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Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation

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1. On 11 November 1998 the Commission adopted a notice on the application of the state aid rules to measures relating to direct business taxation[1] (hereinafter "the notice"). This was in response to the undertaking it had given when, on 1 December 1997, the Council adopted a code of conduct for business taxation[2] aimed at establishing coordinated voluntary action by the Member States to tackle harmful tax competition. The notice forms part of the wider objective of clarifying and reinforcing the application of the state aid rules in order to reduce distortions of competition as they affect the single market and economic and monetary union.

2. In paragraph 37 of the notice, the Commission announced that it would "examine the plans for tax aid notified to it and tax aid illegally implemented in the Member States" and would review existing systems. It is not the purpose of this report to produce an exhaustive list of all tax aid cases handled by the Commission since the notice was published. Rather, it will focus mainly on cases in respect of which the Commission launched investigations in 2001, alongside the work on the code of conduct, and cases which best illustrate the principles set out in the notice.

3. The Commission notice did not constitute a new set of guidelines for assessing tax aid, in so far as it did not signal any change in the Commission's approach to assessing the compatibility of such aid. It was largely based on the case law of the Court of Justice and Court of First Instance and was designed to clarify how Articles 87 and 88 of the EC Treaty applied to tax measures. This fact has been confirmed by the Court of First Instance.[3] The notice has thus significantly helped to clarify how the state aid rules are applied in the tax field.

4. The Commission was initially supposed to report on the application of the notice two years after its publication.[4] Since there were relatively few tax aid cases before 2001, the Commission preferred to build up a larger body of experience before carrying out any review. It now has sufficient experience to be able to carry out an initial review of how the notice has been applied. It will look at three aspects:

   – the notice as a basis for the Commission's work in the tax aid field;

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1 OJ C 384, 10.12.1998, p. 3.

2 OJ C 2, 6.1.1998, p. 1.

3 Joined Cases T-269/99, T-271/99 and T-272/99 *Territorio Histórico de Guipúzcoa - Diputación Foral de Guipúzcoa, Territorio Histórico de Álava - Diputación Foral de Álava* and *Territorio Histórico de Vizcaya - Diputación Foral de Vizcaya* v *Commission* [2002] ECR II-0421, at 79.

4 See paragraph 38 of the notice.

- the relationship between state aid monitoring and action to tackle harmful taxation; and
- the question of whether the principles set out in the notice that concern only direct taxation can be applied to indirect tax measures.

1. THE NOTICE AS A BASIS FOR THE COMMISSION'S WORK IN THE TAX AID FIELD

5. The notice has provided a basis for assessing numerous tax aid cases and has proved suitable in so far as the principles laid down in it have been applied and fine-tuned as and when aid schemes have been assessed. In terms of the concept of state aid, the main lessons to be drawn from its application are as follows.

1.1. Concept of aid

6. The concept of aid is an objective concept that leaves the Commission no margin for discretion. The notice therefore essentially illustrates the circumstances in which the criteria laid down in Article 87(1) of the EC Treaty are met. The principles spelt out in the notice fall outside the scope of the Commission's discretion, but the examples given are not intended to provide an exhaustive list of all cases in which a tax measure may rank as aid since producing such a list is impossible. The forms in which tax aid may be granted depend on developments in methods of taxation and tax engineering. The purpose of this report is, therefore, not to add to the notice, but to show how the principles it contains have been applied.

7. The Commission's systematic approach to tax aid since the adoption of the notice has led it to deal with very diverse tax measures. Based on an analysis of its practice, the various criteria for classing a measure as aid may be spelt out in more detail:

   - Does a selective advantage exist?
   - Are state resources involved?
   - Is Community trade affected?
   - Is the measure justified by the nature of the tax system?

1.1.1. Concept of advantage

8. As already pointed out in the notice, an advantage may take a number of forms: reduction in the tax base, reduction in the amount of tax, deferment of tax debt, etc.

1.1.1.1. Concept of advantage in the context of alternative taxation methods

The cost-plus method

9. The principles set out in the notice apply both to traditional analytical tax methods, where taxable income is determined by the difference between the company's revenues and expenses, and to alternative tax methods such as those recommended for cross-border intra-group transactions.

10. This applies, for example, to the cost-plus method, which is one of the methods recommended by the OECD. It is an international principle set out in the 1995 OECD report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. It involves taking the costs incurred by the supplier of goods (or services) in a transaction between associated companies and then adding to those costs a cost-plus mark-up to obtain an appropriate profit in the light of the functions performed, assets used, risks assumed and market conditions. Although the method as such is not caught by Article 87(1) of the EC Treaty, it can give rise to an advantage where the tax arrangements applied do not take proper account of the economic reality of the transactions and thereby result in a lower rate of taxation than if the standard tax method had been applied. Since the adoption of the notice, the Commission has examined seven schemes[5] of this type and has identified the existence of an advantage in various forms.

11. First, as regards the tax base, some schemes based on the cost-plus method explicitly provided for the exclusion of certain expenditure from the calculation base. The expenditure excluded was closely linked to the business of the companies concerned. In some cases it was staff costs,[6] in others costs relating to sales promotion, carriage of goods and credit,[7] certain subcontracting costs[8] or financial costs.[9] Excluding certain costs from the tax base in this way generally confers an advantage on the firms concerned as compared with the normal situation. Under the cost-plus method, the tax base is established by applying to the costs borne a pre-determined percentage corresponding to the company's estimated profit margin. Underestimating expenditure therefore necessarily results in a reduction in the tax due. Such a reduction is particularly significant when the expenditure concerned accounts for a large proportion of the company's total costs.

12. In some cases, the advantage was present in the profit margins, which could be set arbitrarily, without any account being taken of the real nature of the activities carried out. The advantage was all the greater in that the margin was underestimated.

13. For example, in two decisions relating to Belgium (coordination centres and US sales corporations), the Commission found that, in practice, for the calculation of the tax base of coordination centres, the Belgian authorities recommended that, in the absence of any

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5 The schemes for Belgian coordination centres (decision of 17 February 2003, OJ L 282, 30.10.2003), for the control and coordination centres of foreign companies in Germany (decision of 5 September 2002, OJ L 177, 1.7.2003), for coordination centres in Luxembourg (decision of 16 October 2002, OJ L 170, 9.7.2003, p. 20), for Luxembourg finance companies (decision of 16 October 2002, OJ L 153, 20.6.2003, p. 40), for coordination centres in Vizcaya, Spain (decision of 22 August 2002, OJ L 31, 6.2.2003, p. 26), for headquarters and logistics centres in France (not yet published) and for US foreign sales corporations in Belgium (decision of 25 June 2003, not yet published).

6 Belgian coordination centres, loc.cit.

7 Case involving US sales corporations in Belgium, loc. cit.

8 Case involving advantages granted in France to headquarters and logistics centres, loc. cit.

9 Coordination centres in Vizcaya (Spain), loc. cit.

objective criteria for determining the percentage of profits to be taken into account, a mark-up of 8% should be used, whatever the type of service provided and without any checks being made as to whether this corresponded to economic reality. Likewise, in the Luxembourg cases involving finance companies and coordination centres, the tax authorities systematically applied the minimum mark-up laid down by the legislation, without checking whether this rate reflected the economic reality of the underlying services. In the German case, the control and coordination centres to which the cost-plus method was applied benefited from a 10% ceiling on their cost-plus mark-up. The Commission found that this system could give rise to an advantage if real margins were greater than 10%. The absence of checks meant that the German tax authorities could exercise their discretion in setting the mark-up rate. The Spanish scheme allowed coordination centres in Vizcaya to opt for the cost-plus method for the calculation of their tax base. However, depending on the type of business carried on by the companies concerned, this possibility could result in an undervaluing of economic reality.

"Traditional" tax exemptions

14. Lastly, some of the schemes examined by the Commission from the point of view of the application of the cost-plus method also contained more traditional exemptions from taxes and dues on income not taxable under the cost-plus method.

15. Specifically, the Belgian coordination centres scheme exempted the centres from the general tax arrangements applicable to property tax and withholding tax. The French headquarters and logistics centres scheme contained a partial exemption from the annual flat-rate tax ("imposition forfaitaire annuelle" - IFA), which constituted a derogation from the ordinary application of the French tax system.

1.1.1.2. Concept of advantage and avoidance of double taxation

16. In another field,[10] also related to cross-border transactions, the Commission was faced with an Irish scheme exempting certain categories of foreign income from national tax where such income was repatriated for investment aimed at creating or safeguarding employment in Ireland. The scheme derogated from the rules ordinarily applied in Ireland to prevent double taxation by way of tax credit, since it was based instead on the exemption method. The ordinary tax credit method involved deducting from national tax tax that had already been paid abroad within the limit of the amount of tax normally due in Ireland on the same income. Under the exemption method, on the other hand, no national tax was paid at all, irrespective of the amount of tax due abroad. The Commission found that the Irish scheme could in practice confer an advantage on firms benefiting from it where the tax due abroad was less than that normally payable in Ireland on the same income.

[10] Decision of 17 February 2003 (OJ L 204, 13.8.2003, p. 51).

Box No 1

To determine whether a tax scheme derogating from the normal system may constitute state aid, it must be established whether the resulting tax burden is lower than that which would have resulted from application of the relevant Member State's normal taxation method.

1.1.1.3. Recipients of aid

17. In examining the cost-plus-type schemes, the Commission found that the recipients of state aid could be both the companies taxed under the cost-plus method and the groups to which they belonged. In the case of the Belgian coordination centres mentioned above, the centres were exempt from withholding tax on the income they paid to the other companies in the group. Under Belgian tax law, the withholding tax is, in principle, the final tax on income distributed to non-resident companies. The Commission therefore took the view that the general exemption from withholding tax granted to the income distributed by a coordination centre directly benefited companies in the group established abroad.

Box No 2

The recipients of aid are not necessarily confined to the firms subject to a special tax measure. Rather, account must be taken of the actual effects of the aid, with a view to classing as aid recipients all firms which have actually benefited from it.

1.1.2. State resources criterion

18. On the question of state resources, the Commission has maintained its traditional stance of regarding this criterion as met if the tax normally payable by the beneficiary is reduced. Granting a tax concession entails a loss of resources for the State in that it forgoes revenue. In accordance with the case law,[11] this reasoning also applies to regional or local public bodies below central state level.

19. The fact that a tax aid scheme has a positive overall effect on budget revenue is not sufficient to rule out the presence of state resources.

20. In the case of the Belgian coordination centres,[12] the Belgian authorities argued that the state resources criterion was not met because the tax concessions granted to firms investing in Belgium had attracted foreign companies and thus contributed to Belgian state resources. The same argument was advanced by the Dutch authorities in the case regarding aid for international financing activities.[13] The Commission rejected it, stating

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11 See, for example, the judgment of the Court of 14 October 1987 in Case 248/84 *Germany* v *Commission* [1987] ECR 4013, at 17.

12 See footnote 5.

13 Decision of 17 February 2003 (OJ L 180, 18.7.2003, p. 52, paragraph 84).

that the state resources criterion must be assessed at the level of individual recipients. The criterion cannot be assessed on the basis of a "cost-benefit" analysis of the inferred indirect effects of the measure in economic or budgetary terms.

> *Box No 3*
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> It follows from these decisions that the concept of state resources as defined in Article 87(1) must be assessed in the light of the aid recipient's situation, without reference to the induced effects of the measure in economic or budgetary terms. Otherwise, any advantage would cease to rank as state aid as soon as it enticed a company to set up in a given Member State, thereby enabling that State to increase its tax revenue.

1.1.3. Effect on trade and competition

21. According to paragraph 11 of the notice, the mere fact that aid strengthens a firm's position compared with that of other firms which are competitors in intra-Community trade is enough to allow the conclusion to be drawn that intra-Community trade is affected.

22. Following the same logic, the Commission considers that this criterion is always met where some or all of the aid recipients are multinational companies operating in sectors open to competition.

23. In its decision on the aid for financing activities introduced by the Netherlands,[14] the Commission found that the aid strengthened the financial position of companies belonging to multinational groups, most, if not all, of which were active on the intra-Community market. In addition, since the scheme was open to all sectors of economic activity, it necessarily covered sectors where there was intense intra-Community trade. The Commission therefore concluded that trade was affected in this case.

24. The Commission also confirmed its traditional stance based on the case law of the Court of Justice and the Court of First Instance[15] that the existence of comparable or rival tax rules in other Member States does not justify the granting of tax aid. Each scheme must be assessed in the context of the tax system in the country concerned.[16]

> *Box No 4*
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> As soon as aid strengthens the competitive position of one or more companies in a sector open to Community competition, the criterion requiring an effect on trade is met. The existence of similar aid in other Member States has no effect on the Commission's assessment of this criterion.

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14 Decision of 17 February 2003, see above (footnote 13), paragraph 85.

15 Case T-214/95 *Het Vlaamse Gewest* v *Commission* [1998] ECR II-717.

16 See, for example, the decision on Belgian coordination centres, loc. cit., paragraph 101.

1.1.4. Selectivity

25. As emphasised in the notice, the selectivity criterion can be analysed in various situations. Since the notice was adopted, the Commission has been faced with a series of cases in which it has had to assess this criterion from two angles:

1.1.4.1. Material selectivity

26. Besides "standard" cases, such as measures restricted to certain economic sectors or types of company,[17] the Commission has also examined measures which were not formally restricted in this way but which turned out to be very selective.

27. In particular, the Commission has stressed that rules laying down thresholds relating to turnover[18] or to establishment in a specific number of foreign countries[19] meet the selectivity criterion.

28. According to paragraph 20 of the notice, "some tax benefits are on occasion restricted to certain types of undertaking, to some of their functions (intra-group services, intermediation or coordination) or to the production of certain goods. In so far as they favour certain undertakings or the production of certain goods, they may constitute state aid ...". In accordance with this principle, the Commission has found measures reserved for certain types of intra-group transaction to be selective. In one case[20] the Commission even indicated that the requirement to establish a company in order to benefit from an advantage linked to the performance of intra-group business rendered the measure selective. In the case in point, tax concessions had been granted only to "captive" insurance companies (i.e. companies carrying on their business within a group) managed by a limited company operating from the Åland islands. The Commission regarded this measure as selective because the conditions for benefiting from the tax concessions required a certain economic strength. The formation of a captive company implies that the group concerned is large enough to generate a turnover that will allow it to cover the fixed costs and obtain a profit.

29. Lastly, in the tax aid cases involving a reduction in the tax base implemented by the Basque "historical territories" (Spain), the Commission found the measures to be selective because only firms set up after the entry into force of the legislation concerned were eligible for aid.[21]

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17 Case 143/99 *Adria-Wien Pipeline and Others* [2001] ECR I-8365, at 49-54.

18 See the decisions on the Belgian and Vizcaya coordination centres (footnote 5).

19 Decision on the state aid scheme implemented by the Netherlands for international financing activities, loc. cit., and decision of 11 December 2002 on the aid scheme for central corporate treasuries in France (not yet published).

20 Decision of 10 July 2002 (OJ L 329, 5.12.2002, p. 22, paragraph 52).

21 Decision of 11 July 2001 (OJ L 174, 4.7.2002, p. 31), decision of 11 July 2001, (OJ L 314, 18.11.2002, p. 1), decision of 11 July 2001 (OJ L 17, 22.1.2003, p. 1), decision of 20 December 2001 (OJ L 40,

Box No 5

Measures open to all sectors can, none the less, be regarded as selective where the eligibility criteria in practice restrict the potential number of recipients. This is the case with measures that apply only to multinational companies or large companies. Such measures exclude all small businesses or local firms from receiving aid. The same is true of measures that apply only to firms set up after a certain date, in that existing companies are excluded from receiving aid.

1.1.4.2. Geographic selectivity

30. The Commission gave its view on the issue of regional selectivity in its decision on the tax system in the Azores.[22]

31. In this case, the Commission had to assess the selectivity of a tax measure involving a reduction in corporation tax granted by the regional authorities in the Azores under the fiscal autonomy granted to them by the Portuguese Constitution.

32. The Commission found that the selectivity of a measure was based on a comparison between the advantageous tax treatment granted to certain firms and the treatment that applied to other firms within the same reference framework, which it defined as the territory of a Member State.

33. In the case in point, the reductions granted by the regional authorities in the Azores could not be regarded as a mechanism that would allow all local authorities of a particular level to introduce and levy local taxes with no reference at all to national taxation. On the contrary, the measure involved a reduction applicable solely in the Azores in the rate of tax established by national legislation and applicable in the rest of Portugal. It therefore had to be regarded as selective.

Box No 6

In a case where a local authority introduced a specific reduction in a tax which was part of the national tax system, the reduction was viewed as selective.

1.1.5. Justification of a measure by the nature or general scheme of the system

34. Obviously, as stated in the notice, the differential nature of a measure does not necessarily mean that it must be regarded as state aid. The presence of aid may be ruled out where the measure is justified by the nature or general scheme of the tax system.

14.2.2003, p. 11), decision of 20 December 2001 (OJ L 77, 24.3.2003, p. 1) and decision of 20 December 2001 (OJ L 17, 22.1.2003, p. 20).

22 Decision of 11 December 2002 (OJ L 150, 18.6.2003, p. 52). See also the conclusions of Advocate-General Saggio in Cases C-400/97, C-401/97 and C-402/97, which were struck off at the request of the parties.

1.1.5.1. Justifications accepted by the Commission

35. In line with the case law of the Court of Justice and the Court of First Instance, the Commission has continued to take the view that this justification must be based on the intrinsic features of the system concerned. It is for the Member State to show how a derogation is justified by the nature and general scheme of the system.[23] Only in a few cases has the Commission found that a materially selective measure was justified by the general scheme of the system.

36. It found on two occasions that exemptions from land tax in the agricultural field were justified by the nature and general scheme of the system.[24] In both cases, agricultural land benefited from exemptions or tax relief compared with the standard land tax system. In accordance with paragraph 27 of the notice, the Commission accepted that these advantages could be justified by the specific role of land in agricultural production.

37. The Commission has also accepted that a selective measure can be justified by the principle of tax neutrality. In an Italian case,[25] it had to examine a measure exempting from transfer taxes the conversion of certain public undertakings with special status into joint stock companies. In Italy transfer taxes normally apply to the creation of a new economic entity or to the transfer of assets between different economic entities. However, in this case there was merely a change in the legal status of the firms concerned which did not involve any increase in income or in the capacity to produce income. This type of transaction was systematically exempted from transfer taxes in accordance with the principle of tax neutrality enshrined in Italian tax law. Moreover, the Commission found that the change in company form was not a transaction that would be carried out by a private investor but a public authority decision regarding the choice of legal instrument for the provision of certain services and that it could therefore not be treated like the normal incorporation of a company. The Commission accordingly considered the exemption to be justified by the principle of tax neutrality consistent with the tax system.

> *Box No 7*
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> The specific nature of certain sectors or certain types of transaction may in exceptional circumstances justify tax treatment that departs from the standard system for reasons inherent in the logic of the tax system concerned. It is for the Member State concerned to show that the derogation is justified by the nature and general scheme of the system.

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23 See Conclusions of Advocate-General Léger of 12 June 2003 in Case C-159/01 *Netherlands* v *Commission*, paragraph 65 (not yet published).

24 See Cases N 20/2000 (Netherlands) and N 53/99 (Denmark) available at http://europa.eu.int/comm/secretariat_general/sgb/state_aids.

25 Decision of 5 June 2002 on state aid granted by Italy in the form of tax exemptions and subsidised loans to public utilities with a majority public capital holding (OJ L 77, 24.3.2003, p. 21).

1.1.5.2. Justifications rejected by the Commission

38. The Commission has rejected the justification based on the need to make certain companies more competitive. Likewise, it has rejected the justification based on the fact that the selective nature of the measures resulted from the application of objective criteria, where the advantage was not conferred at the discretion of the public authorities.

39. In two decisions, one on Italian Law No 461/98 relating to banks and the other on the Dutch scheme for international financing activities, the Commission accepted the principle that certain business activities could require specific tax treatment. However, for such treatment to be justified in the light of Article 87(1) of the Treaty, it had to be consistent with the rationale of the tax system concerned.

40. In the Italian case,[26] the authorities had introduced tax breaks for mergers in the banking sector carried out within a certain period. The Commission acknowledged that it was legitimate to adapt the tax system to the distinctive features of an economic activity such as banking but found that the measures concerned constituted *ad hoc* aid having the effect of improving the competitiveness of certain undertakings, i.e. the banks involved in certain types of merger. The Commission also stressed that the justification for the aid put forward by the Italian authorities, namely the need to restructure the banking sector, bore no relation to the normal operation of the tax system.[27]

41. In the Dutch case,[28] the Commission had to decide how to view a measure allowing international companies to establish a tax-exempt risk reserve. The Commission recognised that international transactions entailed specific real risks which could justify a derogation. However, it decided that the eligibility criterion set by the Dutch authorities, namely the requirement to carry out financing activities for parts of a group in at least four countries or on at least two continents, did not fit in with the rationale of the system. Objectively speaking, groups active in only three countries or on one continent are no less exposed to the risks associated with international financing activities.

42. The principle on which the decision in the Dutch case was based was referred to by the Court of First Instance in a judgment of 23 October 2002,[29] in which it stressed that the fact that exceptional tax measures "operate according to objective criteria and conditions does not prove that restricting the circle of beneficiaries of the tax concession is justified by the internal logic of the tax system" concerned.

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26 Decision of 11 December 2001 (OJ L 184, 13.7.2002).

27 However, where a derogation is directly related to the specific features of banking or financial transactions, the Commission can accept that it is justified by the general scheme of the system. In Case N 482/2001, the Commission approved a Danish measure allowing credit institutions to make provisions for losses inherent in credit risks.

28 See footnote 13.

29 Joined Cases T-346/99, T-347/99 and T-348/99 *Álava* [2002] ECR II-4259, at 58-63.

Box No 8

While the specific features of some sectors may justify a tax exemption, there must be a direct link between the alleged specific features and the tax concessions granted. Moreover, the criteria adopted by the Member States to determine the beneficiaries of such a derogation may not exclude certain market players in a discriminatory manner. The fact that such exclusion is based on objective criteria does not suffice to prove that the measure is consistent with the logic of the system concerned.

1.2. Compatibility of tax aid schemes

43. It was not the purpose of the notice to lay down specific criteria for tax aid, but to clarify the concept of aid in this field. Aid in the form of tax measures has therefore been assessed in the light of existing Commission guidelines. However, as pointed out in paragraph 32 of the notice, in most cases, tax relief provisions are neither limited in time nor linked to the carrying out of specific projects. They therefore constitute operating aid. Under the current guidelines, the Commission can authorise such aid only in exceptional cases and subject to strict conditions.

44. Generally speaking, the Commission does not have any specific positive or negative bias with respect to aid in the form of tax measures as compared with aid granted in other forms (subsidies, guarantees, etc.). The fact that aid takes the form of a tax measure has not influenced the Commission's attitude when it has assessed such aid for its compatibility. The Commission has approved a number of tax aid schemes, mainly under the guidelines on regional aid.

45. For example, in two decisions, one on the tax aid scheme for the special economic zone (ZEC) in the Canary Islands[30] and the other on tax reductions for the Madeira Free Zone,[31] the Commission found that some of the tax aid designed to promote the development of certain regions eligible for aid under Article 87(3)(a) of the Treaty was compatible.

46. In the decision on the ZEC, the Commission assured itself in particular that the operating aid provided for was "in proportion to and targeted at" the regional development objective it was designed to meet, within the meaning of paragraph 33 of the notice. The tax aid concerned (notably the reduction in corporation tax) was found to be targeted at the regional development objective since it related to activities genuinely likely to contribute to such development. Activities whose contribution to regional development was likely to be small compared with the possible amount of aid were either excluded, as in the case of financial services, intra-group services and coordination centres, or made subject to a lower ceiling in order to prevent more aid being granted than would have an effect on regional development. In this way, the risk of large amounts of aid being granted with little effect on regional development was reduced or eliminated. However, activities with a greater local impact, such as manufacturing, received favourable treatment in the form of higher ceilings. The same

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30 Decision of 4 February 2000 (N 708/98).

31 Decision of 11 December 2002 (N 222/A/02).

approach was taken to the differentiation and limitation of aid in accordance with the net volume of jobs created. The aid was proportionate in that the intensity of and ceiling on the tax concession increased with the number of jobs created. In these circumstances, the Commission found that the aid was likely to be proportionate to its contribution to regional development. It also noted that a number of measures had been taken to avoid tax-related relocations. For example, financial activities, leasing, intra-group services and coordination centres were excluded from the scheme and the tax concessions were reserved for income from activities effectively carried out in the ZEC. Lastly, the Spanish authorities explained that the investment condition required "productive" or "active" investment (as opposed to "passive" investment such as the acquisition of shares or patents for hire which would not lead to substantive activity in the ZEC) and could not be met merely by a capital injection or merger, and that the hiring or transfer of assets between dependent companies was not eligible. The Commission found that all these clarifications provided the necessary guarantees with respect to the conditions laid down in paragraph 33 of the notice.

47. In both the above cases, the Commission also took account of the fact that the assisted regions were outermost regions, whose permanent handicaps are specified in Article 299(2) of the EC Treaty, and were among the least-developed regions in the EU. However, it restricted the aid to the activities likely to boost local employment and to contribute most to the economic development of the regions concerned. Activities whose contribution to regional development was considered insufficient compared with the amount of aid and the economic gain to the recipients were not authorised to benefit from the scheme. This applied in particular to financial intermediation, insurance and intra-group services.

48. As regards aid for research and development, the Commission approved a number of UK schemes based on tax incentives[32] which met the criteria for compatibility laid down in the Community framework for state aid for research and development.[33] Also in the research and development field, the Commission communication *Investing in research: an action plan for Europe* encourages concerted use of tax incentives to address research policy issues of common interest.

49. However, as pointed out in paragraph 32 of the notice, in most cases tax relief provisions are general in nature: they are not linked to the carrying out of specific projects. In almost all tax aid cases that the Commission has examined on its own initiative since the adoption of the notice, the measures concerned have been shown to be incompatible operating aid because of the absence of any link with an investment project or any ceiling on the tax concessions. Of the fifteen measures in respect of which the Commission initiated the state aid procedure on 11 July 2001, thirteen[34] were found to contain incompatible operating aid and were subject to a negative decision. In view of the negative impact of such schemes on competition and trade, the Commission

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32 For example, decision of 3 September 2003 (Case N 245/03). See also decisions in Cases N 228/02 and N 802/99.

33 OJ C 45, 17.2.1996.

34 Two measures are still under examination. They are the qualifying companies and exempt companies schemes in Gibraltar (United Kingdom).

considers it necessary to continue its work of investigating and reviewing tax schemes in force in the Member States.

50. However, in some tax aid cases, although the Commission has found the scheme concerned to be incompatible, it has not ruled out the possibility that its application in individual cases may have involved compatible aid or aid which is compatible in part. This applied in particular to the Basque "tax holidays" of 1996,[35] which were found to be incompatible, but which in two individual cases were regarded as compatible in part[36] by the Commission.

Box No 9
The Commission has assessed the compatibility of tax aid in the light of the ordinary rules. Tax aid is often not linked to the achievement of specific objectives and can be viewed as operating aid, which is currently authorised only in a limited number of cases and under strict conditions.

1.3. Procedures

1.3.1. Distinction between new and existing aid

51. Article 1 of the Regulation laying down detailed rules for the application of Article 87 of the EC Treaty[37] distinguishes between existing aid and new aid. Existing aid is aid which was put into effect before the entry into force of the Treaty or before the accession of the Member State concerned and aid already authorised by the Commission or measures which did not constitute aid at the time they were put into effect but which subsequently became aid owing to the development of the common market.

52. The Commission assesses the compatibility of existing aid in the light of the Treaty rules. If it finds the aid to be incompatible, it proposes appropriate measures to the Member State concerned with a view to removing the distortion of competition caused by the aid. However, it may not require such aid to be recovered from the recipients.

53. New aid must be notified to the Commission before being put into effect. If a measure which constitutes aid is implemented before receiving prior authorisation from the Commission, it is unlawful and, should it prove to be incompatible, must in principle be recovered.

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35 See footnote 21.

36 See Commission decisions of 22 December 1999 on the state aid implemented by Spain for Ramondín SA and Ramondín Cápsulas SA (OJ L 318, 16.12.2000, p. 36) and of 24 February 1999 concerning state aid granted by Spain to Daewoo Electronics Manufacturing España SA (Demesa) (OJ L 292, 13.11.1999, p. 1).

37 Regulation of 22 March 1999 (OJ L 83, 27.3.1999, p. 1).

1.3.1.1. The notice does not affect the classification of existing aid

54. In some cases,[38] it was argued that the adoption of the notice on the application of the state aid rules to measures relating to direct business taxation signalled, for the first time, a change in the Commission's assessment of the selectivity criterion in the tax aid field. Interested parties claimed that, without this change, the measures at issue would not have been classed as state aid and that publication of the notice should therefore be viewed as a development of the common market rules and aid assessed in the light of the notice should be classed as existing aid.

55. The Commission could not accept these arguments. The notice did not signal any change in its approach to aid in the form of tax measures. Rather, it is a tool designed to clarify its previous practice in the field. Moreover, as stressed by the Court of First Instance in *Álava*,[39] the notice is based largely on the case law of the Court of Justice and the Court of First Instance. Furthermore, the Commission has not changed its approach to the measures concerned.

> *Box No 10*
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> The notice does not represent a change in the Commission's approach to the assessment of tax aid.

1.3.1.2. Distinction between substantive and severable amendments

56. In a judgment delivered on 30 April 2002,[40] the Court of First Instance stated that, where an aid scheme is amended, a distinction must be made between alterations affecting the actual substance of the original scheme and those which are clearly severable from the scheme. An alteration which extends an aid scheme to an additional type of transaction or adds a type of company to the eligible recipients can be regarded as severable from the initial tax aid scheme, in that it does not affect the intrinsic functioning of the scheme. Severable amendments do not alter the classification as existing aid of the original scheme.

> *Box No 11*
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> Where an existing tax scheme is amended, a distinction must be drawn between amendments affecting the actual substance of the original scheme and those which are clearly severable from the scheme. Only amendments which are clearly severable from the original scheme will not give rise to its reclassification as new aid.

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[38] In particular, the Basque tax holiday cases, see footnote 21.

[39] See footnote 3.

[40] Joined Cases T-195/01 and T-207/01 *Government of Gibraltar* v *Commission* [2002] ECR II-02309.

1.3.2. Legitimate expectations

57. When it adopted the notice, the Commission undertook to take account of all the specific circumstances in each individual case.[41] In doing so, it has had to apply the principle of protecting legitimate expectations.

58. This is one of the general principles of Community law and has been the subject of a large volume of case law.

59. Article 14 of the Procedural Regulation (Council Regulation (EC) No 659/1999[42]) in principle requires recovery of any aid ruled contrary to the Treaty by the Commission. However, it allows the Commission not to require recovery of the aid if this would be contrary to a general principle of Community law, such as the principle of protecting legitimate expectations.

60. The Court of Justice and the Court of First Instance have always applied this principle restrictively, limiting it to situations where the stance of the Community institutions had been such as to influence the conduct of participants in the economy.

61. In accordance with the case law, the Commission has continued to apply the principle strictly, confining it to cases where its own conduct had been such as to lead businesses or Member States to believe that certain measures were not caught by the state aid rules.

62. In this context, the Commission has taken account of the comparability of measures in relation to which economic players have cited legitimate expectations. It has applied the legitimate expectations principle in a number of cases relating to tax schemes deviating from the normal system which were based on the cost-plus method.[43] These schemes were introduced by the Member States concerned after the Commission had found a similar scheme in Belgium not to be covered by Article 87(1) of the Treaty.

63. However, the Commission has rejected claims of legitimate expectations based on an absence of action on its part. For example, in three decisions dated 20 December 2001[44] and concerning aid in the form of "tax holidays" implemented by the regional governments in the Basque Country in 1993, it refused to apply the legitimate expectations principle. It stressed that, since the Spanish authorities had failed to notify the aid, it had never had the opportunity to assess its compatibility with the common market. Moreover, it did not agree to take into account a previous decision on another aspect of the Basque tax system. That decision did not relate directly to the measures at issue and could not therefore be viewed as implying "tacit approval" of the entire Basque tax system including the "tax holidays".

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41 See paragraph 37 of the notice.

42 See footnote 37.

43 See footnote 5.

44 OJ L 17, 22.1.2003, p. 20, OJ L 40, 14.2.2003, p. 11; and OJ L 77, 24.3.2003, p.1.

Box No 12

The principle of protecting legitimate expectations is interpreted strictly by the Commission. It is recognised only in exceptional cases, such as where a similar scheme has in the past been viewed by the Commission as not caught by Article 87(1) of the Treaty or has been judged compatible. However, authorisation of part of a scheme does not mean that other aspects of the same scheme will necessarily be regarded as being in line with the Treaty.

2. Relationship between state aid monitoring and tackling harmful tax competition

2.1. Concept of aid and of harmful tax measure within the meaning of the code of conduct

64. Although they pursue the same general goal of reducing distortions of competition within the internal market, it must be borne in mind that the procedure for examining tax schemes from the state aid angle is distinct from the work in connection with the code of conduct. Moreover, as pointed out in the notice, the classification of a measure as harmful under the code of conduct does not necessarily mean that it will be regarded as state aid. Although the criteria laid down respectively in Article 87(1) and in the code of conduct are similar in a number of ways, they do not always overlap. To be classed as harmful, a measure must fulfil at least one of the criteria listed in paragraph B of the code of conduct,[45] which are not identical to those laid down in Article 87(1). Moreover, the geographical scope of the code of conduct is broader since it also applies to the dependent and associated territories, which are not subject to the state aid rules.

65. In an exercise launched on 11 July 2001, the Commission scrutinised fifteen tax measures in twelve Member States. The measures had all been examined under the code of conduct for business taxation, and thirteen of them had been found to be harmful in the light of the code.

66. The classification of a measure as harmless does not guarantee that it involves no aid within the meaning of Article 87(1). The Commission has adopted a number of decisions in which it found that measures classed as harmless under the code of conduct

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45 Namely, whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, whether advantages are ring-fenced from the domestic market so that they do not affect the national tax base, whether advantages are granted even without any real economic activity and substantial economic presence within the Member State concerned, whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles or whether the tax measures lack transparency.

constituted aid.[46] Conversely, it would be quite possible for a measure classed as harmful in the light of the code of conduct not to be caught by the concept of state aid, although the Commission has not taken any such decisions to date. As stated in its first recital, the code of conduct is designed *inter alia* to prevent the tax bases of some Member States being eroded to the benefit of others, while the purpose of state aid control is to prevent situations where competition and trade between firms are affected. Likewise, it must be borne in mind that state aid monitoring applies only to specific measures and thus cannot eliminate distortions of competition that might result from general rules in force in the Member States.[47] State aid monitoring policy cannot therefore replace efforts by the Member States to coordinate their tax policies with a view to abolishing harmful tax measures.

67. Lastly, classing a measure as state aid does not necessarily mean that it is incompatible with the common market. Its compatibility must be assessed in the light of the exemptions laid down in Article 87(2) and (3) of the Treaty (see point 1.2 and paragraph 70 of this report).

Box No 13

Although it pursues the same general goal of reducing distortions of competition within the internal market, the procedure for examining tax schemes from the state aid angle is distinct from the work in connection with the code of conduct. In accordance with the Commission's obligations under the Treaty and with its political undertakings, its assessment of the compatibility of tax measures with the common market is based on objective criteria, which may differ from those laid down in the code of conduct for assessing whether such measures are harmful. Accordingly, classifying a tax measure as harmful under the code of conduct does not necessarily mean that it constitutes state aid, and vice versa.

2.2. State aid monitoring and action to tackle harmful tax competition

68. As stated above, despite sharing the same general objective, the concepts of state aid and of harmful measure within the meaning of the code of conduct may differ. None the less, the Commission's work in the state aid field has to some extent facilitated finalisation of the agreement on the code of conduct for a number of reasons.

69. In performing its undertaking to review tax measures in force in the Member States, noted in paragraph J of the code of conduct, the Commission has given priority to measures which were also being examined under the code. In February 1999, it sent the Member States a series of requests for information regarding a large number of tax measures. After examining the replies, on 11 July 2001 the Commission initiated the state aid procedure in respect of fifteen tax schemes, thirteen of which had meanwhile been found harmful by the Council's code of conduct group. The fifteen measures

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46 See Commission decision of 31 October 2000 on the Spanish scheme of tax deductions for export activities (OJ L 60, 1.3.2001, p. 57) and Commission decision of 11 December 2002 on the French aid scheme for central corporate treasuries (not yet published).

47 See paragraph 6 of the notice.

targeted by the Commission were selected mainly on account of their significant economic impact and their particularly harmful effects on competition and trade.

70. In paragraph 33 of the notice, the Commission indicated that the examination of tax aid for its compatibility with the common market would take account *inter alia* of its effects brought to light by the code of conduct. In practice, it has not developed new compatibility criteria based on the harmful nature of a measure[48] and has given priority to examining tax measures which constitute state aid and have significant economic impact and particularly harmful effects on competition and trade. The Commission's action in this field has, in certain cases where Member States had not yet planned to dismantle harmful measures, provided a further incentive to consider doing so, in accordance with the code of conduct.[49]

Box No 14

The Commission's state aid work, carried out in parallel with the code of conduct work, has to some extent helped to facilitate the conclusion of an agreement on the code of conduct. The Commission naturally intends to continue its work on tax aid in future, giving priority to aid with a significant economic impact and particularly harmful effects on competition and trade.

3. APPLICABILITY OF THE PRINCIPLES SET OUT IN THE NOTICE TO MEASURES RELATING TO INDIRECT TAXATION

71. Although the Commission notice in principle covers only direct taxation, it has provided a basis for analysing certain cases in the field of indirect taxation. The Commission has referred to the notice in a number of decisions[50] relating to indirect taxation measures, particularly as regards the principle of a measure being justified by the nature and general scheme of the system. Obviously, indirect taxation measures have specific features which are not caught by the notice in its present form.

72. To be caught by the concept of state aid, measures must favour certain undertakings by reducing the charges normally borne by them. In this connection, VAT reductions are subject to strict Community rules and conform to the principle of equality of taxation for similar products. Such reductions are therefore not usually caught by Article 87(1). As a general rule, the same is not true of excise duties, which directly affect businesses. A reduction in such duties which favours certain undertakings may constitute state aid. At this stage, the Commission considers that a debate could be launched on whether it would be appropriate to clarify and codify the rules in this field.

73. In order to reconcile the objectives of its state aid monitoring policy and to ensure that they are more consistent with the proposals it presents to the Council in the field of tax harmonisation, the Commission now conducts simultaneously an examination of requests for tax exemptions from the Member States and an analysis in the light of the

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48 See point 1.2.

49 See paragraph D of the code of conduct.

50 See point 1.1.5.1. of this report.

state aid rules.[51] This practice was outlined in a letter sent to Member States including a detailed questionnaire to be returned to the Commission with any request for an exemption made under Article 8(4) of Directive 92/81/EEC. The questionnaire enables Member States to indicate whether the measure for which they are requesting an exemption under the Directive might not also constitute state aid. Such simultaneous assessments will continue with the forthcoming entry into force of the "Energy Tax" Directive (scheduled for 1 January 2004), which will continue to allow Member States to grant specific tax exemptions.

74. Reconciliation of the state aid rules with the requirements of tax harmonisation in the energy field was a key element in the negotiations that led on 27 October 2003 to the Council's agreement on the proposed Energy Tax Directive. This Directive is based directly on the principles laid down in the case law of the Court of Justice and the Court of First Instance and by the Commission's decision-making practice in the tax field. In particular, it finds that ruling out the taxation of energy products used other than for fuel can be justified by the nature and general scheme of the Community tax system.

Box No 15

Although the notice does not cover aid in the form of indirect taxation, the principles it contains seem largely applicable to such aid. However, certain specific features of indirect taxation could be addressed in a separate notice.

4. CONCLUSIONS AND RECOMMENDATIONS

75. Application of the notice by the Commission has allowed the principles it contains to be clarified and fine-tuned.

76. In particular, the Commission has continued to apply strictly the selectivity criterion and the justification of tax exemptions by the general scheme of the tax system concerned.

77. The Commission's decision-making practice, especially in cases in which it initiated an investigation on its own initiative, has shown that a majority of cases involve incompatible operating aid. The Commission intends to continue examining and reviewing existing tax schemes but considers that its work must be accompanied by action to increase knowledge of the tax aid rules among both Member States and businesses. To this end it will pursue its training and publicity efforts in respect of the state aid rules.

78. To date, the notice has proved to be a suitable tool for assessing tax aid and there is no need to revise it in the immediate term, especially since the case law on which it was based has confirmed its content and has not undergone any major change in the tax field since 1998. However, since the notice is general in scope, it cannot, by its nature, cover

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51 Examples are Case N 179/2002 on state aid granted to France by way of a reduced excise rate on "traditional" rum produced in the overseas departments and Case N 804/2001 on a reduced rate of excise duty on biodiesel in the United Kingdom.

all potential cases which might by brought to the Commission's attention. Accordingly, in the light of developments in the case law of the Court of Justice and the Court of First Instance and of its own decision-making practice, the Commission could have to supplement and clarify certain aspects of the notice. As regards the compatibility of tax aid with the common market, the Commission would stress that the form in which aid is granted does not influence the assessment of its compatibility, whether it is granted in the form of a tax measure or in another form. It therefore does not intend to devise specific compatibility criteria for state aid granted in the form of tax measures.

79. As regards tackling harmful taxation, the Commission's parallel work in the state aid field to some extent facilitated the agreement on the code of conduct. However, the Commission's work on tax aid is not meant to be confined to measures caught by the Council's code of conduct for business taxation. Therefore, following the agreement of 3 June 2003, the Commission will continue to review tax aid, focusing on aid with significant economic impact and particularly harmful effects on competition and trade.

80. Lastly, with regard to indirect taxation, the current notice has provided a basis for the Commission's work in certain cases, in particular as regards the application of the principle whereby measures may be justified by the nature and general scheme of the system, but it does not cover all aspects of indirect taxation. The Commission considers that a debate is advisable on the need for clarification and codification in this field.