality of treatment among Member States as well as among third parties and have been issued in different forms, as “communications”, “recommendations”, “notices”, “guidelines”, “codes”, “frameworks”, and “letters”.\(^52\) The main question arises as to what their legal nature is. In this respect, it must be noted that Art. 249 of the EC Treaty mentions explicitly only “regulations” and “directives” as legally binding documents that may be challenged by the Member States before the ECJ on the basis of Art. 230 Treaty: they form the so-called EC secondary law.\(^53\) All the (other) Commission documents concerning state aid are acts sui generis or “soft law” which, not being mentioned in Art. 249, do not have legally binding effect and, therefore, may not be directly challenged by the Member States before the ECJ on grounds of legality. This is a consequence of the fact that these acts merely contain policy statements explaining the Commission’s view and interpretation of the state aid rules for the sake of objectivity and openness and do not form part of EC secondary law since they lack binding force.\(^54\)

The fact that these documents sui generis are not legally binding does not mean that they lack effect altogether. On the contrary, where they are published they may be binding on the Commission because they are able to create legitimate expectations for the Member States and for undertakings: this is why they are referred to as ‘soft’ law. This entails that the general EC principle of legitimate expectations represents

\(^{51}\) Case 730/79, cit.

\(^{52}\) See, e.g. the 1988 Communication on regional state aid (above at 3.3.2), which concerns the exemptions laid down in Art. 87(3)(a) and (c), as well as the 1998 Guidelines (see below in Section 3.7, especially at 3.7.2). As to the Commission’s interpretation of Art. 87(1) and, in particular, what measures are in principle caught by the incompatibility principle, see the documents on ‘sectoral’ or ‘horizontal’ aid in section 3.2, and the Notice on fiscal state aid to be discussed at length below in section 3.6.

\(^{53}\) See, for case law concerning this point, J. Usher, Cases and Materials on the Law of the European Communities, Butterworths, pp. 83 ff. Needless to say, the recent Council regulations on the application of the state aid exemptions based on Art. 89 mentioned above (see at 3.2.4) do form part of EC secondary legislation and are legally binding towards Member States.

\(^{54}\) This has been also confirmed by the ECJ in Desfil, cit., and in Case C-313/90, Comit International de la Rayonne et des Fibres Synthetiques and Others v. Commission, [1993] ECR I-1125. On the contrary, the Commission considers that in case there is a formal agreement with the Member States on these acts sui generis, these might be considered to have binding effects, as with regard to the 1988 Communication on regional aid; see EC Commission, Competition, cit., at 13.
another limit to the Commission’s discretion in the interpretation of the state aid rules. In particular, where one of these documents sui generis has been issued and published by the Commission, the latter has to comply with its policy statements contained therein, and derogating from them results in a breach of legitimate expectations. The consequence of this breach is that a Commission decision based on criteria or principles contrary to those laid down in one of its acts sui generis may be challenged by Member States and interested parties before the ECJ on the basis of Art. 230.

The principle of legitimate expectations may not be invoked in cases in which the Commission is required to modify its interpretation or policy statements contained in its soft law due to a different (economic) situation that arose after publication which needs to be taken into account in the fundamental interest of the Community. Furthermore, expectations may only be founded on principles or criteria explicitly stated by the Commission in its published pieces of ‘soft’ law. As a consequence, if a certain situation is not expressly covered or addressed by these, no legitimate expectations may be claimed by Member States or undertakings. The principle of legitimate expectations plays a fundamental role in the recovery of state aid (with interest) unlawfully handed out by Member States in breach of the Treaty provisions. In this respect, Art. 14 of Regulation 659/1999 has codified its application by stating that “the Commission shall not require recovery of the aid if this would be contrary to a general principle of Community law.” This implies that where the Commission has erroneously applied one of its acts sui generis or has otherwise created legitimate expectations that a certain situation was not to be considered state aid, the recipients of the aid can no longer be forced to return such aid under the general rule. An application of this principle is given by the case concerning an Italian Law on the extraordinary administration of large firms in state of insolvency, which the Commission mistakenly characterised as an “existing” aid instead of a “non-notified” aid, meaning that no repayment would have been asked to the beneficiaries. As a consequence of an ECJ judgement on the same Italian Law

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56 See P. Craig and G. de Burca, EC Law - Text, Cases & Materials, at 349 ff.

57 As mentioned above, this possibility is also available where the Commission’s acts sui generis are contra legem because no discretionary power was granted to the Commission in a certain area or this power was exceeded by the act.


59 See the Deuffi case, cit., An example may clarify this aspect. If the Commission were required to assess the compatibility of a regional state aid with the Treaty, its decision might be based not only on the economic and social factors explicitly mentioned in the 1988 Communication (or the new 1998 Guidelines), but also on other factors considered relevant for the situation concerned even though not contained therein. In this case, (Member States and) interested parties might not claim a breach of legitimate expectations arisen upon the publication of the 1988 Communication just because of the absence of such a criterion in the Communication.

characterising it as a non-notified aid under Art. 87 of the Treaty, the Commission withdrew its previous decisions and changed the qualification of this Law accordingly, but by virtue of the principle of legitimate expectations was barred from ordering repayment of the aid to the recipients due to its previous mistake in the qualification of the aid.

In certain cases legitimate expectations may be entertained where the Commission has been inactive for a long time, and as a result it may not recover the aid already granted for the past. In the recent case on the Gibraltar offshore regimes, one of the arguments of the Gibraltar authorities was that the Commission had been inactive for 15 years before clarifying the concept of 'fiscal' state aid (i.e. through the Notice, see section 3.6) and subsequently opening an investigation on the Gibraltar regime. In their view, this behaviour had *inter alia* given rise to legitimate expectations that the offshore regime was compatible with the state aid rules. This was supported by the Commission handling of the Irish *corporation tax* case, in which the inactivity on the part of the Commission for almost 20 years did give rise to legitimate expectations (see in detail at 3.5). The CFI rejected the claim clarifying that "the mere fact that for a relatively long period the Commission did not open an investigation into a State measure cannot in itself confer on that measure the objective nature of existing aid, if it does constitute aid" and that "any uncertainty ... may at most be regarded as having given rise to a legitimate expectation on the part of the recipients so as to prevent recovery of the aid paid in the past. Article 15 of the regulation on state aid procedure [i.e. Regulation 659/1999] ... merely precludes recovery of aid established more than 10 years before the Commission first intervened."

### 3.4 Fiscal State aid

#### 3.4.1 Categorisation of fiscal state aid measures

Absent a universally accepted categorisation of fiscal state aid measures, it seems most appropriate to divide the various forms of state aid granted via the tax system according to the elements used to calculate the tax liability and to ensure the collection of the taxes due: (i) taxable base; (ii) tax liability; and (iii) enforcement of tax claims.

A first category of fiscal state aid includes measures that have an impact on the calculation of the taxable base. Measures having the effect of modifying the standard method of determination of the final taxable amount by affecting the calculation of any of the items taken into account for this purpose fall into this category. Examples are the granting of special exemptions of certain items of income from the tax base or of special deductions not normally available under the general tax system, the
possibility to set up special tax-free provisions or to claim special accelerated depreciation, as well as notional methods of calculation of the taxable base (e.g. cost-plus or resale-minus methods). The main problem in all these instances is that these measures are very often difficult to be detected, because they may be granted pursuant to unpublished and/or discretionary administrative practices or may be hidden within the provisions of a country’s general tax system. A second category encompasses fiscal aid measures working through a modification of the tax liability due by taxpayers. Examples are special reduced or nil tax rates in favour of income derived from certain activities (e.g. financial services or manufacturing activities) or from operations carried out in special tax-free areas. Also measures such as tax credits linked to investments in business assets have the effect of reducing the taxpayers’ final liability.

The third category concerns the actual collection of taxes due by taxpayers, which is the last stage in the governments’ revenue-raising process. In particular, every form of relinquishment by a State of its right to recover unpaid tax debts constitutes a fiscal aid measure. For example, tax enforcement of tax rules, leniency in recovery of tax claims and systematic tax debt cancellation or deferment granted by the tax authorities fall into this category. Needless to say, it is extremely hard to discover these forms of fiscal state aid, because they usually take place on a case-by-case basis and are not disclosed by the tax administration.

3.4.2 Fiscal state aid in the Commission practice and ECJ case law

By and large, the same four conditions required in general for the application of Art. 87 of the Treaty (see at 3.3.1) also apply to direct taxation. In particular, any tax incentives which represents a relief from the tax burden normally placed on firms and which is financed through state resources in the form of a reduction of corporate (or individual) tax revenue is caught by the ban of Art. 87. These tax incentives have the effect of hindering fair competition within the internal market by favouring certain taxpayers and affecting Community trade within the meaning highlighted above. As to the specificity or selectivity criterion, it is the most difficult to apply with respect to tax measures as well. For a tax measure to be specific or selective, it must constitute a departure from the general tax system of the Member State concerned: in this regard, the most troublesome task is to find an objective distinction between a country’s benchmark fiscal system and the deviations from that benchmark. For example, the tax rules on the determination of depreciation rates or bases may either be considered part of the general tax system or constitute a derogation if they set special rates or larger bases with respect to certain sectors of the economy or to certain taxpayers. Furthermore, even where a tax measure is deemed to be specific or selective, the Commission and the ECJ in practice recognise the possibility of a justification in the “nature or general scheme of the tax system”, which was first introduced by the ECJ in 1974 without any significant elaboration. Since then, this justification has always been taken it into account in the assessment on the compatibility of fiscal measures

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with the Treaty, although in practice it is difficult to apply this rather vague criterion.\footnote{For a more detailed explanation of this justification given by the Commission in its recent Notice on fiscal state aid, see below in Section 3.6.4.}

In addition to being subject to the general rules contained in the EC Treaty, state aids of a fiscal nature are, like all the other forms of state aid, governed by the various Commission acts sui generis on "sectoral", "horizontal", and "regional" aid (see above in Sections 3.2 and 3.3). Consequently, sectoral tax incentives such as tax exemptions or tax credits specifically available for investments undertaken by companies engaged in the textile, agricultural, steel or other sectors are subject to the corresponding documents applicable to all aid measures in those sectors. In a parallel way, where a certain horizontal tax incentive is granted in favour of e.g. R&D activities or new employment, the related Commission documents on their compatibility with EC law also apply in tax matters. A greater relevance in the fiscal state aid area is borne by the regional aid measures featuring tax incentives limited to certain depressed areas within some Member States. This is the case, for instance, of the so-called tax-free areas, which are deemed compatible with the common market as long as the tax incentives granted therein are restricted to regions covered by the Art. 87(3)(a) or (c) exemptions, i.e. if they have a GDP/PPS ratio lower than 75% of the Community average in the former instance, or a GDP/GVA ratio lower than 85% and/or a structural unemployment rate higher than 115% of the national average in the latter instance (see at 3.3.2). This is the picture concerning the legal treatment of state aids up to and including 1998. This picture is still viable, but is to be supplemented with the specific rules contained in the Notice on fiscal state aid and the Guidelines on national regional aid. A more detailed analysis in the light of these documents, in particular of the selectivity criterion and of the justification of the nature or general scheme of the system, will be carried out below (see Section 3.6). In this section, there will be an analysis of relevant cases up to 1998, which do not take into account these documents as they have been decided prior to their release or entry into force: it will help for a better understanding of this very complex subject area through practical examples until the stricter change in policy towards fiscal state aid by the Commission.

3.4.3 Investment allowances and relationship with Treaty fundamental freedoms

A very common form of fiscal state aid acts on the computation of the taxable base and/or of the tax liability of the recipient firm(s). A common device used for these purposes is the granting of investment allowances, which usually apply in connection with the purchase of certain assets used in a firm's business activity. These allowances may take the form of deductions or tax credits and thus affect the taxable base in the former case and the tax liability in the latter case. There are quite a number of examples of investment allowances in the tax laws of several Member States, such as Belgium and the Netherlands. The issue is whether these deductions are to be considered state aid within the meaning of Art. 87 of the EC Treaty. Based on the four criteria explained above, it may be concluded that this is probably not the case, given that the specificity condition does not seem to be present in these incentives and in
any event they would seem justified by the nature or general scheme of the tax system. In fact, these investment allowances are available for all the firms established in these countries and for all the sectors of the economy, and thus they may also be deemed integral parts of their general tax systems. The same considerations are true with regard to tax credits granted in general with respect to investments in fixed assets.

An example of fiscal state aid in the form of an investment allowance involving the application of regional (and sectoral) aid rules concerned Germany and was assessed by the Commission over an extended period of time. The object of this case was the concession of an investment allowance equal to 10% of eligible acquisitions or production expenses incurred by legally independent firms established in the area of West Berlin (and the Neue Ländere and meeting certain conditions. Eligible assets were those purchased or produced between 1995 and 1999 and used in connection with investment projects requiring new or replacement assets. The Commission decided that this investment allowance was in principle caught by the incompatibility principle of Art. 87(1) of the Treaty since it conferred an advantage to firms, was financed by the state in the form of a corporate tax revenue shortfall and was specific in that it only applied to firms established in the West Berlin area. However, the Commission considered the West Berlin area eligible to the Art. 87 (3)(c) exemption, and approved the aid subject to a number of conditions, namely that it was limited to new investment (i.e. operating aid was in any event not allowed) and capped to the thresholds indicated in the 1988 Communication.

An interesting case showing the relationship between state aid rules and Treaty fundamental freedoms provisions (see also Chapter 2, section 2.3) concerned another tax incentive introduced by Germany in the West Berlin area (and the Neue Ländere as part of a package of favourable measures to encourage its development. This incentive allowed German individuals and corporations to offset gains from the sale of certain assets used for a reinvestment in new shares or capital increase of companies established in the West Berlin area and having less than 250 employees. The ECJ upheld the Commission decision considering that the four conditions for the application of the state aid rules were fulfilled, and in particular that this tax-free reinvestment implied a loss of tax revenue for Germany in the form of a tax deferral and that its qualification of aid was not affected by the circumstance that investors take independent decisions as Germany claimed. The Court characterised this incentive as an operating aid regionally specific as it was limited to the West Berlin area, which also barred it from being considered a general measure of fiscal or economic policy or from being covered by the Art. 87 (3)(c) exemption (see above). As mentioned above, what is interesting in this case is the interplay between the state aid


70 Eligible firms were those operating in the West Berlin area and in the Neue Ländere and involved in the manufacturing or craft sector with a number of employees not exceeding 250 persons (50 persons in other areas surrounding West Berlin). Furthermore, a ceiling of DEM 5 million per firm per year was set as the maximum allowance available to qualifying firms.


provisions and the Treaty provisions on the freedom of establishment laid down in Art. 43 (see also Chapter 2, section 2.3). In this respect, the Commission observed that the German tax incentive was (also) at odds with this latter provision as it discriminated in favour of companies established in the West Berlin area as well as of German resident natural or legal persons entitled to the relief. Agreeing with the Commission, the Court stated more in general that the application of the state aid rules “must never produce a result which is contrary to the specific provisions of the Treaty. State aid, certain conditions of which contravene other provisions of the Treaty, cannot therefore be declared by the Commission to be compatible with the common market.”

This case suggests that in the application of the state aid rules the Commission must make sure that the other Treaty provisions, namely those on the fundamental freedoms, are not frustrated by its decisions. This principle is fundamental especially with regard to the specificity criterion, as its presence in an aid measure might also mean that this is in breach of the Treaty freedoms. The main interpretative issue is what happens where a selective state aid is approved by the Commission on the basis of one of the Art. 87(3) exemptions or of the justification of the nature or general scheme of the system (see at 3.6.4) but is nevertheless contrary to the fundamental freedoms provisions. As seen above, the ECJ has consistently held in a number of cases in which authorised state aid measures contravened Arts. 28 and/or 90 of the Treaty that the Commission authorisation does not constitute a sufficient justification to discriminate against foreign products or to impose a levy or an indirect tax having an equivalent effect. However, the Court has also accepted the argument that a Member State applying a (tax) measure authorised by the Commission may claim the principle of good faith if that measure is in breach of Arts. 28 and/or 90 of the Treaty on the grounds that such authorisation is consistent with (other) Treaty objectives. This case law seems to leave open the question as to what impact the Commission authorisation of a fiscal state aid under one of the Art. 87(3) exemption or under the justification of the “nature or general scheme of the system” has on the freedoms of establishment, provision of services, and capital circulation. In the absence of specific case in this respect, the answer depends on which of these two sets of Treaty provisions should prevail. This, in turn, depends on which of their underlying goals are considered more important for the EU and the common market given that they are at the same level in the hierarchy of sources of (EU) law.

By and large, the most equitable solution is to leave the assessment of the prevailing objective(s) to the ECJ on a case-by-case basis after a thorough evaluation of all the circumstances of the case. This solution is also implicitly endorsed by the Commission, which in its Notice on fiscal state aid (see section 3.6) states that “the Commission could not, however, authorise aid which proved to be in breach of both the rules laid down in the Treaty, particularly those relating to the ban on discrimination and to the right of establishment, and of previous secondary law on

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73 See para. 78 of this judgement, cit., which also refers to Case 73/79, Commission v Italy, [1980] ECR 1533, para. 11, and Case C-25/91, Matra v Commission, [1993] ECR 1-3203, para. 41. See also more in general on this F. Vanistendael, Fiscal support measures and harmful tax competition, EC Tax Review, 3/2000, p. 152, at 153-154. On this issue, see also the quote from the Commission Notice on fiscal state aid referred to below in the text.

74 See Vanistendael, cit., at 153, and bibliography cited therein in note 7.

75 See Vanistendael, cit., at 154, and bibliography cited therein in note 8.
taxation. Such aspects may, in parallel, be object of a separate procedure on the basis of Article 169 [i.e. now Art. 226]76 From a practical point of view, if the Treaty fundamental freedoms would be considered to prevail, the ECJ would have to declare their incompatibility with the relevant provision. If, on the other hand, the objective pursued by the fiscal state aid, such as the need to boost the development or employment of a certain depressed area within the meaning of Art. 87 (3) or another desirable “internal” tax policy goal (see at 3.6.4), would be considered to prevail, then the Court might consider it as a (new) mandatory requirement of public interest under the rule of reason.77 A solution of this type would ensure an ECJ’s balanced decision based on an assessment of all the relevant facts and circumstances.

3.4.4 (Special) depreciation rules: the German Airlines case

Another mechanism used to grant state aid through the tax system is the design of depreciation rules with regard to certain business assets in sectors of the economy. Such rules have an impact on the amount of deductions to which taxpayers are entitled for the taxable year and therefore allow eligible firms to reduce the amount of taxable income for that year. Usually depreciation rules form part of the general structure of a country’s taxable system as they are rather technical and are justified by the difficulty of determining the actual economic wear and tear which the legal rules should theoretically be based on and/or by policies meant to boost the economy by encouraging certain investments or to pursue desirable social goals by encouraging environment-friendly investments (see also at 3.6.3). However, sometimes they may constitute state aid caught by the ban of the Treaty whenever they are considered special and are not justified by the technical difficulty to calculate the economic wear and tear and/or by an acceptable policy goal.

An interesting case concerning depreciation rules and confirming these conclusions concerns a special depreciation provision contained in German tax law and was object of a Commission decision in 1996.78 Art. 82f of German Income Tax Law provided for a special depreciation facility in favour of airlines and companies engaged in maritime activities, under which aircraft used for the international carriage of passengers and cargo and registered in Germany, as well as any merchant boat and fishing ship, were entitled to a special depreciation amounting to 30% of the purchase price over the year of acquisition (and the following four years) in addition to the normal depreciation allowance granted under the general tax system.79 The German Government put forward by a number of justifications, among which that the depreciation scheme did not confer an advantage on the German airlines and formed part of the general German tax system and was inseparable from the remaining rules.

The Commission focused almost entirely on the application of the depreciation scheme to airlines, as the sector of merchant ships and fishing boats was covered by a

76 See the Notice, cit., point 29.
77 On the rule of reason, see e.g. in Terra & Wattel, cit., at 31 ff., and in Chapter 2, section 2.3, and Chapter 5, especially section 5.3.2.
79 Under the general rules of German tax law, an aircraft may be depreciated over a 10- to 15-year period depending on the characteristics of the airline, as stated in the Commission Decision.
special Commission document. In its reasoning, the Commission made it clear that the scheme fell within the scope of Art. 87(1) because it conferred on airlines the advantage of tax deferral, which means significant tax savings in terms of net present value and increased cash available to the recipient firms for the carrying on of their activity. As to the argument that Art. 82f was a general provision of the German tax system, the Commission pointed out that the first step in the assessment of the specificity criterion was to make a comparison between the general depreciation rules applying to all of the firms in the same objective situation as airlines and the special rules under review. If it was found that there was a differentiation in their treatment, the second step would be to ascertain whether such a differentiation could be justified on the basis of the "nature or general scheme of the system", which was interpreted as having to do with the efficiency of the tax system. In this respect, the Commission pointed out that usually depreciation rules "are not applied solely to specific sectors, are based on objective and horizontal criteria or conditions, and are not limited in time."

The Commission found that Art. 82f was specific in several respects, namely: (i) it covered only certain assets, leaving out of its reach all the others; (ii) with respect to some of these assets (i.e. aircraft), it even required additional conditions to be satisfied; (iii) it was intended to favour specific sectors of the German economy, i.e. civil aviation, and merchant shipping and fisheries; (iv) it did not set out objective criteria for its application. As a consequence, given the potential distortions to the common market caused by the aid to German airlines as opposed to international airlines not benefiting, the Commission considered the depreciation scheme an aid within the meaning of Art. 87 (then Art. 92) since all the four required conditions had been fulfilled.

This decision suggests that in principle depreciation rules do form part of a country's benchmark tax system even if they are limited to a certain sector. However, if they lay down a different treatment within the same sector by favouring certain taxpayers (e.g. resident ones) and are not justified by the efficiency of their tax system and/or by technical considerations relating to the wear and tear of certain assets, they are caught by the ban of Art. 87 (1).

3.4.5 Administrative practices and lax behaviour of tax authorities

A particular form of fiscal state aid is any practice of the Member States' tax authorities having an impact on the determination of the taxable income and/or on the actual collection of outstanding tax claims owed by taxpayers. As the effects of such practices turn out most of the time to be the same as those caused by other fiscal incentives, these are considered incompatible with EC law if they meet the four

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80 The Commission referred to the Council Regulations on the shipbuilding sector and to the Decision issued on 1 March 1995 in Case N 64/193.
81 In particular, it required every aircraft to be registered in Germany, a non-disposal period of at least six years and the specific purpose of international transportation of goods and services.
82 It is worth noting that this decision was challenged by a number of private airlines before the CFI under Art. 230(4) of the EC Treaty: see Case T-86/96 of 11 February 1999. Unfortunately, the Court found a procedural impediment for rendering a judgement on the substance of the case. Indeed, it might have been very interesting to learn its view with respect to the Commission's criteria used in the assessment of the depreciation facility and, in particular, to the possible justifications underlying its original implementation.
criteria required for the application of the Treaty state aid provisions. The main problem caused by administrative practices or lenient behaviour of a country's tax authorities is their (in)visibility for the Commission, due to their non-publicity and to the confidentiality assured to the taxpayers involved in negotiations with them or in an enforcement procedure of recovery of tax claims. The Commission was able to strike down some of those illegal practices when it was made aware of them by Member States' notifications or by competitors' complaints, or managed to spot them in other ways.

A first enlightening example may be found in a Commission decision dating back to 1990 and concerning Greece. The object of this decision was not fiscal aid, but an aid granted by the Greek Government in the form of a conversion into capital of its claims with respect to a local company engaged in the production of cement. The Commission found out through the Greek press that this company was in deep financial difficulty due to its growing outstanding liabilities and debts owed to a large extent to public enterprises. As these enterprises "were apparently showing a leniency ... which could no longer be considered to be in conformity with normal market behaviour", the Commission ruled that "whenever public services and authorities show an abnormal leniency towards a certain company in collecting their claims, such action - or rather the lack of it - is likely to constitute state aid." The corollary to this decision for our analysis is that every practice of a Member State's authorities, including its tax administration, entailing laxity or leniency in the recovery of its own (tax) claims does constitute state aid incompatible with the EC Treaty.

Another interesting case useful to demonstrate the Commission's view on this matter concerns the Italian Law providing for a special bankruptcy procedure in favour of large firms in state of insolvency (see also at 3.3.4). Amongst the special benefits normally not available under the ordinary Italian bankruptcy law there is the possibility for eligible firms to be exempted from repayment of debts due to tax authorities, as well as to enjoy an immediate suspension from the interest charge normally due for delayed payments. The question arises as to whether such privileges fall under the scope of Art. 87 (1) of the Treaty and are to be notified to the Commission on the basis of Art. 88. In this regard, it is stated in the Commission Notice of 1997 that "prior notification ... is necessary, primarily because the debts of insolvent firms generally comprise debts to the tax authorities ... which effectively results in a transfer of State resources, in the form of non-recovery of taxes ... owed, to the firms concerned." It is also worth noting that the Commission objects to the discretion conferred on the Italian tax authorities in the granting of the authorisation for the special procedure, which may give rise to non-objective and discriminatory treatment of different firms.

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84 See the Commission Notice pursuant to Art. 88 (then Art. 93) (2) of the EC Treaty to other Member States and interested parties concerning the extraordinary administration of large firms in a state of insolvency, C 7/97 (ex E 13/92), published in OJ C 192 of 24/6/1997, at 4. See also the subsequent decision of 28/7/1999, OJ L 83 of 27/3/1999, and the final decision of 16/5/2000, OJ L 79/29 of 17/3/2001, on the Commission's procedural mistake, explained more in detail in the text at 3.3.4, which does not affect the analysis contained herein.
3.4.6 Tax-free areas: the Madeira ZFM and the Trieste FIC

State aid rules play an important role with regard to the establishment by Member States of tax-free areas (also referred to as T-zones or offshore areas), in which a general reduction of the fiscal burden applies to both direct and indirect taxation and is usually coupled with other tax and non-tax (e.g. financial) incentives. In order to attract foreign investment Member States may structure such areas in compliance with the EC state aid rules by simply limiting the reduction of the tax burden to an area qualifying under one of the exemptions contained in Art. 87(3), provided the rules contained in the Commission documents on regional aid (i.e. the 1988 Communication up to 2000, see at 3.3.2, and the 1998 Guidelines, see at 3.7.2). There are several examples of this type of tax-free areas created throughout Europe (see also in Section 3.5 and 3.7).

A first instance is the special tax regime implemented in the Portuguese archipelago of Madeira in 1987 (i.e. Zona Franca Madeira, hereinafter: “ZF M”), which provides for a number of fiscal incentives concerning both direct and indirect taxes as well as customs duties (see for its detailed analysis at 3.7.5). In reviewing the compatibility of these incentives with the state aid rules, the Commission took into account the very low development of that area, which qualified as an Art. 87(3)(a) region since its per capita GDP was much lower than 75% of the Community average. Furthermore, the Commission also took into account the fact the archipelago is one of the “outermost” regions of the Community needing particular support in order to develop itself economically and socially. In 1998, the Commission has opened an investigation to review the compatibility of the Madeira ZFM area with EC law in the light of the new documents on fiscal state aid and national regional aid (see in detail at 3.7.5).

Another case concerned a special offshore centre established in Italy within the city of Trieste for companies engaging in financial and insurance activities (hereinafter: “FIC”, see also Chapter 4, Section 4.3). The FIC features a corporate tax exemption in favour of eligible companies operating therein and providing eligible activities in favour of Eastern European countries. In 1995, the Commission adopted a decision of compatibility of this tax regime with the EC Treaty. Also this regime is currently

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86 See, in particular, the Commission XVth Report on Competition Policy, 1987, para. 252, and the XXVth Report on Competition Policy, 1995, COM 96(126) final, para. 198, where it is stated that the Madeira per capita GDP was only 24% of the EC average.

87 See Declaration 26 on the outermost regions of the Community, annexed to the Final Act of the Treaty on European Union. This declaration makes it clear that the implementation of specific measures aiming at the purpose indicated in the text is allowed where there is an objective need to adopt such measures. It is also worth noting that the same grounds constituted the basis for the approval by the EC Council of special customs incentives in favour of goods (excluding agricultural ones) to be processed in the archipelago: see Council Regulation EC 122/96 of 22 January 1996 establishing favourable tariff treatment for imports of certain goods into the free zones of Madeira (and the Azores) by reason of their end use, in OJ L 20 of 26/1/1996. For a discussion on the recent developments concerning the “outermost” regions and the introduction of Art. 299 (2) in the EC Treaty, see in detail at 3.7.2 and with regard to the ZFM at 3.7.5.

under the scrutiny of the Commission as a result of the release of the Notice on fiscal state aid and the subsequent large scale investigation (see at 3.6.6 and at 3.7.7 specifically on the FIC).

The Commission found that the FIC regime satisfied the four conditions required for a measure to be considered state aid under Art. 87(1). The next step in the Commission's investigation focused on whether one of the exemptions on regional aid contained in Art. 87(3) was applicable to the centre. Having found that the conditions required for the application of subparagraph (a) were not met by the area of Trieste, the Commission concluded that the exemption under subparagraph (c) did apply to that area. This outcome was somewhat surprising, because the socio-economic conditions of Trieste were considerably higher than those required for its application by stage one of the 1988 Communication. However, the final decision was based on some of the other factors to be taken into account in the second stage of the assessment procedure laid down in the 1988 Communication (see at 3.3.2), which were considered in the Commission's view able to demonstrate clearly the aim for the establishment of the offshore centre “to develop a particular economic activity of interest to the Community”. More specifically, the Commission found that the development of a capital market in Eastern Europe through the mobilisation of private capital did converge with one of the Community interests, i.e. the provision of private funds to replace the lack of public funds available for this purpose. Furthermore, the city of Trieste was considered to have enough experience in the banking and insurance sectors to achieve this goal and even its position was strategically perfect, as demonstrated by the fact that it had constantly been a point of reference in the trade with Eastern European countries. The Commission also acknowledged that such an initiative would facilitate the process of reconstruction and development of the Trieste area after the war in former Yugoslavia and that it would stimulate the revival of the Eastern European economies. In the light of these considerations, the granting of the aid was subjected to a number of conditions laid down in the decision, namely a 5-year time limit and specific ceilings to the permissible amounts of tax aid with regard to investments (i.e. ITL 65 billion) and loans (i.e. EUR 3.5 billion).

3.5 The Commission decision in the Irish corporation tax case

3.5.1 Background

The Irish experience with regard to fiscal state aid is very interesting because it dates back almost twenty years and has led to repeated Commission scrutiny over this
period. The Irish corporation tax case is fundamental in this area as it has marked the change in Commission policy and its firm commitment to scrutinise very carefully every potential fiscal state aid in the EU as part of its strategy to counter harmful tax competition.

In 1980 Ireland introduced a preferential tax rate of 10% in favour of companies, both resident and non-resident, deriving income from manufacturing activities within the country for a period up to the year 2000. Over the years, the "manufacturing relief" was extended to several activities which, although not manufacturing in the strict sense, were fictitiously considered so, such as certain agricultural activities, computer services, film production and shipping activities. The Commission did not open any investigation under the state aid rules, considering this 10% rate part of the general Irish tax system and therefore outside the scope of Art. 87 of the Treaty because it was available on a non-discriminatory basis to all companies operating in Ireland and thereby did not fulfil the specificity condition. In 1990, the Irish Government extended the "manufacturing relief" up to the year 2010.

In addition to the "manufacturing relief", in 1987 the Irish Government introduced a special regime in favour of companies performing a wide range of financial and insurance activities established in the International Financial Services Centre (hereinafter: "IFSC") located in the Dublin Docks. In brief, this regime features the application of the preferential 10% tax rate to income from eligible financial activities, which are fictitiously assimilated to the activities entitled to the "manufacturing relief". Furthermore, the IFSC regime provides for additional tax incentives, such as immediate expensing for new equipment and other outlays, special depreciation facilities, and double deduction for rental fees and exemption from local property tax with regard to buildings located in this area (see also below at 3.5.3). Its final expiration date was set in the year 2005, whereas the deadline for the submission of new projects for approval by the Irish authorities was set in the year 2000.

The Commission found that, unlike the "manufacturing relief", the IFSC regime did constitute state aid within the meaning of Art. 87 of the Treaty because it was limited to companies operating in the area of Dublin: it was therefore considered 'regional' fiscal aid. Nevertheless, the Commission approved it the first time in July 1987 for a period of three years under Art. 87(3)(a) based on "the serious economic and social situation in Dublin but also on the developmental benefits of the project in the overall Irish context". In July 1990 the IFSC regime was authorised for one more year, and

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93 This preferential rate, usually referred to as "manufacturing relief", was introduced by the Finance Act 1980, Sec. 39. The manufacturing relief was meant to replace the former "Export Sales Tax Relief", which was considered by the Commission incompatible with EC law; see McNally, cit., at 5. It is also worth noting that in 1981 the 10% "manufacturing relief" was extended to companies establishing in the area of Shannon Airport, on the "Shannon relief" see also the Eurovings case in Chapter 2, at 2.3.3, and in Chapter 5, Section 5.3.2.7.

94 The IFSC regime was introduced by Finance Act 1987, Sec. 30. For a discussion in the light of the Code of Conduct, see Chapter 4, at 4.4.2.

again in May 1991 until the year 2000 on the basis of the same exemption, as the Commission considered the whole Ireland a region qualifying under that provision in the light “of the worsening of the economic and employment situation” in the area.\textsuperscript{97} Finally, in 1994 the Commission authorised the validity of the IFSC regime up to the year 2005.\textsuperscript{98}

3.5.2 The 1998 Commission Recommendations

In 1998, as a result of an agreement reached with the Irish authorities, the Commission issued two sets of Recommendations (hereinafter: “Recommendations”) addressed to Ireland and concerning the IFSC regime and the preferential 10% rate for manufacturing activities, respectively.\textsuperscript{99} The background to the Recommendations is a substantial reform of the Irish corporate tax system, which will rely on the application of two different tax rates depending on the nature of taxable income: 12.5% on income “from trading activities” (i.e. active income) and 25% on income “from non-trading activities” (i.e. passive income), effective from 1 January 2003.\textsuperscript{100}

As to the content of the Recommendations, they basically contain the outcome of the agreement between the Commission and the Irish authorities on such reform of the Irish corporate tax system in a way compatible with the Treaty state aid provisions without at the same time jeopardising the legitimate expectations of companies and taxpayers already operating in Ireland. In particular, it is stated that the “manufacturing relief” will apply until its anticipated expiration year (i.e. 2010) in favour of companies already benefiting from it before their release, and until 2002 in favour of new investors starting an eligible activity in the meantime.\textsuperscript{101} With respect to the IFSC regime, the Recommendations stipulate that companies already enjoying its tax advantages before their issuance will be entitled to them until the anticipated expiration in year 2005\textsuperscript{102} and that new projects approved until the year 2000 (and limited by a quota) will benefit from the preferential regime until 2003, and thereafter will be entitled to the new tax rate on trading income equal to 12.5%.

The grounds for the early withdrawal or limitation of the benefits of the IFSC regime and the “manufacturing relief” were based on the fact that Ireland (and Dublin) were due to lose its Art. 87(3)(a) status at the end of 1999 as a result of the implementation of the new Guidelines on regional aid (see at 3.7.2). More specifically, with respect to the IFSC regime the Recommendations refer to the Guidelines’ principles that

\textsuperscript{98} See OJ C 390 of 31/12/1994, at 16.
\textsuperscript{101} The tax rate applicable on this income thereafter will be the new 12.5% rate.
\textsuperscript{102} These companies will be subject to the 12.5% rate on income earned in the Centre thereafter.
"operating aid can only be given ... if: (i) it is justified in terms of its contribution to regional development; and (ii) its level is proportional to the handicaps it seeks to alleviate," and conclude that "the Irish authorities have not demonstrated the existence or importance of regional handicaps affecting the sectors concerned (in particular, the financial sector) which the IFSC ... seeks to alleviate".  

As to the "manufacturing relief", the Recommendations stress that while the specificity condition "was not regarded as met ... in 1980, it now appears clearly to be fulfilled. The measure imposes a lower rate of tax on manufacturing companies than those in other sectors without any justification for this on the basis of the nature or general scheme of the tax system. The reason ... is rather the attraction of mobile investment in the manufacturing sector to Ireland through the reduction of the sector's costs of production."  

3.5.3 Further considerations on the Recommendations and follow-up

The statements of the Recommendations on the Irish corporation tax cases just referred to may imply significant consequences for other Member States' tax incentives. It is also remarkable that the Commission admitted its fault for not considering the Irish "manufacturing relief" as state aid for a period of almost twenty years. The Commission Press Release is quite frank in this regard: "the Commission has now decided that disparate treatment of manufacturing and service companies respectively means that the system qualifies as state aid" as the "principal distortive effect of the system has been to cause investors in the manufacturing sector to move their operation to Ireland". It is also interesting to note that the Commission itself found a justification for that, lying in "the growing awareness of the effects of harmful tax competition ... following the Code of Conduct". This is also reflected in the Commission Ninth Survey on State aid, which states that "if the Commission, taking into account changing circumstances, decides on the State aid character of a measure that was previously considered as not constituting State aid, the aid amount is fully integrated in the Survey. For example, following an examination of the Irish corporation tax, the Commission decided ... that this existing scheme constituted State aid. As a result of this decision, levels of State aid in Ireland have markedly increased."  

The consequences of the Recommendations may be remarkable, to say the least, if the principles endorsed therein are applied strictly by the Commission also in the future. The most evident one will be that all tax incentives resulting in a reduction of firms' current expenses and limited to the manufacturing or the financial sector (as well as to other defined sectors or intra-group activities) are to be considered aid within the meaning of Art. 87 of the EC Treaty even where they are available indiscriminately for both resident and non-resident taxpayers. In fact, this conclusion has been codified in the Commission Notice on fiscal state aid (see in Section 3.6), stating that "a derogation from the base rate of corporation tax for an entire section of the economy therefore constitutes ... State aid, as the Commission decided for a measure

103 See the Recommendations, at 15.
104 See the Recommendations, at 19.
105 See the Commission Ninth Survey on State aid, ci., para. 16, and more in detail above at 3.2.4.
concerning the whole of the manufacturing sector”, which suggests that the Commission will indeed follow this approach in the future.

A more recent case scrutinised by the Commission under the state aid rules and linked to the Irish corporation tax case regards two incentives forming part of the package of incentives relating to the IFSC regime, i.e. the double deduction of rents paid by companies tenants of certain buildings located in the Dublin Custom House Docks area and the exemption from local property tax on the same buildings. Confirming its lenient approach towards Ireland, the Commission approved this scheme although it “would not normally consider that such a measure would be compatible with the common market. However, the Commission has also taken into account the fact that Ireland has modified the original scheme, introducing … a termination date of 31 December 2003.” Even though there is no explicit reference to the Irish corporation tax case, it seems that the compatibility decision is mainly based on the same grounds, as also shown by the fact that the period of validity of this scheme has been reduced consistently with the phasing out of the corporate tax benefits of the IFSC regime, and that the principle of legitimate expectations was at stake also in this case as “the Commission treated similar aid measures as investment aid until the end of 1997.”

3.5.4 The Irish corporation tax case as the milestone in the Commission’s change of policy

A last interesting statement contained in the Commission Press Release regarding the Irish corporation tax case acknowledges that “the Commission is not taking the view on what the level of corporate taxation should be in Ireland”. It follows that the new 12.5% rate applicable in Ireland on trading income will be considered compatible with the state aid provisions, and so will other low corporate tax rates that other Member States might be willing to introduce to try to compete with Ireland. In itself, this seems a corollary of the sovereignty of Member States in the area of direct taxation, which is not to be affected by EU law, meaning inter alia that Member States are free to set their general corporate tax rate at any level they feel appropriate, even a very low one (see also in Chapter 2, especially at 2.3.3). However, it needs to be stressed that the new 12.5% tax rate will not be the general Irish corporate tax rate, but will be limited to income from trading activities, whereas the remaining income will be subject to the new 25% tax rate. In other words, the Commission is in fact acknowledging that Member States have full sovereignty not only in setting a single general corporate tax rate, but also in differentiating rates depending on the underlying category of income derived by (both resident and non-resident) corporate taxpayers.

The question arising is then: has the Commission made a move that is consistent with its “growing awareness of the effects of harmful tax competition”? A twofold consideration may shed some light in this respect.

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106 See the Notice, point 13, and also below especially at 3.6.3 and 3.6.4.
107 Case C 1/99 (ex NN 133/98), Commission decision of 22 December 1999 on aid to non-residential building tenants in the Customs House Dock Area in Dublin, OJ L 260, 14/10/2000, p. 37. See also the Commission Report on Competition Policy, 1999, cit., para. 265, p. 78. See also the Commission Report on Competition Policy, 1997, cit., p. 212, referring to the previous approval of these incentives.
Firstly, it will be important to see how the Irish authorities will define income “from trading activities” as opposed to income “from non-trading activities” for the application of the lower 12.5% corporate tax rate. Apparently, this distinction coincides with the distinction between income from active trading (to be determined e.g. with regard to the taxpayer’s frequency of dealings, period of ownership, and object of the sales) and income from passive investment. This being so, much depends on the definition of ‘active’ and ‘passive.’ There is the risk that the current “manufacturing relief” will again find its way into the Irish tax system through the back-door if ‘trading activities’ are defined as encompassing the same “manufacturing activities” eligible for the 10% rate with only slight differences. In order to avoid this, the Commission will have to scrutinise the overall Irish corporate tax system once its reform is completed and, in particular, whether this still contains incentives available only to a specific sector of business activity (i.e. the manufacturing or the financial ones) or to a certain category of taxpayer (i.e. the non-resident ones).

Secondly, the effects of the Commission’s (and the Council’s) other efforts to tackle harmful tax competition will have to be awaited, i.e. whether the Code of Conduct will be implemented (and enforced) (see Chapter 4) and whether the Treaty provisions on internal market distortions (i.e. Articles 96-97 of the Treaty, see in Chapter 2, section 2.4) will be used by the Commission. Assuming that the new Irish corporate tax system will be compatible with the EC fiscal state aid rules, it still needs to be ascertained whether it is also compatible with the Code of Conduct and with Art. 96 of the EC Treaty. While the answer seems positive in the former case, it might be negative in the latter, especially considering the much higher average corporate tax rate in the EU. This might well be the case if other Member States, especially the smaller ones, follow suit and substantially lower their corporate tax rates, which might ultimately cause a serious distortion to competition within the meaning of these provisions (see Chapter 2, especially at 2.4.4. and 2.4.5).

Despite the above considerations, it is clear that the Irish corporation tax case represents the milestone of the Commission’s changed attitude towards (harmful) fiscal state aids. This milestone separates the previously isolated and scattered attempts by the Commission to strike down only the most blatant cases of fiscal state aids distorting the common market mainly due to the fear of stepping on the Member States’ sovereignty in the direct tax area from a new coherent and systematic approach meant to use these Treaty legally-binding rules as a tool to counter harmful tax competition in the EU the hard way. While this change was originally blessed by the Member States and the Council, the subsequent strict and inflexible Commission approach may not be equally shared by them due to concerns of an excessive impact on their tax sovereignty, whose magnitude and potential effects had probably been overlooked or underestimated by Member States.

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108 See, on the point, McNally, cit., at 7.

109 See McNally, dt. In particular, the Preamble to the Code of Conduct clarifies that the Code “does not affect Member States’ rights and obligations ... in accordance with the Treaty”, meaning that Member States’ national sovereignty in direct tax matters (including the setting of tax rates) is fully preserved in any event.
3.6 Fiscal state aid, the 1998 Commission Notice, and harmful tax competition

3.6.1 Overview

As mentioned above, the EC state aid rules apply to all favourable measures implemented by Member States falling under Art. 87 EC Treaty regardless of the form chosen (and their causes or aims), what counts being a measure’s actual effects on competition and intra-Community trade (see at 3.3.1 and 3.3.4). This implies that all the principles and rules on state aid analysed above also govern aids granted by Member States via their tax system. Until a few years ago, not much attention was given to the application of the Treaty state aid provisions to direct taxation, mainly due to the Member States’ sovereignty in this area and the Commission’s attitude to intervene only against the most obvious forms of fiscal state aid. However, with the Irish corporation tax case this situation has changed as a result of the commitment by Member States to fight harmful tax competition within the EU, sanctioned by the approval of the “Package” and the Code of Conduct in December 1997110 (see in Chapter 4 and also above in Chapter 1, Sections 1.2 and 1.4).

As part of the “Package”, the Commission was also asked by the Member States (through the Council) to be more effective and clear in the application of the Treaty state aid rules in the area of direct taxation as an additional tool to counter harmful tax competition in the EU (see at 4.2.1).111 The outcome was the release in 1998 of the Notice on the application of the state aid rules to corporate taxation, which was the first official document in this area.112 As a result of the Notice, the Commission has undertaken a rigorous scrutiny of potentially fiscal state aid measures of Member States, also in their depressed areas.

In order to fulfil its function in a consistent way, the Notice aims at setting uniform principles and standards applicable to fiscal state aid in order to ensure objectivity and equality of treatment between Member States.113 In this respect, it indicates the need to ensure “that Commission decisions are transparent and predictable” and to guarantee “consistency and equality of treatment between Member States” in accordance with the general state aid policy trends summarised above (see at 3.2.4).114 The broader objective of the Notice is “clarifying and reinforcing the application of state aid rules in order to reduce distortions of competition in the single market”, especially in view of the repercussions deriving from the characterisation of a certain tax measure as state aid under Art. 87 of the Treaty. As to its legal nature, the Notice

110 The “Package” to tackle harmful tax competition was published in OJ C2 of 6 January 1998, at 1. For its analysis, see Chapter 4, at 4.2.1.

111 See Para. J of the Package, cit.: “...the Council notes that the Commission undertakes to publish guidelines on the application of the State aid rules to measures relating to direct business taxation”. See also below at 3.6.6. and in Chapter 4.


113 See the introduction to the Notice, at 1-2.

114 See the Notice, point 4. The Notice also states that these goals are inspired by the incompatibility of state aids with EC law and the need to interpret as strictly as possible the exemptions from it, especially in the light of the increased importance of direct taxation as a consequence of the monetary union and the consolidation of national budgets.
forms part of the Commission’s acts *sui generis* or ‘soft’ law containing policy statements on the application of the Treaty state aid rules, and therefore it is able to create legitimate expectations for both Member States and interested parties (see at 3.3.4).

As will be seen, the importance of the Notice lies in its acknowledgement that fiscal measures must be assessed in the light of the state aid provisions on the basis of the same four conditions required in general (see at 3.3.1), but also that some specific principles must be followed to tailor the application of the Treaty provisions to the peculiarities of the fiscal area. In fact, direct taxation is a somewhat special form of government intervention as it is a ‘forced’ intervention in order to pursue fundamental social and economic objectives through the financing of public expenditure and service, and therefore distortion of competition occurs if such intervention is not proportionate with regard to taxpayers in similar situations and targeted with regard to the said social and economic objectives. The Notice indirectly endorses these considerations as a matter of principle, by making clear with regard to specificity that “this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production.” This is further confirmed throughout the Notice, which leaves enough flexibility to the Commission to take into account the peculiarities of direct taxation and balance them with the necessity to firmly counter Member States’ potentially harmful measures.

### 3.6.2 Criteria for application of Art. 87 to direct tax measures

The Notice explains in detail the application of the general principles contained in Art. 87 of the Treaty as developed by the Commission and by the case law of the ECJ to the corporate tax area. In this regard, it refers to the four conditions required for the application of Art. 87 (see at 3.3.1), which must also be met with respect to tax measures: (i) advantage conferred on a firm (or firms); (ii) from state-originated resources; (iii) distortion of competition and impact on intra-Community trade; and (iv) specificity or selectivity.

First of all, the advantage conferred upon firms must consist of any alleviation of charges or any relief concerning the tax burden normally imposed on them. The Notice makes a reference to the mechanisms used for the granting of the following kinds of fiscal relief (see at 3.4.1), which may have an impact on a firm’s or firms’ taxable base (e.g. special deductions, accelerated depreciation, formation of tax-free provisions):

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116 See on this also Schön, *cit.*, at 290.

117 See the Notice, *cit.*, point 13.

118 See the Notice, point 9.

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• taxable amount (i.e. tax exemption and/or credit); and
• collection of taxes due (i.e. deferment, cancellation or special rescheduling of tax debts).

As to the second condition, the Notice interprets it as the aid being financed through a tax expenditure, i.e. a special tax measure deviating from the benchmark tax system whose effect is to cause an actual reduction in the country’s tax revenue (see Section 3.2). This requirement is closely linked to the specificity condition because the main characteristic of tax expenditures according to many fiscal theorists is their special nature as opposed to the standard tax system. Such a special measure may be enacted through laws, regulations, or administrative practices of the tax authorities by either central governments or decentralised bodies provided with autonomous powers, which makes the scope of the notice an all-catcheing one.

Despite its broadness, the concept of fiscal state aid may not be interpreted so as to encompass also any potential loss of tax revenue suffered by a country as a result of its legislative or statutory provisions. In PreussenElektra, the ECJ ruled on this issue with regard to a German legislative provision obliging suppliers of public electricity purchased from producers of renewable energy sources produced within their area of supply to buy at minimum statutory prices higher than its actual market prices. One of the issues was whether the producers of renewable energy received aid in that they were entitled to a compensation higher than the one they would have received in the absence of this German provision. In particular, this aid would entail a transfer of public resources as a result of the suppliers of electricity suffering higher costs for the purchase of renewable energy, which meant lower taxable profits and thus lower tax receipts for Germany. Disagreeing, the ECJ ruled that this obligation stemming from German law did not involve any direct or indirect transfer of State resources since the financial burden was distributed between them and upstream private electricity network operators. The Court went on to state that “that conclusion cannot be undermined by the fact ... that the financial burden ... is likely to ... entail a diminution in tax receipts for the State. That consequence is an inherent feature of such a legislative provisions...”.

The third condition is that the tax measure has a potential negative impact on competition and trade within the common market. On this point, the Notice summarises the interpretation and application by the ECJ described above (see at 3.3.1) and does not add any particular rule with respect to tax measures. In this respect, it is interesting to analyse the Maribel bis/ter case, which concerned a Belgian general scheme providing for lower social security contributions in favour of undertakings belonging to the processing industry sector. The Court referred to its case law that intra-Community trade can be affected even if the beneficiary does not export products and that the Belgian measure specifically stated that beneficiaries of the aid were employers mostly exposed to international competition (see also at 3.3.1).

119 This category should perhaps refer to the final tax liability, which may be affected not only by exemptions and/or credits, but also by nil or reduced tax rates.
121 See PreussenElektra, at paras. 59-62.
122 Case C-75/97, Belgium v. Commission ('Maribel bis/ter' scheme), [1999] ECR I-3671, also explicitly cited in the Notice, point 18, as an example of sectoral fiscal aid (see next paragraph).
and concluded that in these circumstances the Commission may be discharged from having to prove that this condition is met given the manifest potential impact of this scheme on intra-Community trade.\textsuperscript{123} As will be seen, this conclusion implies that in almost all cases of fiscal state aid scrutinised by the Commission this requirement is deemed satisfied without the necessity to prove the actual impact of the tax incentive on intra-Community trade (see Section 3.8).

3.6.3 Specificity criterion: benchmark tax system vs. special tax incentives

The interpretative doubts concerning the application of the ‘specificity’ criterion to direct business taxation as well as the justification of “the nature or general scheme of the tax system” call for further analysis. Starting with the specificity criterion, the Notice points out that an advantage must be granted by way of an “exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice on the part of the tax authorities”. In order to clarify what is meant by ‘general’ (i.e. ‘benchmark’) tax system as opposed to ‘specific’ tax measures, the Notice refers to the criterion of availability to all of the firms carrying on a business activity within a Member State on an equal, objective and non-discriminatory basis. Based on this, it states that general measures are those having:\textsuperscript{124}

(a) a “technical nature”, such as the ones concerning tax rates, depreciation schedules, period of loss carry-forward, or prevention of double taxation; and

(b) an underlying general economic policy objective to be achieved by way of an alleviation of part of the tax burden concerning certain firms’ production costs, such as R&D expenses, environment-friendly investments, and training and employment activities.

With regard to fiscal provisions falling into either category, however, the Notice makes it clear that they will be considered to form part of a country’s general tax system only as long as they do not have the effect of favouring certain taxpayers and/or sectors of the economy. Moreover, as to category (b) there must be a justification for the measure concerned consisting of an appreciable goal of domestic economic policy or another desirable social or economic goal. Fiscal measures that favour firms relying on a labour-intensive production process (with respect to R&D, training and employment incentives) or on a capital-intensive one (with respect to incentives for environment-friendly equipment), therefore, only escape the incompatibility principle if they are not likely to distort competition or if they can be justified (see below). Moreover, the Notice explicitly mentions as selective or specific provisions:

- ‘sectoral’ fiscal measures, whose applicability is limited to certain sectors of the business activity (e.g. manufacturing, financial sector, etc.);
- ‘horizontal’ fiscal measures, which are limited to certain functions within a firm (e.g. R&D, environment, training and employment, etc.); and
- ‘regional’ fiscal measures, whose applicability is limited to a certain area within a Member State.

\textsuperscript{123} See Maribel bis/ter, cit., paras. 48, 50, and 52.

\textsuperscript{124} See the Notice, point 13.
Interesting are some specific principles laid down in the Notice with respect to the above categories. For example, with regard to sectoral fiscal state aid the Notice states that a lower tax rate applying to an entire sector of the economy, like the manufacturing sector, must be considered to meet this condition. As to horizontal fiscal state aid, the Notice mentions special tax regimes covering certain vital functions performed within multinational companies, such as coordination, intermediation, and other intra-group services, which “may constitute state aid as referred to in Art. 92(1) [i.e. now Art. 87(1)]” (on this point, see extensively in section 3.8). With respect to regional fiscal aid measures, the Notice makes a reference to the exemptions contained in Art. 87(3)(a) and (c), and, in addition, contains other specific rules which will be analysed in greater detail below (see in section 3.7).

The above principles on the ‘specificity’ criterion do not lift all uncertainties in the practical distinction between general and specific tax measures. This is fundamental in the tax competition area, as this criterion is crucial in the determination of their harmful character. It is therefore necessary to further analyse some more recent Commission decisions and legal literature.

The Commission recently considered that the specificity condition was not met by a Dutch tax measure under which (a portion of) investment in R&D facilities was entitled to accelerated depreciation. In this regard, it found that the measure was general and not limited to specific sectors, and that its application did not involve the exercise of discretionary power by the tax authorities. This case is an application of the general rule contained in the Notice and in the previous decision in the German Airlines case (see at 3.4.5), which was different from this measure in that it provided for special rules within a certain sector and limited to certain assets only.

In another case, the Commission decided that a tax credit scheme requiring a minimum investment of €15 million did meet the specificity criterion as it was limited to large companies and favoured them as opposed to smaller companies less likely to have sufficient financial means to undertake such an investment. This seems consistent with the principles of the Notice, allowing these ‘technical’ measures only if not limited to certain sectors or specific (categories of) firms, or in other words only if not constituting disguised or de facto state aid.

Two interesting Commission decisions deal with individual income tax systems implemented by Sweden and Denmark in favour of foreign experts moving temporarily to these countries to take up highly-skilled employment. Under the Swedish system, the tax base of eligible individuals is reduced by 25%, while there is also a corresponding 25% reduction in social security contributions due by their

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125 See the Notice, point 18, which refers to the Irish corporation tax case discussed above at 3.5.

126 See the Notice, point 20.


129 See also the cases concerning the Basque provinces regimes, below at 3.7.6, which featured tax credits limited to investments of more than ESP 2.5 billion and thus were considered specific by both the Commission and the CFI.

employers, for a period of no more than three years, provided the employment relationship is not anticipated to last longer than five years. Under the Danish regime, there is a low flat income tax rate of 25% for individuals recruited abroad for a period of six months to three years. In both cases, the Commission decided that neither scheme was specific, since they were available for firms engaged in all sectors, both the public and private ones (in the Danish case), and to both large companies and SMEs, and did not involve discretion on the part of the tax authorities. These decisions suggest that even special tax regimes apparently deviating from a country’s ‘benchmark’ tax regime in that they feature a reduced tax base or a lower tax rate fail to meet the specificity criterion if they are open to all sectors and economic activity and are not designed to constitute a disguised incentive for large (foreign-based) companies.131

Despite the above principles, there is still uncertainty as to the actual criterion or test to distinguish general tax measures from specific ones caught by the ban of Art. 87, or in other words where the borderline between ‘benchmark’ tax system and deviations from it lies. Legal literature has pointed out that a solution for this purpose could be mapping out a set of common corporate tax rules that would form the benchmark at EU level, and every rule adopted by Member States inconsistent with it would be deemed to meet the selectivity criterion.132 However, it has also been recognised that this solution would be in breach of EU law principles, namely Member States’ sovereignty in direct tax matters, and thus that the benchmark must be singled out with regard to each individual Member State’s tax system, which must be judged on its intrinsic logic and entirety for its assessment under the state aid rules. This conclusion is also consistent with the Notice, which specifically requires a determination of the general system of taxation of the Member State concerned and, subsequently, some evidence that the suspect measure is to be labelled as a specific measure, i.e. a deviation from it.133

Given the need to stick with objective rather than subjective tests in accordance with ECJ case law (see at 3.3.1 and 3.3.4), a possible solution is to focus on the recipients and beneficiaries of the aid.134 In this respect, the specificity test should be applied with regard to all involved parties, and only if a tax measure would actually have the effect to favour directly only certain recipients or indirectly any other potential beneficiaries in the light of sectors of the economy, horizontal functions of enterprises, or specific regional areas, would this criterion be satisfied.

131 From these decisions one may draw other more general conclusions in the direct tax area. The first is that similar tax regimes implemented in Belgium and the Netherlands in favour of foreign experts relocating into their countries would seem to meet the specificity criterion, as they are mostly limited for large multinational companies and the Belgian one is connected to the special ‘coordination centre’ regime (see at 3.8.1 and 3.8.2). The second is that the decision by Member States to discriminate against resident experts not entitled to the same beneficial tax treatment is perfectly legitimate under the Treaty state aid rules, meaning that ‘reverse discrimination’ is not incompatible with them (on this issue, see also in Chapter 2, at 2.3.2).

132 See Schön, cit., at 923, citing Frick, Einkommensteuerliche Steuervergünstigungen und Beihilfeverbot nach dem EG-Vertrag, 1994, at 27, but supporting the different approach indicated in the text.

133 The words used in the Notice in this respect are “exception” and “differentiation” (see point 16).

134 See Schön, cit., at 931, and literature cited therein. See also Nicolaides, cit., at 331-332, containing a summary of the tests proposed by the Advocates-General of the ECJ and proposing an alternative two-stage method (at 332-337).
3.6.4 The justification of the "nature or general scheme of the tax system"

The first stage of the investigation on the state aid nature of a fiscal measure within the meaning of Art. 87 of the Treaty ends with the evidence that all four conditions are met. Even if this is the case, there must be a further stage of investigation focusing on whether this fiscal measure is justified by the "nature or general scheme of the tax system", i.e. whether it stems "directly from the basic or guiding principles of the tax system in the Member State concerned". This last analysis will lead to the final decision by the Commission on the compatibility of this measure with the EC Treaty provisions on state aid. From a procedural point of view, the Notice specifies that the burden of proof lies on the Member State concerned, which will have to explain what these domestic economic objectives are or why the measure in question is inherent in its tax system.

From a substantive point of view, a fiscal state aid measure is covered by this justification if it is "necessary to the functioning and effectiveness of the tax system". As an example, the Notice states that "the progressive nature of an income tax scale ... is justified by the redistributive purpose of the tax," and that the "calculation of asset depreciation and stock valuation methods ... may be inherent in the tax system to which they belong", which once again shows the link between the specificity criterion and this justification (see also at 3.6.3). Furthermore, the Notice contains a distinction between "external" objectives of tax measures (e.g. social or regional development) and their "internal" objectives inherent in the tax system itself (namely, the broad goal of raising revenue). However, this distinction is not made workable in practice by identifying practical criteria. On the one hand, it is stated that "each firm is supposed to pay only once" and that "it is inherent in the logic of the tax system that taxes paid in the State in which the firm is resident ... should be taken into account." On the other hand, it is affirmed that "certain exceptions to the tax rules are difficult to justify by the logic of a tax system ... for example if non-resident companies are treated more favourably than resident ones or if tax benefits are granted to head offices or to firms providing certain services (for example, financial) within a group." Further clarification is needed by analysing Commission practice, ECJ case law and the legal literature. On the face of it, it may seem that this justification is nothing new or different from the specificity criterion, which for its application also requires an analysis of a Member State's general tax system to see whether the measure scrutinised forms part of the 'benchmark' or is inherent to it, or it constitutes a specific deviation from this benchmark. However, as legal commentators have observed, there is a logical distinction between selectivity and this justification as both the Commission and the Court have at times found specific fiscal state aid measures that were nevertheless justified by the logic of a country's tax system. In particular, the former deals with the objective interpretation of the concept of aid, while the latter requires an overall analysis of the tax system as a whole and its

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135 See the Notice, point 16. See above at 3.4.2 more in general on this justification.
136 See the Notice, point 23.
137 See the Notice, point 24.
138 See the Notice, point 26.
139 See especially Schön, et al., at 930.
underlying (subjective) aims. Even so, taking as a starting point the Notice and the distinction between internal versus external objectives of a tax system, in practice the distinction between specificity and the “nature” justification is rather blurred. A joint reading of the rules contained in the Notice does not help in this respect. As for the specificity criterion, the Notice states that Member States in principle enjoy sovereignty in the direct tax area as to the framing of the main tax rules (see points 13 and 14, explained at 3.6.3), which seems analogous to the assessment of the “internal” and “external” objectives of the tax system under this justification (see points 24 and 26).

In order to overcome the rather confusing statements contained in the Notice, the starting point is that taken together, these two sets of principles acknowledge that the direct tax area has special features to be taken into account in the application of the state aid rules as opposed to other law areas, namely the fundamental need to raise revenue in order to finance budget expenditure and public services as well as to correct market imperfections or failures in order to encourage the use of certain factors of production (e.g. labour or capital) or the development of certain depressed areas (see also at 3.6.1). In other words, they acknowledge that the direct tax area constitutes an exception to the general rule that only the effects must be objectively evaluated in the compatibility assessment under Art. 87 (1), as a qualitative assessment based on the subjective policy goals of a certain (special) tax measure is allowed under the “nature” justification. This being so, the distinction between specificity and the justification must be based on an objective and a subjective assessment of a possible fiscal state aid measure. First, it must be seen whether such tax measure objectively deviates from the ‘benchmark’ (see in detail at 3.6.3). If it does, the “nature” justification must be assessed by taking into account the tax policy objectives pursued by this measure, such as the goal to redistribute income linked to the ability-to-pay principle, or the goal to avoid international double taxation (i.e. its “internal” objectives), or other economic and social goals linked to the need to make up for structural handicaps suffered by a certain depressed region (i.e. its “external” objectives).

A few practical examples may clarify this distinction. The exemption from corporate taxation of charities and non-profit organisations contained in most Member States’ tax laws, although a specific measure, is justified on the grounds that the objective of these entities is not to make a profit for its shareholders but to use them for appreciable social goals which sometimes the Member States are unable to pursue themselves for lack of necessary resources and funds. Sometimes different tax treatments are justified having regard to the business characteristics of specific sectors, such as banks or insurance companies which are more exposed to risks from bad or doubtful debts and thus may be beneficiary of special tax rules allowing e.g. to form special tax-free provisions for this purpose or to contribute a higher portion of

140 In particular, Point 13, first dash, on specificity, seems to require an analogous assessment than Point 24 on the internal objectives. Point 13, second dash, seems to require an analogous assessment than Point 26 on the external objectives. A case potentially showing the ambiguity of the current approach concerns the Irish relief on foreign-source income, see at 3.8.5.

141 See the Ladbroke Racing case, cit., at para. 28, and Schön, cit., at 928, also pointing out that the exemption from other taxes for these organisations is unjustified under the state aid rules, as is a corporate tax exemption also for their profit-making activities relating to the charitable ones.
their income to them,\textsuperscript{142} or oil companies due to the high exploration risks incurred in their business.\textsuperscript{143}

In some cases the ECJ has ruled that a special tax measure conferring advantages to certain sectors or recipients without a sufficient, targeted, or proportioned underlying policy justification based on the nature or general scheme of the system is incompatible with the Treaty. In the Maribel bis/ter case (see also at 3.6.2), the ECJ concluded that although the Belgian reduction of the social security was a desirable general scheme aimed at promoting job creation (i.e. conferring an advantage on a specific factor of production), it was nevertheless not justifiable as a general measure of economic policy. Interestingly, the Court stated that “it is true that an increased reduction of social security contributions ... does not at first sight appear to derogate from the nature and scheme of the general system of social protection. Moreover ... Member States retain their powers to organise their social security systems ... However ... increased reductions ... in order to attain that objective have the sole direct effect of according an economic advantage to the recipient undertakings alone ... belonging to certain sectors of economic activities, is not justified by the nature or general scheme of the social security system in force in Belgium.”\textsuperscript{144} In other words, the sectoral specificity of the Belgian scheme caused in the Court’s view a distortion of competition which could not justified by the social character of the system and the incentive for the employment factor of production, despite Member States’ sovereignty in this area.

More recently, the Commission has rejected as a justification based on the general nature of the tax system the introduction of favourable tax measures in order to offset the higher tax burden usually applied on a sector of the economy. In the Italian banking case,\textsuperscript{145} the object was an Italian Law providing for a special reduced corporate tax rate of 12.5% on certain mergers in the banking sector. One of the arguments put forward by the Italian authorities was that this sector is subject to specific regulations and a special treatment is justified \textit{inter alia} because of the higher tax burden suffered by this sector. Rejecting this argument, the Commission reasoned that if the aid is justified by the nature of the (banking) business, the underlying reason cannot be a compensation for higher taxation borne by this sector, because a selective measure of this type may not be justified by the presence of other selective measures in the tax system, which would cause a dangerous vicious circle in the system.\textsuperscript{146} This outcome is consistent with the previous ECJ judgement in the Italian road hauliers case,\textsuperscript{147} in which it ruled that disparities in (indirect tax) legislation bringing about distortions of competition may not justify the introduction of a compensatory state aid by the Member State having laid down a more unfavourable (tax) treatment pursuant to its (tax) sovereignty.

From all the above one may conclude that for the application of the Treaty provisions in fiscal state aid matters the evaluation of the specificity criterion and of the

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\textsuperscript{142} However, this is not always true, as shown by the Italian banking case, explained below in this paragraph.

\textsuperscript{143} See on this also Schön, \textit{cit.}, at 926, and Nicolaides, \textit{cit.}, at 326.

\textsuperscript{144} See Maribel bis/ter, \textit{cit.}, paras. 35-39, and its description above at 3.6.2.


\textsuperscript{146} As the Commission decision has been challenged by the Italian government and the banks concerned, it will be interesting to see what the Court rules on this issue.

\textsuperscript{147} Case C-697, \textit{Italy v Commission}, [1999] ECR 1-2981. See also in Chapter 2, at 2.3.4.
justification of the nature or general scheme of the system are closely linked, even though in principle it must be carried out separately. The first prong of the assessment concerning specificity requires an objective analysis of the specific character of the tax measure in a sectoral, horizontal, or regional perspective. The second prong of assessment on the “nature” justification involves a subjective, qualitative analysis of the underlying policy goals of such tax measures, both “internal” to the tax system (e.g. progressivity, need to prevent double taxation) and “external” (i.e. economic and social goals). Also the appropriateness and proportionality of the tax measure to achieve the said goals must be taken into account and weighed against the distortion of competition caused to the internal market. From a practical point of view, this second prong of the assessment could coincide with the assessment of the justifications based on the rule of reason carried out by the ECJ in evaluating the compatibility of direct tax measures with the Treaty provisions on the fundamental freedoms. Even though there is no mention of this in the Notice or in the ECJ case law on the fiscal state aid provisions, the well-developed body of principles with regard to the Treaty freedoms as applicable in the direct tax area and the desirability of a consistent application of these two sets of provision would seem to strongly support this conclusion. This twofold assessment is required in consideration of the special nature of the direct tax area, which plays a fundamental role for the Member States’ ability to fund public expenditures and their pursuit of such fundamental policy goals as income redistribution, economic development, and correction of market imperfections or failures.

3.6.5 The Notice and the administrative practices of tax authorities

A separate paragraph is devoted by the Notice to the “discretionary administrative practices” of the tax authorities. In accordance with settled case law (see at 3.4.6), these are presumed to be specific fiscal aid measures falling foul of the incompatibility principle stated by Art. 87 Treaty whenever they: (i) entail a deviation from the benchmark tax system of a country, due to (ii) the exercise of discretionary powers by the tax administration. This rule is an application of the general principle that specific measures applied on a case-by-case basis and lacking objectiveness, transparency and legal certainty lead to discrimination against firms not enjoying them. In this regard, the Notice contains a reference to a judgement of the ECJ which explicitly affirmed that “treating economic agents on a discretionary basis may mean that the individual application of a general measure takes on the features of a selective measure, ... where exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria”. The Notice also clarifies that the presumption of fiscal state aid does not exist where the administrative practices concern the mere interpretation of a provision of the general tax system, nor where they do not lack transparency or do not imply discretionary decisions by the tax authorities. From this principle it may be inferred that if the presumption does not exist, there will be a reversal of the burden of proof

148 See on this also at 3.4.3, and more in general in Chapter 2, section 2.3, and in Chapter 5, section 5.2.
149 See the Notice, point 21, which refers to Case C-241/94, France v. Commission (Kimberly Clark Sopalin), [1996] ECR I-4551.
on the Commission to submit evidence to the contrary. An application of these principles may be found in a different section of the Notice, which states that “if the tax authority has discretionary freedom to set different depreciation periods or different valuation methods, firm by firm, sector by sector, there is a presumption of aid”. Moreover, it is made clear that “such a presumption also exists when the fiscal administration handles fiscal debts on a case by case basis with an objective different from the objective of optimising the recovery of tax debts from the enterprise concerned”.150

An interesting application of these principles may be found in the Technolease case, which was decided by the Commission in 1999.151 The facts concerned a ruling issued by the Netherlands tax authorities, which approved a technolease agreement between Rabobank and Philips regarding a sale and leaseback of know-how from the latter to the former. This case arose mainly due to the lack of transparency of the Netherlands tax authorities’ practice and to the evasive reactions of these authorities to press publications detailing the technolease deal and questioning the fact that other firms applying for the same type of ruling were not able to obtain it (with the exception of the aviation firm Fokker). The situation was complicated by the fact that at the time of issuance of the ruling there was no specific rule with regard to these kinds of transactions neither in Dutch civil law nor in Dutch tax law to determine whether the Dutch tax authorities had (ab)used their discretionary power by granting a favourable ruling only to Philips (and Fokker) and not to all other taxpayers applying for it.

The Commission concluded that there had been no such abuse of discretion on the part of the Dutch authorities, and thus that the specificity condition was not met in this case. This was based on the grounds that in the absence of specific statutory provisions on this type of deals the Dutch tax authorities merely applied the general Dutch tax law principle of “sound business practice” as interpreted by the Dutch Supreme Court. In other words, the fact that there was no actual discretionary deviation from settled case law, or more specifically that had the Netherlands tax authorities not granted advance legal certainty, and had Rabobank and Philips taken the case to court, they would have had a good enough perspective of winning their case, was sufficient for the Commission to rule out the satisfaction of the specificity criterion. Moreover, this conclusion was based on an ex post examination of the technolease deal on the basis of the guidelines on this subject released by the Dutch tax authorities after the clearance of this deal to ensure transparency and legal certainty. In this respect, the Commission ascertained that even if these guidelines had been published before the clearance of the deal between Philips and Rabobank, this would have been cleared in any event. This case shows the strict attitude of the Commission in the investigation of the rulings issued by a country’s tax administration with regard to the transparency of its behaviour as well as the degree of discretion exercised and its deviation from statutory tax law. Once again, the main problem for the Commission in these cases is to become aware of the issuance of rulings by the tax authorities, often kept secret in accordance with domestic law, and

150 See the Notice, point 24.
to gather as much information as possible also after the opening of an investigation to make a correct decision.

3.6.6 Implementation of the Notice: the Commission large scale investigation on fiscal state aid of July 2001

In addition to substantive policy statements, the Notice contains specific implementation steps. In particular, it states that the "Commission will ... as from the time of its publication, examine the tax aid plans notified to it and ... illegally implemented in the Member States and will review the existing systems".152 This had been explicitly anticipated by the Council in the "Package" to tackle harmful tax competition: "the Council also notes that the Commission intends to examine or re-examine existing tax arrangements and proposed new legislation by Member States, case by case, thus ensuring that the rules and objectives of the Treaty are applied consistently and equally to all"153 (see also at 3.6.1).

As a result of its commitment and after a thorough investigation parallel with the work relating to the implementation of the Code of Conduct (see in Chapter 4, section 4.2), the Commission announced in July 2001 the launch of a number of formal investigations into Member States’ (harmful) corporate tax regimes potentially in breach of the Treaty state aid rules under Art. 88 (2).154 This investigation regards 15 such regimes in 12 Member States and has as its main target regimes mainly or exclusively available for intra-group activities or for the financial sector and usually limited to multinational companies. The majority of these regimes (i.e. 11) are ‘non-notified’ measures, meaning that if they turn out to be in breach of the State aid rules, the Member States concerned are in principle under the duty to recover the aid from the beneficiaries with interest. This is also explicitly envisaged in the procedural rules contained in the Notice with regard to the application of Art. 88 of the Treaty to fiscal state aid (see at 3.3.3), which states that Member States having failed to notify tax measures which constitute fiscal state aid under the Notice will have to recover the tax aid unlawfully handed out “calculated on the basis of a comparison between the tax actually paid and the amount which should have been paid if the generally applicable rule had been applied”.155

The Notice also makes it clear that the recovery of illegal aid will not have to take place “where this would be contrary to a general principle of Community law, in particular legitimate expectation to which the Community’s behaviour can give rise”.156 It is on the basis of this principle that the Commission simultaneously started a review of ‘existing’ fiscal state aid with regard to 4 (potentially harmful) tax regimes already erroneously approved on the basis of the State aid rules in the light of the new rules laid down in the Notice (and in the Guidelines on regional aid). A more

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152 See the Notice, point 37.
153 See the Package, para. J.
155 See the Notice, point 35.
156 Ibid, previous footnote. See on this point in detail at 3.3.3.
detailed analysis of some of these regimes currently being investigated by the Commission follows in the next two sections.

3.7 New rules on regional fiscal aid and the future of tax-free areas

3.7.1 Introduction

As mentioned above, in 1998 the Commission released two documents affecting the principles concerning fiscal state aid limited to regions within Member States potentially covered by the Art. 87 (3) (a) and (c) exemptions: the Notice on fiscal state aid rules to direct business taxation (see Section 3.6) and the Guidelines on national regional aid. While the former sets out a number of principles that the Commission will apply exclusively to tax incentives granted to companies investing in depressed regions qualifying under the said exemptions, the latter contain the new method of application of such exemptions and replaces the 1988 Communication discussed above (see at 3.3.2 and 3.4.7).

As to the interrelationship and interaction of these two sets of principles, they are applicable simultaneously to the same situation if a Member State grants a regional incentive of a fiscal nature. In practice, a three-step investigation will need to be carried out for an assessment on their compatibility with the EC Treaty. First of all, the Commission will have to determine whether such a tax incentive is to be considered “aid” within the meaning of Art. 87(1) under the rules contained in the Notice. If this is the case, the Commission will have to resort to the general principles contained in the new Guidelines to ascertain whether this incentive is to be labelled “regional” because it applies within an area qualifying under either of the Art. 87(3) exemptions. If this is so, the Commission will have to apply the specific principles on regional fiscal aid contained in the Notice in order to issue a final decision on the compatibility of this tax incentive with the Treaty. In this section, the main principles of the new Guidelines on national regional aid will be touched on first, followed by a detailed description of the principles concerning regional fiscal aid contained in the Notice. The impact on some tax-free areas available in the EU is then focused on, in particular the Canary Islands ZEC regime and the Madeira ZFM regime. The former clearly shows that the strict approach of the Commission in allowing special tax-free areas only to the extent they do not cover (also) financial activities and other mobile intra-group services that are not related with the handicaps suffered by these areas. The latter was previously approved and is now being tested against the new rules on regional fiscal aid. Lastly, there will be an analysis of the Basque provinces’ tax incentives, as they have been object of a recent judgement by the CFI showing its attitude towards the strict Commission approach in regional fiscal aid.

3.7.2 The new guidelines on national regional aid and the “outermost regions”

In March 1998 the Commission approved the new Guidelines on National Regional Aid the application of the exemptions laid down in Art. 87(3)(a) and (c), which were meant to replace all of the documents previously issued on this subject matter, including the 1988 Communication. Generally speaking, the Guidelines focus on the
rules concerning regional aid and are broadly shaped on the 1988 Communication, with some differences mainly aimed at reducing the amounts of regional aid allowed consistently with the state aid policy trends highlighted above (see at 3.2.4). The introduction to the Guidelines confirms the exceptional nature of the Art. 87(3) exemptions and the need to narrow their scope in accordance with the general principles explained above (see at 3.3.2). As to the definition of regional aid measures, the Guidelines refer to those which “differ from the other categories of government support (in particular R&D, environmental protection, or firms in difficulty), in that they are reserved for particular regions and have as their specific aim the development of those regions”. The Guidelines deal with measures whose goal is to assist and promote investments in depressed areas and at the same time to boost the employment therein so as to bring about “expansion, modernisation and diversification of the activities of the establishments located in those regions” and encouragement for “new firms to settle there”.157

The Guidelines focus on the (new) method of application of paragraph (3) of Art. 87 of the Treaty. The criteria for the exemption contained in Art. 87(3)(a) are the same as those endorsed by the 1988 Communication, i.e. eligible areas are those whose local GDP is lower than 75% of the EU average over the last three years. However, the aid intensity ceilings of maximum allowed aid have been reduced from 75% to 50% (after tax). The Guidelines contain a difference with respect to the criteria for the application of the Art. 87(3)(c) exemption. The two-stage assessment based on fixed economic indicators and adjusted by other socio-economic parameters laid down in the 1988 Communication has been replaced by a two-stage assessment relying on a closer cooperation between the Commission and the Member States, which is still linked to the former method as regards its mechanics. In the new first stage of assessment the Commission must set specific ceilings for the maximum population eligible to regional aid under Art. 87(3)(c) and decide on the consequent distribution of such regional aid amongst the Member States. In doing so, the Commission must take into account the same economic criteria used in the old first stage, i.e. the ratio GDP/GVA of such areas must be lower than 85% or the structural unemployment higher than 115% of the EC averages over the last three years. The new second stage allows Member States to notify to the Commission a list of domestic regions considered eligible to qualify under Art. 87(3)(c) on the basis of an assessment which is to be: (i) objective, (ii) explained in detail, and (iii) able to show significant socio-economic disparities between these regions and the rest of the country. Even though the Guidelines do not explicitly mention any such indicator, it may be maintained that all the socio-economic indicators contained in the 1988 Communication with regard to the former second stage of assessment may serve as a reference for the Member States for this purpose. The ceilings of maximum aid intensity have been reduced also with regard to Art. 87(3)(c) regions from 30% to 20% (after tax).

These are the most important principles contained in the Guidelines affecting regional fiscal aid. There are several other policy statements with respect to Art. 87(3), but they will not be analysed here because are rather technical and are not relevant for the fiscal area. As a result of the Guidelines, the new maps of regions entitled to benefit from these exemptions for the period 2000-2006 have been approved by the

157 See the Guidelines, in the Introduction.
Commission, which are also valid for the granting of aids from the Union’s Structural Funds.\textsuperscript{158} The application of the Guidelines has immediately meant a reduction of the average regional aid granted, as well as of the population covered by the regional aid maps down from 46.7\% to 42.7\% of the EU population.\textsuperscript{159} Shortly after the implementation of the Guidelines, the Commission has also relaxed its policy on national regional aid granted to the “outermost” regions of the Union.\textsuperscript{160} These regions are covered by Art. 299 (2) of the Treaty, added by the Treaty of Amsterdam, and include the Canary Islands (in Spain), the Azores and Madeira (in Portugal), and the French overseas departments. By virtue of their “structural and economic situation ... compounded by their remoteness, insularity, small size, difficult topography and climate, economic dependence on a few products,” the Commission granted them extra privileges in derogation to the Guidelines, which have been amended accordingly as a result of the entry into force of the Amsterdam Treaty in May 2000. As a result, the “outermost” regions (i) are allowed to grant operating aid even if it is not progressively reduced and limited in time where it is meant to offset the higher costs resulting from the said disadvantages listed in the Treaty, and (ii) are eligible to benefit from Art. 87 (3) (c) status regardless of the satisfaction of the required conditions. These privileges, which add up to the higher aid intensity ceilings previously granted to outermost regions compared to the other Art. 87(3) regions, are important in the assessment on the compatibility with the Treaty of special tax regimes implemented by (some of) them, as will be seen below.

3.7.3 The rules on regional fiscal aid contained in the Notice

In addition to the principles analysed above (see Section 3.6), the Notice addresses the issue of regional fiscal aid. After endorsing the settled principles governing the application of the Art. 87(3)(a) and (c) exemptions, the Notice explicitly refers to the new Guidelines so as to ensure consistency between the two documents.\textsuperscript{161} In this respect, in order to benefit from the exemptions of Art. 87(3) of the EC Treaty the Notice requires that regional fiscal aid measures:\textsuperscript{162} (a) have a positive impact on regional development and employment; (b) be potentially able to improve a regional disadvantage; and (c) bring about positive effects within the Community without causing serious negative distortions in other countries’ economies.

Two important clarifications are then added. With respect to the requirement under (a), it is pointed out that the establishment of offshore (i.e. tax-free) areas is usually not considered to be a sufficient stimulus to the concerned region’s economy because the positive externalities created by them are too low. Therefore, fiscal incentives

\textsuperscript{158} As in the past, the Commission is to issue on a regular basis a list of depressed regions qualifying under Art. 87(3)(a) and (c) and the corresponding maximum amounts of aid for each region. The national ceilings for regional aid for the period 2000 to 2006 has been published in OJ C 165 of 21 January 1999 and may be found on the Commission Competition web site. For the latest news on the maps of eligible regions, see at http://europa.eu.int/comm/competition/state_aid/regional/.

\textsuperscript{159} See also the Commission Report on Competition Policy, 2000, cit., paras. 344 ff.


\textsuperscript{161} See the Notice, point 32.

\textsuperscript{162} See the Notice, point 33.
offered through the establishment of tax-free zones are no longer likely to be considered compatible with EC law and to receive Commission approval. With regard to the condition under (b), the Notice explains that “it is open to question whether there are any real regional handicaps involved in activities for which for example transport costs are of little relevance, such as financing activities, which lend themselves to tax avoidance”. This means that the concession of fiscal incentives in favour of financial (and similar intra-group) activities even in depressed areas covered by one of the regional aid exemptions may from now on be considered incompatible with the EC Treaty in any event (unless they are granted in “outermost” regions, see at 3.7.2 and 3.7.5).

The reason behind this is that the remoteness or depression of the areas concerned has no significant relationship to the carrying out of financial intra-group activities. The usually much higher costs of establishing an active business in these areas do not occur in case of financial (and similar) services, since these activities are easily movable elsewhere. Consequently, there would be no justification for allowing a distortion of competition in favour of them even in these depressed areas, since the relevant benefits would be more than cancelled out by the negative effects caused to other Member States’ economies, i.e. those stemming from the relocation of mobile activities to newly-created offshore areas. This would in turn violate the principle contained under (c) above, i.e. the (negative) international spill-over effects, which are one of the undesirable consequences caused by harmful tax competition (see Chapter 1. Section 1.2).

3.7.4 Impact of the new rules on the Canary Islands Regime

An interesting case directly affected by the application of the new rules on regional fiscal aid, and illustrative of the interaction of fiscal aid rules and regional aid rules, is the tax-free area established in the Spanish archipelago of the Canary Islands. Since 1991 this area features a special economic and fiscal regime (i.e. Régimen Económico y Fiscal de Canarias, hereinafter: "REF") approved by the Spanish Government with the aim of favouring the development of this depressed area. As part of this regime, several tax incentives concerning both direct and indirect taxation were introduced, such as a (limited) corporate tax holiday, the possibility to create a tax-free investment provision, an investment deduction, and an exemption from capital transfer tax. In addition, a special tax regime was introduced in 1994 in favour of non-resident multinational companies establishing within the archipelago entities carrying on certain financial and insurance activities (i.e. Zona Especial Canaria, hereinafter: “ZEC”). Under the proposed ZEC regime, eligible entities were virtually exempt from corporation tax on profits deriving from eligible activities, and their outbound payments of dividends, interest and royalties were exempt from

withholding tax in Spain. The ZEC regime, which has never entered into effect in this version for the reasons explained below, was originally due to expire in the year 2024. The Spanish Government notified the REF regime to the Commission for the assessment of its compatibility with the state aid rules. The Commission came up with a positive decision but conditional on the fulfilment of certain conditions. The reasoning for the approval focused on the fact that the Canary Islands were covered by the exemption of Art. 87(3)(a) and, in addition, were included among the "outermost" regions entitled to grant additional benefits in consideration of their remote location (see at 3.7.2).

As for the ZEC regime, the Spanish government and the Commission started difficult negotiations under the state aid rules. On the one hand, this was due to the adamant attitude by the latter to deny its approval based on the (then proposed) rules of the Notice, and in particular its goal to attract financial investments and its exclusive availability for non-resident multinational companies, which was part of its tough strategy in the application of state aid rules to counter harmful tax competition after the Irish corporation tax case. On the other hand, the Spanish Government felt discriminated against because similar competing tax-free areas had been approved by the Commission, such as the Irish IFSC (see in Section 3.5), the Belgian coordination centre regime (see in Section 3.8) and the Madeira ZFM regime (see at 3.4.7 and below at 3.7.5), whereas others had not even been scrutinised (see in Section 3.8). What further complicated the situation was the fact that the Canary Islands were due to lose Art. 87(3)(a) status and possibly to acquire the Art. 87(3)(c) status and that the new Treaty provision on the "outermost" areas as well as the amendment to the Guidelines on regional aid were not effective at that time.

The Commission finally approved the new Canary Islands ZEC regime in January 2000 as a result of a number of modifications accepted by the Spanish government. These modifications were necessary to ensure compliance with the principles of both Guidelines and Notice, and aimed AT granting the special tax incentives only to the extent that there would be actual investments lasting for a certain period and creating employment. This is also reflected in the estimates by the Spanish authorities that some 563 firms would be attracted by the regime and some 2,815 new jobs would be created in the archipelago, with a net tax revenue loss of about € 102 million.

The details of the new ZEC regimes are interesting to understand the new tough Commission approach in the fiscal state aid area also towards depressed areas. New entities, either companies or local permanent establishments, will be eligible for the special regime provided their main office and the management takes place in the Canary islands and the shares are registered. Furthermore, these companies must undertake a minimum investment of € 100,000 and create at least five new jobs, in specified business activities. These requirements show that only companies effectively active on the islands, contributing to the local development and employment, and whose ultimate beneficial owner is disclosed, are entitled to the new regime. As for the eligible activities, they include manufacturing (e.g.

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production, transformation, handling and distribution of products in a wide range of business sectors) and service activities (e.g. transportation, processing, handling and marketing of products, and computer-related services). However, financial activities, coordination types of services, and other intra-group services are specifically excluded from the benefits of the ZEC. This is an application of the principle that these activities do not contribute to a significant extent to the development of the Canary islands due to their mobility, and that the main effect of this regime would will be to unduly erode other (Member) States’ taxable bases.

The main incentive featured by the ZEC regime is a corporate tax rate of 1% to 5% depending on the year of registration, the creation of employment, and the activity carried out. This rate progressively increases each year in order to reduce the amount of aid suffered by the Spanish treasury (i.e. is digressive). There are other incentives for eligible entities, such as exemption from the local VAT, exemption from transfer tax, and a reduction of local taxes. On the other hand, ZEC entities are subject to other minor taxes for the registration in the ZEC Registry and for the issue of other documents by the local authorities (i.e. the ZEC Consortium). After the amendment, the ZEC regime is available until 31 December 2006 (i.e. when the new maps of regions entitled to regional aid will have to be approved), with possibility for eligible companies to enjoy its benefits until 31 December 2008.

The Canary Islands regime shows that the Commission is committed to stopping any form of fiscal state aid not justified by the underdevelopment or underemployment of areas entitled to regional aid under the Art. 87(3) exemptions. As a result of the application of the principles contained in the two sets of documents (i.e. the Guidelines and the Notice), the Commission allows aids in the form of corporate tax reductions or exemptions only where they are targeted to the objectives of spurring local growth and employment, are proportionate to the higher costs implied by the local handicaps of these areas, must be limited in time and digressive as for their amount, and in no event must be ring-fenced from the rest of the economy.

3.7.5 Is there a future for tax-free areas? The Madeira ZFM case

The application of the new principles on regional fiscal aid by the Commission as well as the impact of the Canary Islands case with regard to the Madeira ZFM regime (see for its history and approval at 3.4.7) will be of paramount importance to infer whether there still is a future for comprehensive tax-free zones in the EU. The ZFM regime as repeatedly approved by the Commission was available for a number of activities and featured several tax incentives. In particular, the ZFM is composed of an industrial free zone, an international business centre (hereinafter: “IBC”), a financial services centre (hereinafter: “FSC”), and a shipping register (hereinafter: “MAR”). Eligible entities are entitled to a corporate tax exemption from their income, as well as to a lower VAT rate and customs duties on the import of goods. Furthermore, there is an exemption from withholding taxes on payments of

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167 It is also worth noting that ZEC entities are entitled to the application of tax treaties as well as to the application of the Parent/Subsidiary Directive.

168 The tax (and financial) incentives of the ZFM were laid down in Decree-Law 502/85 of 30 December 1985 as amended by Decree-Law 165/86 of 26 June 1986, transposed into Art. 41 Tax Incentive Statute (approved with Decree-Law 215/89 of 1 July 1989).
dividends, interest, and royalties, as well as on fees paid to providers of services. These exemptions do not apply, however, if the transactions involve Portuguese residents or mainland Portugal, which makes this regime ring-fenced from the Portuguese economy (see also at 3.8.4). All these incentives are due to apply until 2011 for companies licensed before 31 December 2000. Despite the issue of the Notice on fiscal state aid and the Guidelines on national regional aid, the Commission started a review of the ZFM regime in early 1998 on the basis of Art. 88 (1) of the Treaty (see at 3.3.3). In particular, it raised the attention of the Portuguese authorities on the need to comply with these documents in view of their entry into force and to take appropriate steps to this and effective as of January 2000. After a number of meetings between the Commission and Portuguese officials, no compromise was reached and the Commission decided to open an Art. 88(2) procedure for failure to notify any proposed measure as requested by the Commission. In its Notice, the Commission indicated that the amount of tax aid is quite significant,169 amounting to €1 billion in 1997 only, and benefiting some 4,000 firms employing almost 1,000 people. Furthermore, it pointed out that given the fact that the new amendments on the “outermost” regions had not entered in effect at that time, operating aid in the form of tax exemptions like the ones featured by the ZFM would only be allowed for the transportation sector. Confirming its policy towards the Canary Islands, the Commission restated the same principles as to the need of targeting and proportionality of the fiscal state aid also in Madeira, stating that as from January 2000 “financial sectors and certain international services (‘intragroup’ service firms and coordination centres) would have to be excluded from the scheme, given their small contribution to regional development and the absence of genuine regional handicaps in this field; in addition, the amount of corresponding tax revenue shortfall may have to be limited.” Interestingly, the Commission added that given the proportion of the number of eligible firms to the number of employees and tax revenue loss (see above), “it appears difficult to take the view that the aid is justified in terms of contribution to regional development” and that this conclusion would in no event be affected when operating aid was assessed in the light of new Art. 299(2) of the Treaty on the “outermost” regions. In response to the Commission Notice, the Portuguese authorities approved an amendment to the ZFM effective as from 1 January 2001, with ZFM entities licensed until that date eligible to benefit from the regime until 2011.170 Under the new regime, the corporate tax exemption for the industrial free trade zone (as well as the MAR) are unchanged until the previous anticipated expiration of 2011 also for newly registered ZFM companies. This would probably be justified given the apparent contribution to the local development this type of real investment brings about. As for the IBC regime, international service companies performing e.g. international trading, management and accounting, consulting, and investment and property services, would enjoy a low rate of 1 to 3% until 2011 depending on the year in which they are licensed (with new licenses granted until 31 December 2006 at the latest, like

in the new Canary Islands regime). With regard to the IFS centre, companies performing financial activities such as banking, insurance, leasing, factoring, and fund management, would be subject to a corporate tax rate of 7.5% to 12.5% until 2011 depending on the year of license, under the same conditions and deadlines as for the IBC.

At the moment, the Commission has not yet approved the ZFM in its new version. One may guess that the situation is not an easy one, as on the one hand the Commission has pushed the Spanish authorities to significant concessions and changes for the approval of the Canary Islands regime, and on the other hand has to take into account the new Art. 299 (2) of the Treaty and the subsequent corresponding amendment to the Guidelines on regional aid. The Portuguese authorities have made a smart move by simply enacting a slightly modified version of the ZFM regime immediately effective, with reduced tax incentives to ZFM entities performing financial services and intragroup activities. These changes are probably considered to be sufficient to comply with the new Treaty provision on outermost regions, also supported by the claim that these sectors have indeed significantly contributed to the development and new employment in the archipelago in terms of skilled consultants and managers. One notes that the ZFM regime is still ring-fenced after the said amendments, and particularly suspicious is that the withholding tax exemptions on outbound payments have not been repealed.

Nobody can predict what the outcome of this case will be. If the Commission sticks with its attitude in the Canary Islands case and with the principles contained in the Notice, it will have to issue a decision of incompatibility of the ZFM with the Treaty and force Portugal to recover tax aid unlawfully granted as from January 2000 given the new characterisation of non-notified aid and the resort to the Art. 88(2) procedure. In this case, there will be no room for comprehensive tax-free areas in the future, not even in the “outermost” areas of the EU, but one would expect that the Portuguese government would take the Commission to court seeking annulment of its decision, with the final outcome being years away. In the opposite case, tax-free areas could still survive at least in the outermost regions, but one would expect in all likelihood that the reaction by the Spanish authorities against the Commission would be adamant in this event. Probably, a balanced compromise at political level between the Commission and the Portuguese authorities avoiding both the above scenarios will appease make, although at the moment it seems hard to guess what it will look like.

3.7.6 Tax credits and tax holidays: the case of the Basque Provinces

Simultaneously with the widespread investigation on fiscal state aid (see at 3.6.6. and Section 3.8 below), the Commission issued a decision of incompatibility of six regional fiscal state aid measures implemented by the Basque Provinces. Given the

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171 It is worth noting that the new amendments to the ZFM are effective as from 2001, and therefore even if the Commission would approve this modified version the issue would still remain for the tax benefits unlawfully handed out in the year 2000 as well as for the new licenses granted in that year.

similarity of these regimes, the present analysis will focus on the one adopted by the Province of Álava, which has also been object of a recent decision by the European Court of First Instance.\footnote{Territorio Histórico de Alava - Disputation Foral de Alava and Ramondín v Commission, 6/3/2002, nyr, Whic h wa s th e objec t o f th e judgemen t b y th e CFI. A t th e en d of th e inves tig ation , th e Commissio n isu e d a decisio n o f incompatibilit y fo r al l th e six Basque Provinces’ regimes in July 2001. As fo r th e tax credit, th e Commissio n consid ered ail th e fo ur re quirem ents fo r th e app licatio n o f th e state aid rules met. Interestingly, with regard to the specificity criterion, even though the credit was available for all companies establishing in Álava and for all sectors, the Commission considered the high required threshold for investments as in fact favouring only large firms with substantial financial means. With regard to the regional aid exemptions, the Commission considered that Álava was an Art. 87(3)(c) region, but the amount of investment had exceeded the eligible threshold (i.e. 45% tax credit versus an allowed aid intensity of 25%, with lower intensities depending on the period). As a result, the Commission ruled the Álava aid incompatible with the Treaty state aid rules, but only for the part exceeding the eligible thresholds. As to the tax holiday, the Commission also found that all the four conditions were met on the same grounds. Furthermore, due to its character of operating aid only eligible for Art. 87(3)(c)}

The first tax incentive is a tax credit of 45% for new investments in fixed assets exceeding €15 million (i.e. ESP 2.5 billion), which has been in place in Álava for the period 1995-2000 (and in the other Basque Provinces in the period 1997-2000). The use of the credit was subject to a discretionary approval by the local tax authorities, and the unused credit could be carried forward for nine years. The second measure is a tax holiday in favour of new enterprises established in the Province (i) with a capital of at least ESP 20 million (i.e. some €120,000), (ii) undertaking new investments in fixed assets of at least ESP 80 million (i.e. some €480,000), (iii) submitting an investment plan lasting for at least 5 years, and (iv) creating at least 10 new jobs. The tax holiday was in place in the period 1996-2000 and consisted of a reduction of the taxable base of eligible enterprises by 99%, 75%, 50%, and 25% respectively for four consecutive years.

The Commission initiated an investigation of these regimes in 1999 as a result of a decision concerning two specific companies enjoying the special regimes granted by the Álava Province,\footnote{Commission Decision 2000/795/CE of 22/12/1999, OJ 2000, L 318, p. 36.} which was the object of the judgement by the CFI. At the end of the investigation, the Commission issued a decision of incompatibility for all the six Basque Provinces’ regimes in July 2001.\footnote{Commission Press Release IP/01/981 of 11/7/2001, available on the web site http://europa.eu.int/rapid/start.} As for the tax credit, the Commission considered all the four requirements for the application of the state aid rules met. Interestingly, with regard to the specificity criterion, even though the credit was available for all companies establishing in Álava and for all sectors, the Commission considered the high required threshold for investments as in fact favouring only large firms with substantial financial means. With regard to the regional aid exemptions, the Commission considered that Álava was an Art. 87(3)(c) region, but the amount of investment had exceeded the eligible threshold (i.e. 45% tax credit versus an allowed aid intensity of 25%, with lower intensities depending on the period). As a result, the Commission ruled the Álava aid incompatible with the Treaty state aid rules, but only for the part exceeding the eligible thresholds. As to the tax holiday, the Commission also found that all the four conditions were met on the same grounds. Furthermore, due to its character of operating aid only eligible for Art. 87(3)(c)
regions or "outermost" regions of the EU, the Commission concluded that it was wholly incompatible with regional fiscal state aid rules. The CFI upheld the Commission's view, rejecting all arguments put forward by the Basque authorities and the recipient companies. In particular, with regard to the credit the CFI agreed that specificity in this case is founded on four elements, namely the significant discretionary power of the local tax authorities, its de facto limitation to large companies with substantial financial means, its temporary character, and the limitation of the credit to new investments for certain eligible assets only as well as to companies established in that Basque Province only. The same conclusion was reached with respect to the tax holiday, which was held specific in the same respects. The Court also analysed in detail the justification of the general scheme of the system based on the regional aid exemptions, and in particular on the alleged desirable objectives of industrial policy to favour the creation of new enterprises, new investments, and new jobs in the Basque province. The CFI rejected all of them pointing out that that the decision by the Commission was not based on the regional aid exemption envisaged in Art. 87(3), but rather on the general criteria of Art. 87(1), and therefore no misuse of its discretionary power could be lamented by the Basque authorities. It is also noteworthy that the CFI stated that this justification is not sufficient to deem selective measures like the Álava regional fiscal aid compatible with the Treaty, because this would render meaningless the prohibition of Art. 87(1) and the same objective could be pursued by way of general rather than selective measures.

3.7.7 Fiscal regional state aid: some conclusions

By and large, one notices that all the above cases involve complex issues arising from the interaction or overlap of different sets of rules. More specifically, there is a simultaneous application of the general state aid rules contained in the Treaty (as interpreted under the ECJ case law), of the fiscal state aid rules contained in the Notice, and of the rules on regional state aid contained in the Guidelines, as well as possibly of other rules on horizontal and/or sectoral state aid. Based on the above cases, one may conclude that a logical application of the state aid rules requires first and foremost a determination on whether regional fiscal regimes are to be labelled as state aid within the meaning of Art. 87(1) of the EC Treaty. For this purpose, the general principles laid down in the Notice on fiscal state aid must be used by virtue of the rule lex specialis derogat generali because the Notice specifically deals with the application of this Treaty provision to aids of a fiscal nature. The next step is to investigate the applicability of the justification of the nature or general scheme of the system based on the policy objectives pursued by the scrutinised regimes. If this justification is not applicable, then it must be assessed whether the aid is covered by any of the exemptions contained in Art. 87(3) of the Treaty by applying the method contained in the Guidelines. If this is the case, the specific principles of regional fiscal state aid laid down in the Notice must be applied to make the final decision on the compatibility of these regimes with the Treaty.

176 See the Ramondin case, cit., paras. 32, 35, and 39.
177 See the Ramondin case, cit., paras. 51 and 62.
It is no easy task to balance all interests at stake with this four-step investigation regarding the Member States concerned, the depressed regions entitled to the exemptions, the companies recipient of the aid, and the EU interest to prevent distortions of competition through (local) government intervention. The Commission has shown that it agrees to fiscal state aid in the form of a reduction of the tax base or of the tax liability only if they are effectively linked to real business activity carried out locally and are proportionate to compensate for the local handicaps. The Commission has also shown that the more specific, either de jure or de facto, these tax incentives are, not only with regard to their regional applicability, but also to the size of the beneficiaries, the eligible sector, and the discretionary power exercised by the local tax authorities, the less likely they are justified on the basis of the nature or general scheme of the tax system or of the Art. 87(3) exemptions. The CFI has explicitly blessed this approach by stating that ‘multiple’ specificity of a regime in several respects prevents its justification on the grounds to favour the development and job creation in depressed areas, and in any event that the maximum thresholds of permissible aid granted in Art. 87(3) regions must be complied with.

With more specific regard to tax-free areas like the ZEC or ZFM, one may conclude that the Commission will consider tax-free areas incompatible with the EC Treaty regional fiscal state aid rules unless they are implemented in “outermost” regions or Art. 87(3)(a) regions. Furthermore, even in these cases the Commission will not authorise them unless:

• substantial positive effects may be expected for the area’s development and employment;
• only insignificant spill-over effects will occur in other Member States’ economies; and
• tax incentives granted in such areas will not be limited to income from passive activities (e.g. financial services) or to non-resident taxpayers.

An application of these principles has recently led the Commission to reopen the investigation on the Trieste FIC regime approved in 1995 (see at 3.4.7), on the grounds that it doubts that this tax-free area is still justified by the need to favour the development of Eastern European countries, especially considering that this scheme has not yet been applied in the Trieste area. If one also considers the Commission decisions with regard to the Irish IFSC and the Canary Islands ZEC (and possibly the Madeira ZFM), the only conclusion that can be drawn is that as far as financial (and insurance) activities are concerned tax-free areas in the EU are probably buried for ever.

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178 See Commission Press Release IP 02/325 of 27/2/2002. It is worth noting that the Trieste FIC regime has never been implemented, as it took several years for the Italian authorities to issue legislation to this effect (i.e. Ministerial Decree No. 508 of 8/10/1996 and Presidential Decree No. 352 of 13/7/1999) and nothing has been done to actually set up the centre before the opening of the Commission investigation.
3.8 The 2001 Commission large scale investigation: notional taxation, ring-fenced 'offshore' regimes, and methods to relieve double taxation

3.8.1 Tax base aid: coordination centres and similar intra-group regimes; the Belgian example

As a result of the issue of the Notice on fiscal state aid and its commitment to fight harmful tax competition, in July 2001 the Commission has opened a large scale investigation with regard to 15 special regimes adopted in 12 Member States (see at 3.6.6 above). The most important part of this investigation concerns the compatibility with the Treaty (fiscal) state aid rules of special tax regimes available for intra-group 'centres' performing coordination, financial, service and distribution activities. Entities eligible for these regimes usually include corporations or permanent establishments of multinational groups performing these activities exclusively for the benefit of other group companies and established in the country granting them. In short, these special regimes provide for a favourable tax treatment relying on notional methods of taxation, such as the cost-plus method. According to this method, the determination of eligible entities' taxable income is based on a certain percentage of the costs incurred in the provision of coordination and similar intra-group services rather than on the normal calculation of their income as resulting from their financial statements. There are a number of examples of these regimes throughout the EU, the most notable of which in terms of its widespread use by multinational companies is represented by Belgium.

The special regime for Belgian coordination centres (hereinafter: "BCC") was introduced back in 1982 in favour of coordination centres of multinational companies performing certain support and financial activities exclusively in favour of other group companies (so-called intra muros requirement). In order to be eligible, the multinational group must have: (i) subsidiaries in at least four countries different from the one of the parent company; (ii) net 'foreign' equity outside of Belgium and the country of the parent company of at least BEF 500 million (i.e. some € 12.4 million) or at least 20% of the consolidated equity of the group; (iii) 'foreign' turnover of at least BEF 5 billion (i.e. some € 124 million) or at least 20% of the consolidated turnover of the group; (iv) a consolidated equity of at least BEF 1 billion (i.e. some € 24.8 million) and a consolidated turnover of at least BEF 10 billion (i.e. some € 248 million); (v) at least 10 full-time employees by the end of the second year after the start of the BCC's operations. BCCs may perform two main categories of eligible activities: (i) support activities, including advertising and sales promotion, R&D, information collection and communication, and services such as accounting, administration, and electronic data processing (EDP) centralisation; (ii) financial activities, including group financing, financial and treasury management, re-invoicing, leasing and factoring, etc.

The tax treatment of BCCs is based on the cost-plus method, i.e. their taxable income is equal to 8% of the operating costs and expenses incurred by them. However, significant costs such as personnel and financial costs are excluded from the taxable base. BCCs enjoy additional tax incentives such as exemption from withholding taxes on passive income, exemption from capital duty, and exemption from real property withholding tax. However, BCCs are subject to an annual tax on each of their employees equal to BEF 400,000 (i.e. some €10,000), which is partly compensated by expert foreign employees working for BCCs being entitled to a special tax regime providing for tax-free allowances and expense reimbursement and taxation of their salary only on the basis of the days actually spent in Belgium (see also at 3.6.3). Similar coordination centres regimes have been introduced in the past in a number of other EU countries and some of them are still in effect. In Luxembourg, the coordination centre regime applied to a multinational group active in at least two other foreign countries and whose parent was located outside Luxembourg.\(^{180}\) For the computation of profits subject to the standard Luxembourg corporate tax rate a cost-plus method with a 5% mark-up was used in compliance with OECD standards, with commercial profits fixed at LUF 1.5 million (i.e. some €37,000) in case of expenses lower than LUF 30 million (i.e. some €743,000). Also Germany features a similar regime for headquarters and coordination centres of multinational groups relying on cost-plus with a 5 to 10% mark-up, which is not formalised in an advance ruling but is always accepted by the German tax authorities in case of a retroactive assessment carried out on these entities.\(^{181}\) The three Basque provinces in Spain (i.e. Vizcaya, Guipuzcoa and Aalava, see also at 3.7.6) also offer a coordination centre regime for multinational groups.\(^{182}\) Focusing on the regime implemented by Vizcaya, which is also subject to the Commission investigation, it is available for groups: (i) present in at least two foreign countries; (ii) having consolidated equity of at least ESP 1.25 billion (i.e. some €7.5 million) and (iii) consolidated turnover of at least ESP 8 billion (i.e. some €48 million) both of which must not belong to Spanish entities or arise in transactions carried out in Spain for more than 25%. The tax treatment of eligible coordination centres allows them to compute taxable income either regularly on the basis of their financial records or on the basis of the cost-plus method with a mark-up of 25% of their expenses, with the exclusion of financing charges. In addition to coordination centres regimes, other intra-group regimes applicable to service and distribution activities have been implemented throughout the EU. Belgium features two such regimes in favour of: (i) service centres performing certain intra-group activities of a preparatory or auxiliary nature, and (ii) distribution centres rendering services for the handling of group products and similar activities. The common characteristic of these regimes is that service and distribution centres must perform eligible activities for the exclusive benefit of other group companies and must bear a negligible economic risk. As to the method of taxation, the main

\(^{180}\) This regime was introduced by the Luxembourg tax authorities' Circular L.I.R. No. 119 of 12/6/1989, repealed by Circular L.I.R. No. 1119 of 20/2/1996.

\(^{181}\) The German headquarters and coordination centres regime was introduced by the Ministry of Finance Administrative Order of 24/8/1984 (\textit{Bundessteuerblatt} 1984, part I, p. 458).

difference between these regimes and the BCC regime is that in principle taxable profits of service and distribution centres are those resulting from their financial accounts. However, if the amount of taxable profits is at least equal to the amount resulting from the application of the notional cost-plus\footnote{The cost-plus method is applicable to determine taxable income of distribution centres with a usual mark-up of 5\% and, in certain instances, of service centres with a mark up of 5, 10, or 15\% depending on the activities performed and the risks incurred.} or resale-minus\footnote{The resale-minus method applies to service centres with respect to certain activities. According to this method, the taxable income resulting from their financial records must be at least equal to a fixed percentage of the receipts for the resale of goods effected by them.} methods, it will be accepted by the tax administration without initiating a transfer pricing proceeding even though the amount may turn out to be quite low. Similar regimes featuring notional methods of taxation have been implemented in other EU countries, such as the French centres de logistique\footnote{This regime, although already applying before, was formalised in the French tax administration’s Guidelines BOI 13G-I-97 of 21 January 1997. The guidelines also contain a favourable regime in favour of coordination centres (‘quartiers généraux’) of multinational companies established in France and of employees working for both distribution centres and coordination centres, which latter regimes are not explained in the text. For an explanation of these regimes see e.g.: P. H. Revault and F. Rontani, France Extends Rulings for Cost-Plus Taxation to Headquarters of Multinational Groups, Tax Notes International, 3/3/1997, p. 761; P. J. Douvier, Clarification of Tax Regime for Headquarters and Distribution Centres, European Taxation, 4/1997, p. 131; M. A. Deysine-de Bourqueney & R. Jouffroy, New Tax Developments to Encourage Foreign Investments in France: Headquarters, Logistics Centres and Taxation of Expatriates, European Taxation, 5/1997, p. 219; P. Y. Bourtourault and M. Mbwa-Mboma, New Tax Treatment of Logistics Centres in France, Intertax, 10/1997, p. 342.} and the Dutch distribution centres regimes,\footnote{This administrative practice was introduced by the Resolution of the Dutch Ministry of Finance No. 084.2737 of 25 April 1985, concerning the Tax treatment of certain activities of multinational enterprises (i.e. Resolutie Staatssecretaris van Financien: “Fiscale behandeling van bepaalde activiteiten in concernverband”), by Loyens & Volkmaars, Intertax, 6-7/1986, p. 144. On the Dutch distribution centre regime see e.g.: G. te Spenke, Taxation in The Netherlands, Kluwer, 1995; A. M. Huyghe, The Special Tax Regime for Distribution Centers – a Comparison with the Tax Regime for Dutch Distribution Centers and with Similar Tax Regimes in Belgium, Intertax, 2/1992, p. 97.} both relying on a cost-plus method with a mark-up of 6 to 12\% the former and 5 to 10\% the latter depending on the circumstances and the risks incurred by these entities.

3.8.2 Analysis of these regimes and of notional methods to determine the taxable base under EC (fiscal) state aid rules

Among the above regimes subject to the Commission investigation on fiscal state aid are the Belgian, the Luxembourg,\footnote{Case C 49/2001 (ex NN 46/2000), Commission Notice OJ C 304 of 31/10/2001.} the German\footnote{Case C 47/2001 (ex NN 42/2000), Commission Notice OJ C 304 of 31/10/2001.} and the Basque provinces\footnote{Case C 48/2001 (ex NN 43/2000), Commission Notice OJ C 304 of 31/10/2001.} coordination centres regimes, as well as the French regime for the coordination centre (i.e. quartiers généraux) and the centres de logistique.\footnote{Case C 45/2001 (ex NN 39/2000), Commission Notice OJ C 302 of 27/10/2001.} While the Belgian coordination centre has been characterised as an ‘existing’ aid previously authorised by the Commission in 1984 on the grounds that it did not favour any sector of competition,\footnote{The Commission authorised this regime in its Letter SG (80) D/8756 of 17 July 1980 and Letter SG (84) D/6421 of 16 May 1984. On the investigation regarding the BCC regime, see Case C 15/2002 (ex E 1/2000), Commission Notice OJ C 147 of 20/6/2002, p. 2. See also the Commission Press Release IP /02/235 of 27/02/2002, available on the web site: http://europa.eu.int/rapid/start. The Commission opened an Art. 88(2) procedure after Belgium did not follow its recommendations of July 2001 to amend its regime as requested (see Letter of Commissioner Monti.} the other regimes are considered non-notified subject to recovery with
interest from the recipients (see at 3.3.3). The analysis below will mainly focus on the Belgian BCC regime given its success among multinational companies and the special attention received by the Commission and the other Member States also in the framework of the Code of Conduct (see in Chapter 4, Section 4.6). The same considerations are also valid with regard to the other special tax regimes mentioned above, and references to the Commission's statements in this respect will also often be made due to their analogous validity for the BCC regime.

To begin with, the Commission decisions with regard to the Irish IFSC (see Section 3.5) and the Canary Islands ZEC regime (see at 3.7.4), as well as its investigation with regard to the Madeira ZFM regime (see at 3.7.5) leave little doubt that BCCs (and similar regimes) are to be considered in breach of the fiscal state aid rules. However, one notes that there are different and sometimes conflicting or vague policy statements in the Commission Notice on fiscal state aid that may apply to these special tax regimes relating to intra-group activities (see also Section 3.6). First of all, the Notice states that "some tax benefits are ... restricted to certain types of undertakings, to some of their functions (intra-group services, intermediation or coordination)" and that "in so far as they favour certain undertakings or the production of certain goods, they may constitute state aid" (emphasis added). Furthermore, with regard to the justification of a derogation from the general tax system on the basis of "the nature or general scheme of the system", the Notice reads:

"certain exceptions are ... difficult to justify by the logic of a tax system. This is, for example, the case if non-resident companies are treated more favourably than resident ones or if tax benefits are granted to head offices or to firms providing certain services (for example, financial services) within a group."

Lastly, in a different paragraph the Notice states that:

"specific provisions ... allowing for example tax to be determined on a fixed basis (for example, in the agriculture or fisheries sectors), may be justified by the nature or general scheme of the system and ... not be considered to be an aid, where for example they take account of specific accounting requirements or of the importance of land in assets which are specific to certain sectors."

These statements do not lift the uncertainty concerning the compatibility of Belgian coordination centres and similar special regimes with EC law. With regard to the four

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193 See the Notice, point 20.

194 See the Notice, point 26.

195 See the Notice, point 27.
criteria for the application of the fiscal state aid rules, these regimes seem to constitute an operating aid in the form of relief from charges otherwise due by the recipient companies with a corresponding loss of tax revenue for Belgium (and the other Member States), and are able to significantly distort competition and intra-Community trade as interpreted by the Commission and the ECJ (see at 3.3.1 and 3.6.2). Focusing on the numbers, some 400 large multinational companies have benefited from the use of BCCs for several years and will keep enjoying their benefits up to 2009. One might argue that given the success of this regime, Belgium is actually gaining revenue as all these multinationals would not have located in the country in its absence. In other words, the BCC regime would actually mean higher tax revenue for Belgium in terms not only of corporate tax revenue paid by the BCCs that located therein as a result of its implementation, but also of the head-tax on BCCs' employees (see at 3.8.1), as well as of the tax on income earned by the some 20,000 individuals performing directly and indirectly services for BCCs, leaving aside the additional income and wealth created in the country by the presence of BCCs. In the light of Commission practice and ECJ case law, one may guess that this argument would not be accepted since each measure must be analysed objectively taking into account only its direct effects caused, the potential tax revenue increase linked to its implementation in absolute terms being irrelevant for this purpose as well as (close to) impossible to prove (see also at 3.8.3 on the Dutch CFM case). Furthermore, the Commission Notice stresses that the BCC regime entails significant losses of tax revenue for Belgium linked to the exemptions from capital duty and from withholding taxes on passive income and on real estate tax normally due under the benchmark tax system.

The next question is whether the BCC and similar regimes fulfil the specificity criterion. On the one hand, one would think so as they are clearly limited to large multinational companies active in several countries and having a substantial (foreign) turnover. The Commission has stated that a limited applicability in this respect is sufficient for this purpose, and the Court has supported this view also pointing out that large multinational companies have an advantage towards SMEs and/or large local companies not having (sufficient) cross-border turnover or activity. Furthermore, BCCs and similar regimes are also specific from a sectoral point of view, as they are limited to intra-group coordination and financial services and thus clearly favour these sectors over the other sectors of the economy. By contrast, the fact that the BCC and other regimes usually apply upon issuance of a license or a ruling by the local tax authorities does not make them specific, as they merely apply objective

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196 See Pieron et al., cit., at 285, indicating a number of large multinational companies using a BCC (e.g. Bayer, General Electric, British Petroleum, IBM, Procter & Gamble, Coca Cola, Carrefour etc.), and Heyvaert, cit., reporting that by the end of 2005 111 companies will still hold valid BCC licenses, and that the last 39 will expire in 2009.

197 See the Commission Notice on the BCC regime, cit., especially paras. 24-26 and 39-41 of the letter in the French version sent to the Belgian authorities.

198 This is the opinion of the Commission, which refers to the various conditions of application of the BCC regime to support its selectivity: see the Commission Notice, cit., para. 60 of the French version of the letter to the Belgian authorities.

199 See e.g. the Commission Notice on fiscal state aid, point 27, and the Guidelines on State aid for small and medium-sized enterprises, OJ C 213 of 23/7/1996, currently undergoing discussions for amendments (see in Section 3.2). See also the recent Ramondin case, cit., para. 40, discussed at 3.7.6.
criteria laid down in public documents in a transparent and non-discretionary manner.

The last issue is whether the BCC and the other similar intra-group regimes are justified by "the nature or general scheme of the tax system" (see also at 3.6.4). On the one hand, the mentioned statements in the Notice would seem to explicitly rule out the possibility to invoke this justification in these cases. On the other hand, the fact that the Notice refers to "if", "in so far as", and "may", means that there is room for further investigation in this respect. In particular, one might argue that as these regimes rely on a fixed basis of taxation and there are specific accounting requirements laid down in order to benefit from them, they may in effect be justified by the nature or the logic of the tax system within the meaning of the Notice. The fact that the agricultural and fisheries sectors are explicitly mentioned as an example because of the historical difficulty for individuals and firms involved in these activities to deal with complex tax issues and rules indicates that practicability may be an objective justification for notional taxation. In fact the (main or exclusive) underlying reason for coordination centres and similar regimes is the objective difficulty (rectius: impossibility) to assess the taxable income of entities engaged (almost) exclusively in transactions with related parties entailing mostly expenses and for which there are usually no acceptable comparable independent transactions for transfer pricing purposes. In other words, they are an application of internationally accepted transfer pricing rules, namely those contained in the OECD Transfer Pricing Guidelines, under which notional methods of taxation are adopted in order to: (i) avoid difficult and expensive assessment or transfer pricing procedures, (ii) secure at least a minimum amount of revenue for the government with respect to such intra-group activities, and (iii) ensure an objective and non-discriminatory treatment for all the firms performing them. The Commission acknowledges this by stating that the use of an alternative method to compute the tax base, such as the cost-plus, is indeed a viable justification when transactions between related parties are at stake, but only insofar as the result of its application is a taxable base comparable to the one determined under the ordinary method.\(^{200}\)

The above statements and the grounds for this justification need further thought. In particular, a distinction would need to be drawn between Belgian-type coordination centres regimes, which represent a clear departure from the general tax system because they rely exclusively on the fixed basis of taxation, and Belgian-type service and distribution centres regimes or Vizcaya-type coordination centre regimes, which resort to notional methods as devices to avoid transfer pricing litigation (i.e. safe harbours) while at the same time endorsing the general principles contained in the tax system or leave an option to choose between notional taxation and application of the ordinary regime. While it is true that the former would less likely be justifiable by the nature and logic of the tax system, the latter might not be considered to depart from a country’s system of taxation. In fact, in these cases the benchmark tax system and its general principles are fully applicable in that the firms performing intra-group activities must calculate their taxable profits according to their financial accounts, whose entries must be made in compliance with the general accounting rules used by all other taxpayers. Only if the resulting amount of tax is lower than the amount

\(^{200}\) See the Commission Notice, cit., paras. 46-47 of the French version of the letter to the Belgian authorities.
calculated under the notional method will the latter be used. Therefore, it would seem in these instances that, in addition to a higher likelihood of being covered by the said justification, these regimes would probably not even meet the selectivity criterion as defined in the Notice and, consequently, they would have to be considered outside the scope of Art. 87 of the Treaty altogether.

Further attention must be paid to the compliance of these regimes with OECD transfer pricing principles, which expressly allow the use of notional methods like the cost-plus and the resale-minus. Also in this respect a distinction must be made between BCC-type regimes excluding from the notional tax base significant items of costs, such as financing and personnel costs, and other regimes that include the full amount of costs in the relevant tax base. In this perspective, the BCC regime, far from complying with OECD principles, represents a significant deviation from them meant to artificially lower the BCCs' taxable base without an underlying justification. This seems to rule out not only the arguments that BCC-like regimes do not constitute aid and do not imply tax revenue loss, but also the applicability of the justification of the nature or general scheme of the system. This is confirmed by the Commission, which in the Notice on the BCC as well as in the Notice on the Vizcaya coordination centre regime states that as the “scheme makes it possible to exclude financial costs from the calculation of profit under the flat-rate method, the resulting profit will be lower than that arrived at by the traditional method. The difference will be even greater if the main function of the coordination centre is to carry out financial transactions”.

According to the Commission, this argument also overcomes the objection by the Belgian authorities that the exclusion of financing charges would be in compliance with Art. 7 (3) of the OECD Model Convention, because this provision is applicable by analogy to all situations and activities performed by BCCs. Nor does the Commission accept the argument put forward by the Belgian authorities that the revenue lost due to the exclusion of personnel costs is more than offset by the annual tax on employees (see at 3.8.1), because this tax is capped at € 100,000 (i.e. representing the tax due for 10 employees) even if additional employees are hired by the BCC. Reasoning a contrario, the fact that regimes like the Dutch distribution centre are not object of a state aid investigation indirectly confirms that the mere application of OECD transfer pricing principles, even those relying on notional methods, does not necessarily constitute a breach of the state aid rules, provided these regimes are not limited to (foreign-based) multinational companies and do not exclude significant (cost) items from the relevant taxable base.

A related issue concerns the level of the applicable mark-up for the purposes of these notional methods and its review by the local tax authorities depending on the circumstances of each case. In principle, as seen above the Commission accepts such notional methods, but it also makes clear that the application of the arm's length principle "requires a case-by-case assessment, so that the particularities of the given case be taken into account when fixing the applicable mark-up rate." However, the

201 See the Commission Notice on the BCC, *id.*, para. 53 of the French version of the letter to the Belgian authorities, and the Commission Notice on the Vizcaya regime, *id.*

202 See the Commission Notice on the German coordination centre regime, *id.*, para. 3. This is also confirmed in the Notice on the Luxembourg coordination centre regime, *id.*, in the annexed letter to the Luxembourg authorities, Para. 13 (in French), in which the Commission asks for information on the method to determine the applicable mark-up, the period of validity of the ruling, and the possible revisions of the rate depending on the change of the
Commission seems to contradict itself with regard to the French coordination and logistic centres regimes, in which the applicable rate is “determined on a case-by-case basis by the tax authorities, depending on the nature of the activities and the conditions in which they are carried out,” noting that “the margin rate, once set, is not sacrosanct and may be altered if the factors originally taken into account have changed” and for this purpose eligible centres “are obliged to notify the tax authorities of any change in the factors taken into account when the margin was established.” Contrarily to what one would expect, the Commission refers to the Notice on fiscal state aid, Points 21 and 22 on the discretionary practices of administrative authorities (see at 3.4.5 and 3.6.5), to express “doubts about the way in which the margin rates used in the cost-plus pricing are established” and to call for further analysis of any potential “room for manoeuvre on the part of the authorities that could lead to a departure from the general tax rules.” A similar conclusion is also reached with regard to the Luxembourg regime on finance companies providing intra-group back-to-back loans, which relies on the issue of rulings by the tax authorities to confirm the application of fixed margins between incoming and outgoing interest on these loans. With regard to such fixed taxable spreads, the Commission stresses that “this scheme gives the tax authorities wide discretionary powers in assessing the rates to be applied” within the meaning of Points 21-22 of the Notice on fiscal state aid. These statements are surprising if one considers that the margins are fixed depending on the characteristic of the back-to-back loans and the risks borne by the local finance entities and are not subject to constant review, and thus do not seem to involve “wide” discretionary powers as the Commission puts it.

One would hope that in its final decisions on all the intra-group regimes the Commission adopts a consistent approach and clearly lays down the policy it follows in the future. Back to the BCC regime, the Belgian government has recently proposed some modifications to comply with (some of) the Commission recommendations under the state aid rules, which provide some interesting clues for our analysis. With regard to the applicable mark-up on the costs of BCCs, it will no longer be set at 8% but it will be based on their actual functions and risks on the basis of a case-by-case assessment of all the facts and circumstances by the Belgian authorities. Furthermore, there will be an inclusion in the relevant taxable base also of costs previously excluded, i.e. personnel and financial costs. On the other hand, ignoring the Commission recommendation the Belgian government has decided to maintain the exemptions from withholding taxes on passive income and from capital duty on capital contributions to BCCs. Regardless of what the outcome on the BCC regime circumstances, as well as analogously in the Notice on the Belgian coordination centre regime, cit., para. 46 of the letter to Belgium in the French version.

203 See the Commission Notice on the French coordination and logistics centres, cit., in the sections on ‘Description’ and ‘Assessment’.

204 For an explanation of the Luxembourg (and Dutch) finance company regime, which was published in the tax administration’s Circular L.I.R. No. 120 of 14 July 1989 and has been repealed in 1996, as well as its analysis under the Code of Conduct, see in detail in Chapter 4, at 4.4.3. The Commission has challenged its compatibility with the Treaty under the state aid rules in July 2001: see the Notice on case C 50/2001 (ex NN 47/2000), OJ C 306 of 31/10/2001.

205 For a description of these changes, which should become effective as from 2005, see e.g. P. Kelley, Belgium could change coordination center rules to address EU criticisms, Worldwide Tax Daily, 18/3/2002, 52-2. The amendments recommended by the Commission through the letter of 11 July 2001 are summarised in the Notice on the BCC, cit., para. 12 of the letter to the Belgian authorities in the French version.
will be, one must welcome the Commission’s recommendations to (i) accept the use of notional methods for intra-group activities based on internationally-accepted OECD transfer pricing rules (i.e. as long as no item of cost is excluded from the taxable base), and (ii) call for a case-by-case setting of the applicable mark-up by a country’s tax authorities depending on all facts and circumstances.206 One must also welcome the Commission’s attitude to discourage special exemptions on withholding taxes on passive income and on other taxes, which, coupled with these notional methods, could indeed mean significant tax revenue losses for the EU as a whole.

3.8.3 Other intra-group finance regimes: the Netherlands CFM and the French Centrales de trésorerie

In 1997, the Dutch government introduced a special regime in favour of finance companies (i.e. concernfinancieringsmaatschappij, hereinafter: “CFM”) established in The Netherlands and belonging to a multinational group.207 This regime was meant to improve the tax climate for international groups wishing to centralise their financial activities and reduce the financial risks of international investment and it was mainly directed at Dutch-based multinational companies in order to persuade them to restructure these activities using a Dutch vehicle rather than a foreign finance entity, often located in a tax haven, (or in a BCC or an IFSC).

A number of conditions must be fulfilled in order to acquire the CFM status. First, this regime is limited to international groups of companies present in at least two continents or four countries. Furthermore, CFM entities must perform eligible activities for the exclusive benefit of group companies and not for third parties, and these activities must be performed exclusively from The Netherlands. For this purpose, the central finance management function of the group must be carried out by the CFM, and strict substance requirements apply. Lastly, the CFM may only perform a very limited share of its activities in favour of Dutch group companies so as to prevent any potential attempt to erode the Dutch taxable base through tax avoidance schemes. The financial activities eligible to the special tax treatment include granting of advances and loans, leasing and factoring activities, controlling activities, financial and administrative activities.

The main feature of the CFM regime is that companies are entitled to form a tax-free financial risk reserve (hereinafter: “FRR”) meant to cover the risks arising from financial activities and international investment, which is a special reserve not ordinarily available under Netherlands statutory tax law. Income deriving from eligible intra-group activities may be contributed to the FRR for a maximum of 80% of

206 It is worth noting that these principles are consistent with the (Code of Conduct and) the Primarolo Report, as will be seen in Chapter 4, especially section 4.5.

its amount, only 20% being thus subject to the standard corporate tax of 35%: therefore, the effective tax rate borne by a CFM on its eligible financial activities is in the first instance reduced to 7%. This allows a significant tax deferral on the amounts of income contributed to the FRR, which may be taxed only at the later moment of their release from the reserve. The subsequent releases of funds from the FRR may enjoy a special tax treatment resulting in the application of an effective tax rate much lower than the standard one. In particular, they may take place tax-free if they are used to (i) finance investments undertaken by the group (i.e., acquisitions of new companies), (ii) finance investments of the group exceeding the ordinary risk (i.e., investments undertaken in areas politically unstable or subject to high currency fluctuations); and (iii) finance legal liabilities of other group companies (under certain conditions). In these cases, the ultimate tax rate borne by the CFM on these reinvested profits remains at 7%. The second type of release of funds is referred to as ‘voluntary’ and occurs upon election by the CFM. In this case, the amounts previously set aside in the FRR are included in the CFM’s taxable income in five equal instalments and are entitled to a special tax rate of 10%. The third situation is the “mandatory” release of funds from the FRR, which takes place upon liquidation of the CFM or the transfer of its residence abroad, or for subsequent failure to meet the prescribed conditions. In this event, the release is taxed at the full statutory corporate tax rate, but a significant tax deferral is enjoyed by the CFM for the time during which the income was tied up in the FRR.

The application of the CFM regime is subject to the approval of the Dutch tax authorities, which issue the authorisation upon assessment of the satisfaction of all the required conditions, especially those relating to the substance and the centralisation of all the group’s finance activities in the Netherlands. No deadline has been set with respect to the application of the CFM regime, but the authorisations granted carry a time-limit of ten years.

Apparently, this regime was never notified to the Commission, which opened an Art. 88 (2) investigation as part of its large-scale investigation on fiscal state aid in July 2001. The Commission Notice on the CFM and the letter to the Dutch authorities indicates that from the preliminary analysis all the conditions for the application of the Treaty state aid rules are considered prima facie met. The aid is represented by the tax base reduction of up to 80% of their income and the subsequent tax exemption, reduction, or deferral depending on the type of release of funds from the FRR. This causes a corresponding shortfall in tax revenue for the Netherlands, whose actual amount also depends on the type of release. The CFM regime is likely to distort competition in the EU and intra-Community trade as the beneficiaries are only large multinational groups present in at least two continents or four countries, which also means that the specificity criterion is met (see the Maribel bis/ter case at 3.6.2 and at 3.8.2). As for the justification by the nature or general scheme of the tax system, the

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208 I.e., 20% (percentage of financial income subject to full corporate taxation) x 35% (ordinary tax rate). It is worth noting that the Netherlands corporate tax rate has been lowered to 34.5% as from the year 2002. The examples in the text are based on the old rate, which was applicable in the period affected by the Commission investigation.

209 I.e., 7% (see in the text) + 8% (80% (percentage of income contributed to the FRR) x 10% (preferential tax rate applicable upon voluntary release)).

Commission considers in the first place that the risks incurred by groups present in only one continent or three countries may not be less significant than those incurred by groups qualifying for the CFM. This is an application of the principle that specific measures are never justified if they unduly favour multinational groups present internationally over local companies or SMEs (see at 3.6.3 and 3.7.6). Furthermore, the Commission believes that the percentage of profits eligible for the FRR is disproportionate to the actual risks borne in (ordinary) international investments. These arguments would rule out the applicability of the justification, which makes sense if one thinks that investment in certain countries entail significant risks regardless of how many countries or continents a group is located in, and also that in order to evaluate the proportionality of the amounts contributed to the FRR one should assess on a case-by-case basis all the details of each investments undertaken by a group.

The Dutch government has put forward a number of counter-arguments supporting the compatibility of the CFM with the fiscal state aid rules. First, this regime would not cause a reduction in tax revenue since it is budget-neutral and is even able to cause an increase in the tax revenue due to relocation of finance companies and capital to the Netherlands. Furthermore, the CFM would be a general rather than a special tax provision as it is available for all sectors of the economy and for all multinational companies, mainly Netherlands-based rather than foreign-based ones. This argument is linked to the justification of this regime as necessary to discourage the use of finance companies located in tax havens by repatriating funds to the Netherlands. Another supporting argument that this regime would be inherent to the Dutch system is that under Netherlands statutory tax law it is customary to form tax-free reserves for risks deriving from business activities according to the ‘sound business practice’ principle.

A number of multinational groups benefiting from the CFM regime, after receiving the Commission’s notification of its investigation as a non-notified aid regime, have immediately challenged it before the Court of First Instance on the grounds of legality for violation of Art. 88 Treaty claiming that it should have been characterised as ‘existing’ aid and that other principles have been violated. Another immediate consequence of the investigation has been that Dutch-based multinational companies apparently are considering moving their intra-group finance facilities outside the country (namely to Switzerland), or have already done so. Indeed, this is consequence of the legal uncertainty caused by the investigation, which might turn out to be dangerous for the EU competitiveness as a whole in the international arena. This is likely especially if more multinationals follow suit for the fear that the

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211 See the notice in OJ C/68 of 16/3/2002, p. 19, which mentions the large multinational groups challenging the Commission Notice (e.g. Adidas, Rabobank, Heineken, ING, Unilever etc.) and shows the case as being registered under number T-9/02. This challenge was filed on the basis of the previous Case C-400/99, Italy v Commission, of 9/10/2001, [2001] ECR I-7303 ("Tirrenia"), in which the ECJ explicitly dismissed the Commission’s request for inadmissibility of the challenge by the Italian authorities of a letter sent to it (and published in the OJ) on the state aid character of a certain measure, and of the previous Case C-312/90, Spain v Commission, [1992] ECR I-4117, concerning the challenges of these Commission’s acts are possible before the CFI provided they are based on the grounds of legality linked with them. See also, with regard to the CFM, E. van der Stok and M. Sunderman, Netherlands, EU still at odds over Dutch group financing regime, Worldwide Tax Daily, 8/2/2002, 27-4.

212 For instance, the Netherlands daily newspaper Financiele Dagblad of 18 April 2002 reported the decision by the Dutch-based multinational company Ahuld to move its intra-group finance activities to Switzerland.
Commission will attack all favourable (intra-group) finance company regimes, which fear is supported by the simultaneous investigations on Belgian coordination centres (see at 3.8.1 and 3.8.2) and French treasury centres (see below).

As to the substantive evaluation of the CFM regime, based on the current Commission practice and on the CFI and ECJ case law it will probably be considered in breach of the Treaty (fiscal) state aid rules. In fact, it does constitute an aid within the meaning of all the three forms laid down in Point 9 of the Notice on fiscal state aid, i.e. (i) a reduction in the tax base of up to 80% of otherwise taxable income, (ii) a reduction of the tax amount in case of tax-free or voluntary releases of funds from the FRR, and (iii) a tax deferment in case of mandatory releases subject to full Dutch tax at a later time. The argument that this regime is budget-neutral will in all likelihood be rejected by the Commission and the Court, as the revenue forgone must be assessed in actual terms by comparing the taxpayers entitled to it and those not entitled to it rather than in potential terms with reference to the taxpayers that would not have relocated to the Netherlands in the absence of this regime (see also at 3.8.2). The CFM also seems to meet the requirements of distortion of competition and intra-Community trade as well as the specificity criterion in that it is available to multinational companies active in a certain number of continents or countries and is sectorally limited to financial activities. As for the justifications, one would have to agree with the Commission’s view mainly on the grounds that the amounts eligible for the FRR seem objectively disproportionate to the actual risks deriving most of the times from international investment, which are not always higher than those incurred domestically or in certain countries, and are no different from the risks borne by groups not entitled to the CFM regime as they are not present in four countries or two continents. Also the argument that it is customary under Dutch tax law to form similar tax-free provisions does not seem decisive, as these reserves may only be formed if certain conditions are met, do not allow such a significant amount of profits to be contributed to them, and are open to all taxpayers doing business in the Netherlands. As to the Dutch government’s argument that the CFM regime is meant to fight harmful finance tax regimes enacted by tax havens and other countries, it does not seem a sound one if one considers that the CFM does constitute a harmful tax regime itself (see also its evaluation under the Code of Conduct in Chapter 4, at 4.4.6).

Another more recent regime for finance and cash management activities is the French “treasury centre” regime (i.e. Centrales de trésorerie, hereinafter: “FTC”), introduced in 1999 by an Instruction of the French tax authorities and also object of the broad Commission investigation. The FTC regime applies to French companies or permanent establishments concluding an intragroup cash management agreement (i.e. a loan agreement) with entities of a multinational group present in at least three countries. The agreement must be submitted to the French tax authorities and the amounts covered by it must be separately booked by the group to allow control by them. The two incentives of the FTC regime are the non-applicability of the provision

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of the French tax code limiting the deductibility of intra-group interest payments to the annual average effective interest rate on loans granted by financial institutions with regard to variable-rate business loans with an initial duration of more than two years (i.e. this rate was equal to 5.14% in 1999 and 6.03% in 2000). However, even under the FTC regime interest must in any event be set at arm’s length and it is possible to enter into an advance pricing agreement procedure with the French authorities for this purpose. One must also note that it is being debated whether the French thin capitalisation rules limiting the deductibility of interest to a 1.5:1 debt/equity ratio still apply to eligible FTCs. The second tax advantage is the exemption from the 15% withholding tax on interest payments to non-residents even for interest payments left on current accounts, which effectively prevented cash-pooling transactions through French vehicles before the release of the instruction.\textsuperscript{214} According to the Commission, the FTC regime provides a tax base reduction through the allowance of higher interest deductions normally not available under French statutory law, which also entails loss of tax revenue for the French Treasury. The fact that this regime is limited to French treasury centres belonging to multinational groups active in at least three countries and to finance activities documented in the mentioned agreement implies that both criteria of distortion of competition and intra-Community trade and specificity are met. The Commission also rejects on the basis of its practice and ECJ case law the French justifications that eligible treasury centres are authorised to perform these activities on the basis of Art. 12 (1) of Law 84-46 on the activity and control of financial institutions, as well as that the favourable treatment is necessary to restore the conditions of competition due to a better tax treatment available for similar entities in other countries (see also the Road hauliers case in Chapter 2, at 2.3.4). Indeed, the FTC regime seems to meet all the requirements for the application of the fiscal state aid rules, but one wonders whether it should be justified on the grounds that the (OECD) transfer pricing rules must be complied with (i.e. even if the said limit provided under statutory law is exceeded) and that the thin capitalisation rules, if applicable, would limit the maximum amount of deductible interest from the French payer company. It is true that the limited applicability of this regime to a group active in at least three countries makes it selective and is the main obstacle for such a justification to be accepted by the Commission. However, given these limitations to the deductibility of interest and the very limited harmful character of the FTC regime, one would probably expect that the Commission would have a milder approach in assessing the compatibility of this regime with the fiscal state aid rules. In fact, in this case it seems that the FTC regime was not meant to lure to France finance activities and foreign investment at the expense of other countries, but rather to remove legal obstacles to the exercise of these activities via French vehicles coherently with the general French tax system. In any event, the compliance with OECD transfer pricing rules and with domestic anti-base erosion provisions (i.e.

\textsuperscript{214} The 15\% statutory withholding tax rate is lowered by applicable tax treaties. Under the French tax administration’s Instruction 5 12-89 of 5 June 1989, there is an exemption from this withholding for interest paid to non-resident lenders provided the loan is documented by an agreement concluded before the transfer of the underlying proceeds and stating the principal amount, the maturity date, the interest rate, and any additional remuneration. The exemption, however, does not apply to proceeds left on current accounts by the French borrower.
this is true if French thin capitalisation rules apply as seems likely from recent French case law) should constitute a sufficient justification.

3.8.4 Tax rate and tax liability aid: ring-fencing and offshore regimes; the Gibraltar case

Another broad category of tax regimes potentially caught by the Treaty (fiscal) state aid rules analysed by the Commission in its large scale investigation concerns a reduction of the tax rate and of the liability. A significant example is given by the offshore regimes adopted by Gibraltar: the “exempt company” regime and the “qualifying company” regime. The former was first introduced in 1967 and provides for a complete exemption from corporate tax normally due at 35%, provided (i) no Gibraltar resident is shareholder of, or has a beneficial interest in, exempt companies, and (ii) no trade or business is carried out in Gibraltar or with residents of Gibraltar (with the exception of transactions with other exempt or qualifying companies, see below). The exemption applies upon issuance of a certificate granting this status for a period of 25 years, and additional tax incentives such as an exemption from stamp duty is available for these entities. The “qualifying company” regime was introduced in 1984 and features similar conditions to the exemption company regime as to the ‘ring-fencing’ from the Gibraltar economy and the 25-year duration period. Its main difference is that the applicable corporate tax rate is set on a case-by-case basis by the Gibraltar authorities between 0 and 35% depending on the activities carried on, and is usually set at 5 to 10%.

The Commission has opened an investigation with respect to both these regimes as new (non-notified) aid measures.\(^{215}\) As a result of appeal of the two Notices by the Gibraltar authorities on legality grounds, the CFI has recently annulled the one on the “exempt company” regime on the grounds that it constitutes an existing aid while upholding the Commission characterisation of the “qualifying company” regime.\(^{216}\) Leaving aside the procedural issues addressed by the CFI of the qualification of existing versus non-notified state aid of these regimes as well as the status of the territory of Gibraltar in the EU, it is interesting for our analysis to focus on the substantive issues as laid down in the Commission Notices. In short, the Commission considers both regimes as state aid on the grounds that (i) they imply a tax advantage in the form of corporate tax exemption (and exemption from stamp duty) in Gibraltar, which generates a corresponding loss of tax revenue, (ii) is likely to affect competition and intra-Community trade as these entities are able to carry out activities in the EU, and (iii) are specific in that they are only available for offshore companies not controlled by Gibraltarians and not carrying out business activities in Gibraltar. As for the justification by the nature or general scheme of the tax system, the Commission reasons on the basis of Point 26 of the Notice on fiscal state aid that it

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\(^{216}\) Joined Cases T-195/01 and T-207/01, cit. See on this judgement also at 3.3.4 and Chapter 2, at 3.4.5. See also A. Nishtar, Gibraltar takes EC to court in battle over corporate tax exemption, in Worldwide Tax Daily, 29/8/2001, 168-1, and EU Commission to announce findings of investigation into Gibraltar’s offshore tax regimes, in Worldwide Tax Daily, 5/11/2001, 214-5.
does not apply if tax advantages are exclusively available for foreign-based companies and are ‘ring-fenced’ from the local economy.

Although at first sight there would seem no reason to further comment on these cases, there are indeed a few remarks worth making and some statements contained in the Notice concerning the two special Gibraltar regimes worth referring to. The intended goal of both the exempt and the qualifying company regime was to lure investors and capital to Gibraltar through a considerable tax advantage with no negative repercussion on the Gibraltar taxable base, which is shown by the ‘ring-fencing’ feature of the two regimes. It is true that this feature makes them harmful tax competition, but the investigation under the Treaty state aid rules must look at its specific criteria and more in general to the actual effects of the tax measure concerned. The fact that both regimes are ring-fenced and do not apply with regard to activities connected with the Gibraltar economy casts doubts as to whether (i) there is an actual shortfall in tax revenue for Gibraltar, and (ii) these systems are not justifiable on the basis of the need to prevent double taxation in Gibraltar. In this respect, one must note that both regimes in fact apply to foreign-source income earned by non-Gibraltar residents, which may (or may not) have been subject to tax abroad. In other words, in these cases there would be no tax jurisdiction for Gibraltar to tax this foreign-source income earned by non-residents under generally-accepted international tax law principles. One must also consider that under the ‘benchmark’ Gibraltar tax system, in principle worldwide income of local corporation is taxed at full 35%, but their foreign-source income is taxed only to the extent it is remitted (i.e. distributed) to Gibraltar except their foreign passive income (see below). This means that in principle ‘ordinary’ resident companies not repatriating their foreign-source active income but leaving it on a foreign bank account would be treated the same as exempt companies. As for qualifying companies, the fact that they are usually subject to a tax rate of 5 to 10% could even mean that they would be subject to a higher tax burden in Gibraltar on their foreign-source income than their resident counterparts not remitting this income to Gibraltar.

However, two arguments put forward by the Commission in the Notices seem to impair the validity of the above arguments. The first is that both these regimes feature other tax concessions such as exemption from capital duty, which in any event entail a loss of tax revenue for Gibraltar. One might then object that the actual amounts at stake would have to be quantified to see whether the gain in corporate tax revenue from qualifying companies would outweigh the loss of stamp duty tax revenue, and more in general whether this latter loss would not be covered by the general de minimis exception of € 100,000 not caught by the state aid rules (see at 3.3.1). The second argument linked to the justification of the need to avoid double taxation on foreign-source income, also supported by the impossibility of Gibraltar to conclude double tax treaties due to its status, would be rejected by the Commission on the grounds that “no information on whether taxation occurred abroad, or not, is required from exempt companies.” This argument, however, may also be overcome

217 This is also explicitly stated in the Notice, cit., in which the UK (i.e. the Gibraltar) authorities point out that “the payment of a flat rate of tax is commensurate and proportional to the extremely negligible economic activity which exempt companies are allowed to conduct within Gibraltar. The activities carried out ... outside Gibraltar cannot be taxed in Gibraltar.”

looking at the ordinary Gibraltar tax regime, which taxes foreign-source income of an ordinary company as well on a remittance basis regardless of it having been taxed abroad. The only exception in this respect regards foreign-source interest and dividends, which are exempted from Gibraltar tax on a remittance basis only to the extent they have been taxed in the source country. To sum up, with the exception of this foreign-source passive income, the main difference between exempt (and qualifying) companies and ordinary Gibraltar companies for the exemption from corporate tax to apply is the requirement that the latter do not remit their foreign-source income. One doubts that this difference would objectively have to be considered relevant enough to rule out the applicability of the justification of the nature and general scheme of the tax system in consideration of Point 26 of the Notice (see at 3.6.4).

Two more points are important for the evaluation of these regimes in the light of the Treaty (fiscal) state aid rules. The first is that Gibraltar-based providers of services to exempt and qualifying companies are eligible to acquire “exempt” or “qualifying” status. In this case, as the Commission observes there appears to be a loss of Gibraltar tax revenue as a result of the fact that “financial services can be provided by exempt companies from Gibraltar to non-residents, no physical presence being necessary outside Gibraltar. The revenue of these activities will probably arise directly in Gibraltar without having being taxed outside Gibraltar.” The second remark is that the “qualifying” company regime seems more difficult to justify due to the non-transparent and discretionary power of the local tax administration in setting the applicable corporate tax rate, which the Commission clearly bans as selective state aid (see the Notice, Points 21-22, at 3.6.5 and 3.8.3) with the blessing of the CFI (in the Ramondin case, at 3.7.6). A negative decision of incompatibility of the “qualifying company” regime would have to be praised as an effort to counter a harmful tax regime, given the highly distortive (ab)use of this regime and the frustration of high-tax (Member) States’ anti-avoidance rules denying the application of the participation exemption or of their CFC rules.219

Whatever the outcome on the Gibraltar offshore regimes, it will be interesting to see what principles the Commission follows after completion of the formal investigation and whether the decision will be the same for both of them. It is also worth noting that Gibraltar has already decided to reform its tax system as from the fiscal year 2003, not only abolishing both the exempt and the qualifying company regime, but also bringing the corporate tax rate to 0% for both resident and foreign-based companies.220 These will only be subject to an annual registration fee of GBP 300 or 150, depending on their deriving income, and to a newly introduced business property occupation tax on real estate used in their business. Furthermore, there will be a new company payroll tax charged at a flat rate per year on each employee of the companies. In any event, the combined tax burden from business property occupation tax and the payroll tax may not exceed 15% of the company’s annual income. Furthermore, subject to Commission approval under the State aid rules, the

219 For practical examples of how qualifying companies may be used for this purpose and a discussion in the light of harmful tax competition see respectively in Chapter 4 with regard to the participation exemption (see section 4.6) and in Chapter 5 with regard to CFC rules.

220 On the reform of the Gibraltar tax system, see e.g. C. Serruya, Gibraltar announces extensive company tax reform, Worldwide Tax Daily, 30/7/2002; 146-1.
Gibraltar government is planning to levy corporate tax at a rate of 8% on income from companies performing financial services and utility companies, whose combined tax burden will also enjoy the cap of 15% of their income. In practice, as a result of the reform there will no longer be any differentiation between resident and foreign companies, i.e. ring-fencing, and they will enjoy a low generalised tax burden that will not exceed 15% altogether. It is also striking that the financial services sector, far from being encouraged by the reform, will be treated less favourably as it will be subject to taxation even if foreign-based. Apparently, the Gibraltar authorities consider this as the optimal compromise to stay competitive in the international arena of low-tax jurisdictions by reducing potential job losses in Gibraltar (some 20-25% dependent on these two regimes) and capital flight, while at the same time complying with the EU (and OECD) effort to fight harmful tax competition.

### 3.8.5 Methods to relieve international double taxation: the Irish regime on foreign-source income

The Commission investigation on the Irish tax treatment of certain foreign income earned by resident companies shows its interpretation of the state aid rules with regard to the methods to relieve international double taxation, and in particular how the specificity criterion and the “nature” justification apply in this respect.\(^{221}\) The measure investigated was introduced in 1988 with regard to foreign subsidiaries (i.e. owned for more than 51%) and in 1995 with regard to foreign ‘trading’ branches of Irish companies. It provides for the exemption from Irish corporate tax of foreign dividends or profits received from, and capital gains realised on, these foreign entities as long as they are located in countries having signed a tax treaty with Ireland. In order to qualify, Irish companies must apply with the Minister of Finance and submit an investment plan aimed at maintaining or increasing employment within Ireland. This regime deviates from the ordinary Irish method of relief from international double taxation, under which foreign dividends, profits, and capital gains are subject to tax in Ireland, with a credit for the foreign taxes actually paid limited to the corresponding amount of Irish tax applicable if that income were domestic-source. The Commission notes that there is no restriction of this regime to certain activities and that the underlying goal is linked to the creation or the maintenance of employment in Ireland through foreign trading operations. The aid is represented by the lower Irish tax borne by eligible companies on foreign-source income in cases in which (i) such income has been subject to a lower tax burden than the Irish tax burden and (ii) in the case of foreign subsidiaries their income would have been immediately repatriated to Ireland. This regime would therefore cause a loss of tax revenue and would also distort competition and affect intra-Community trade because by definition it is granted with respect to foreign activities of Irish companies. The specificity criterion would lie in the restriction of this exemption only to companies submitting the investment plan as well as in the (still unclear) discretionary powers conferred on the Irish authorities for its granting. As for the

\(^{221}\) See the Commission Notice concerning measure C 54/2001 (ex NN 55/2000), in OJ C 308 of 1/11 2001. On the general rules contained in the Notice on how specificity and the ‘nature’ justification are interpreted with regard to methods to prevent double taxation, see at 3.6.3 and 3.6.4.
justification, the Commission notes that the aim to create or maintain employment is not directly linked with the form and effect of the measure, and that its granting is not digressive in time as required by the Guidelines on employment aid\(^{222}\) as well as by the Notice with regard to fiscal aid.

Even if this is merely a *prima facie* assessment by the Commission, it is interesting as it shows that a “special double taxation relief, that can involve a tax saving, only for those undertakings that obtained the prescribed certification from the tax authorities” constitutes no exception to the application of the Treaty state aid rules. In other words, the fact that double tax relief is usually considered a general measure (see point 13 of the Notice on fiscal state aid), or at least represents a justification connected to the tax systems’ fundamental goal that firms must pay tax only once (see point 26 of the Notice on fiscal state aid), does not prevent its classification as a prohibited state aid if it deviates from a general double relief mechanism for international double taxation which is less favourable for taxpayers.

The view endorsed by the Commission seems theoretically correct on the basis of the Treaty rules, especially if one considers the discretion of the Irish authorities in approving the favourable regime only if employment is created or maintained in Ireland. However, the Commission attitude does not seem flexible enough in this case and turns out to be extremely penalising for the potential recipients of the tax aid. It would seem that the Commission could be more lenient in cases like this based on a number of considerations. The Irish regime, far from being harmful tax competition, merely grants a more favourable double tax relief with regard to foreign profits from genuine business activities undertaken abroad by Irish companies. The fact that this measure is limited to tax-treaty countries confirms the ‘good’ nature of this aid, which allegedly aims at creating or maintaining a reasonable level of employment in Ireland. The Commission also seems to have ignored that Ireland has been an Art. 87 (3) (a) region until the year 2000, and thus this scheme should be considered differently at least up to that year, which is also indirectly implied by the Commission itself in its letter to the Irish authorities (see Points 24 and 25 of the letter). A careful use of its discretion for the application of the Art. 87 (3) exemptions or of the justification of a special regime would seem appropriate to mitigate the potentially harsh consequences of the application of Art. 87(1) in cases like this, in which the subjective evaluation may correct the results stemming from a purely objective evaluation of an aid measure concerning its main effect (see also in Section 3.3 and at 3.6.4).

Reasoning *a contrario*, had Ireland granted in its statutory tax law the same exemption with respect to all foreign active income earned in treaty countries without requiring prior approval by the Ministry of Finance (and thus not pursuing the desirable employment goal), the state aid rules would not have been applicable. The fact that the granting of the exemption is conditioned on an actual link between genuine foreign activities and the creation or maintenance of employment in Ireland further supports the above conclusion. More in general, if the exemption method is chosen by a country as the ‘benchmark’ relief from international double taxation and the credit method is only applied with regard to foreign passive income, to foreign income not subject to at least a certain amount of tax abroad, or to foreign income earned in non-

treaty countries or in tax havens included in ‘black lists’, in these cases there is no question that the state aid rules are not applicable. Under this reasoning, it should not be relevant what method is adopted as the general, default relief, and what is the special method applicable in certain situations, as long as this choice falls into Member States’ tax sovereignty and is inherent to the fundamental goal to prevent international double taxation and tax avoidance, and as long as it is not structured in a harmful way (e.g. an exemption applying on foreign-source passive income regardless of its having been taxed abroad, see on this also the Gibraltar offshore regime at 3.8.4).

However, the fact that the actual advantage granted under the Irish scheme is only present where the foreign income is subject to a lower tax burden than the Irish (i.e. in all likelihood 10% given the active nature of the income up to 2003 and thereafter 12.5%) and the fact that Ireland does not have CFC legislation, do raise the suspicion that Ireland is trying to make itself attractive for the location of parent companies with subsidiaries or branches in low-tax regimes. It is understandable, therefore, that the Commission opened an investigation, especially given the discretionary mawkishness of the measure, but it should be stressed that in general there is nothing wrong whatsoever with the exemption method as a method for the prevention of international double taxation, not even if it is not applied across the board but next to the credit method. All in all, the state aid rules must not affect the freedom of countries to choose between credit and exemption on the basis of criteria such as (i) presence of a tax treaty, (ii) active or passive income, (iii) individual or companies, (iv) substance or no substance abroad, (v) presence of abuse, etc. This is nothing but confirmed by the Commission Notice on fiscal state aid, which considers methods to prevent double taxation part of a country’s benchmark tax system, or at least justified under the nature or general scheme of the system as an internal objective (see at 3.6.3 and 3.6.4).

3.9 Synthesis: Treaty rules on State aid as an effective tool against harmful tax competition

In the recent years, the Commission has dramatically changed its policy in the application of the Treaty State aid rules against Member States’ tax regimes considered harmful tax competition. This change has been sanctioned in the Irish corporation tax case and its most evident sign has been the 1998 Notice on fiscal state aid, which contains a strong message directed at the Member States in this respect. The subsequent handling of fiscal state aid cases and the 2001 large-scale investigation further confirm the tough stance taken by the Commission as to both authorisation of new fiscal state aids and review of previously approved aid as well as non-notified measures.

In the perspective of fighting harmful tax competition, this change of policy must be seen in conjunction with the approval of the 1997 ‘Package’ and in particular the Code of Conduct on business taxation (see Chapter 4, especially Section 4.2). As the attempt of implementing this non-legally binding document has proven more troublesome than anticipated, the Commission has decided to shift from ‘soft’ to ‘hard’ law by strictly applying Art. 87 of the Treaty. In its recent investigation, it has sent a clear warning that from a legal point of view the area of direct taxation is in
principle nothing special in the light and purpose of the state aid Treaty provisions, notwithstanding feelings of national sovereignty in that area. However, given the sensitivity of this subject matter and the political agreement within the Code of Conduct framework, the Commission felt politically compelled to tackle all similar potentially harmful tax regimes simultaneously and in the same manner, also taking into account the fundamental goals pursued by direct taxation at domestic level. Nonetheless, in some cases the Commission seems to have gone too far in its crusade started as a reaction to the stall of the Code of Conduct process, without taking into full consideration this fundamental role of direct taxation.

With regard to the substantive application of the Treaty state aid rules against harmful tax competition, the Commission makes no distinction between reductions of tax base and of tax liability, or deferral or cancellation of taxes already due, and interprets the selectivity criterion as being satisfied also where these benefits are available de jure or de facto only to multinational companies and/or are based on the discretionary judgement by a country’s tax authorities. As for tax base reductions, the granting of tax holidays is normally not allowed due to their specific advantages and the potentially significant distortion of competition in the EU, which in principle makes them unjustifiable even in depressed Community areas. The use of notional methods to compute taxable income for intra-group transactions (e.g. the cost-plus or the resale-minus) is only allowed insofar as it achieves taxation equal or at least comparable to taxation as resulting from the application of the ordinary method, with the exception of the agriculture and fisheries sectors. In order for regimes relying on these methods to be justified under the state aid rules it is crucial that the OECD transfer pricing rules are complied with, that no item is excluded from the basis for the profit computation, and that the local tax authorities review carefully each situation on the basis of all facts and circumstances, but in a transparent way and without having too wide a discretionary power.

With regard to the reduction of tax liability, the setting of different tax rates depending on the active or passive nature of income falls within the Member States’ national tax sovereignty. On the other hand, setting lower tax rates for a specific sector, even a very large one (e.g. the manufacturing sector), is not allowed under the fiscal state aid rules. In regional areas falling within Art. 87 (3), nil or significantly lower tax rates are only allowed if they are limited to genuine business activities, are digressive in amount over time, and are targeted and proportional to the local disadvantages suffered in these regions. As a matter of principle, financial services and other mobile intra-group activities eligible for these nil or low tax rates are in any event in breach of the state aid rules, with a possible (limited) exception for the “outermost” areas of the EU (i.e. Madeira, the Canary Islands, and the French Overseas territories).

The implementation of offshore regimes ‘ring-fenced’ from the rest of the economy is not allowed by the Commission, especially if they are also partially available for domestic residents and apply regardless of whether the foreign-source income has been subject to tax abroad. These regimes constitute forbidden state aid even if such income is subject to a domestic reduced tax rate, especially if this rate is set by the local tax authorities in a discretionary manner, due to the potentially harmful repercussions on other (Member) States’ domestic tax regimes. Furthermore, while
genera l systems to relieve international double taxation within a country are not covered by the fiscal state aid rules, including the exemption method, a limited selective application of a more favourable relief may be at odds with the Treaty even if it is limited to foreign business income earned in treaty partners if it is subject to a discretionary decision by the local tax authorities.

As for deferral and cancellation of taxes already due, they are also caught by the fiscal state aid rules especially if they involve a discretionary decision by a country’s local authorities. The granting of deferral through the formation of tax-free provisions (e.g. for financial investments) is only allowed if it is in line with the general tax system of a country, is available indiscriminately to all taxpayers, and is targeted and proportionate to the underlying objective(s) for which the provision is formed.

At the moment, the application of the fiscal state aid rules seems the most effective tool to counter harmful tax competition in the EU, especially given the apparent impossibility to find a unanimous consensus to harmonise the relevant tax areas on the basis of Arts. 94 and 95(2) (see Chapter 2, section 2.2), to gain sufficient political support to use Art. 96 (and/or Art. 97, see Chapter 2, section 2.4), or to force Member States to implement the political commitment laid down in the Code of Conduct (see Chapter 4). The Treaty provisions on state aid are legally-binding, are clearly interpreted in public documents issued by the Commission, are applied in a transparent and equal manner to all Member States, and are subject to the careful and competent jurisdictional control by the Court of First Instance and ultimately the Court of Justice. These provisions are also flexible enough to be applied and targeted only against the most harmful tax regimes adopted by Member States or those that distort the most competition in the internal market and are thus contrary to the fundamental Treaty objectives and means. In this respect, the interpretation of the specificity criterion to distinguish objectively between ‘benchmark’ tax system and deviations from it and of the justification of the general nature or scheme of the system to consider the subjective policy goals of special tax regimes are consistent with the distinction between ‘good’ and ‘bad’ tax competition based on a combination of objective and subjective element (see Chapter 1, at 1.2.6 and section 1.5).

Still, in some cases the consequences for the application of the state aid rules seem too harsh, and the resort to a more comprehensive approach rather than a piecemeal one would be preferable in the sensitive tax area. This is shown by recent state aid cases (i.e. the Ramondin and the Gibraltar offshore cases), in which Member States have explicitly complained about the selective use of the state aid rules and have indirectly hinted at the application of Arts. 96 and 97 instead (see Chapter 2, at 2.4.5). Meanwhile, the Commission should be careful not to make its mighty state aid powers backfire: several multinationals resent the legal uncertainty caused by the recent large scale investigation, which may last for years, especially in respect of financial centres, and have already moved their centres, or are in the process of moving them, to third countries, notably Switzerland. This effect would not be in line with the goals of Art. 87 of the Treaty, as it would result in beggaring the EU to the benefit of its neighbours.