COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.1998
SEC(1998) 1800 final

COMMUNICATION FROM THE COMMISSION

on the application of the State aid rules

to measures relating to direct business taxation

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Introduction

1. On 1 December 1997, following a wide-ranging discussion on the need for coordinated action at Community level to tackle harmful tax competition, the Council (ECOFIN) adopted a series of conclusions and agreed a resolution on a code of conduct for business taxation (hereinafter "code of conduct")[1]. On that occasion, the Commission undertook to draw up guidelines on the application of Articles 92 and 93 of the Treaty to measures relating to direct business taxation and committed itself "to the strict application of the aid rules concerned". The code of conduct aims to improve transparency in the tax area through a system of information exchanges between Member States and of assessment of any tax measures that may be covered by it. For their part, the State aid provisions of the Treaty will also contribute through their own mechanism to the objective of tackling harmful tax competition.

2. The Commission's undertaking regarding State aid in the form of tax measures forms part of the wider objective of clarifying and reinforcing the application of the State aid rules in order to reduce distortions of competition in the single market. The principle of incompatibility with the common market and the derogations from that principle apply to aid "in any form whatsoever", including certain tax measures. However, the question whether a tax measure can be qualified as aid under Article 92(1) of the Treaty calls for clarification which this notice proposes to provide. Such clarification is particularly important in view of the procedural requirements that stem from designation as aid and of the consequences where Member States fail to comply with such requirements.

3. Following the completion of the single market and the liberalisation of capital movements, it has also become apparent that there is a need to examine the particular effects of aid granted in the form of tax measures and to spell out the consequences as regards assessment of the aid's compatibility with the common market[2]. The establishment of economic and monetary union and the consolidation of national budgets which it entails will make it even more essential to have strict control of State aid in whatever form it may take. Similarly, account must also be taken, in the common interest, of the major repercussions which some aid granted through tax systems may have on the revenue of other Member States.

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1 OJ C 2, 6.1.1998, p. 1.

2 See Action Plan for the Single Market, CSE(97)1, 4 June 1997, Strategic Target 2, Action 1.

4. In addition to the objective of ensuring that Commission decisions are transparent and predictable, this notice also aims to ensure consistency and equality of treatment between Member States. The Commission intends, as the code of conduct notes, to examine or re-examine case by case, on the basis of this notice, the tax arrangements in force in the Member States.

A. Community powers of action

5. The Treaty empowers the Community to take measures to eliminate various types of distortion that harm the proper functioning of the common market. It is thus essential to distinguish between the different types of distortion.

6. Some general tax measures may impede the proper functioning of the internal market. In the case of such measures, the Treaty provides, on the one hand, for the possibility of harmonising Member States' tax provisions on the basis of Article 100 (Council directives, adopted unanimously). On the other, some disparities between planned or existing general provisions in Member States may distort competition and create distortions that need to be eliminated on the basis of Articles 101 and 102 (consultation of the relevant Member States by the Commission; if necessary, Council directives adopted by a qualified majority).

7. The distortions of competition deriving from State aid fall under a system of prior Commission authorisation, subject to review by the Community judicature. Pursuant to Article 93(3), State aid measures must be notified to the Commission. Member States may not put their proposed aid measures into effect until the Commission has approved them. The Commission examines the compatibility of aid not in terms of the form which it may take, but in terms of its effect. It may decide that the Member State must amend or abolish aid which the Commission finds to be incompatible with the common market. Where aid has already been implemented in breach of the procedural rules, the Member State must in principle recover it from the recipient(s).

B. Application of Article 92(1) of the EC Treaty to tax measures

8. Article 92(1) states that "any aid granted by a Member 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". In applying the Community rules on State aid, it is irrelevant whether the measure is a tax measure, since Article 92 applies to aid measures "in any form whatsoever". To be termed aid, within the meaning of Article 92, a measure must meet the cumulative criteria described below.

9. Firstly, the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, including:

- a reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements or the entering of reserves on the balance sheet);
- a total or partial reduction in the amount of tax (such as exemption or a tax credit);
- deferment, cancellation or even special rescheduling of tax debt.

10. Secondly, the advantage must be granted by the State or through state resources. A loss of tax revenue is equivalent to consumption of state resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in the Member States[3]. Furthermore, state support may be provided just as much through tax provisions of a legislative, regulatory or administrative nature as through the practices of the tax authorities.

11. Thirdly, the measure must affect competition and trade between Member States. This criterion presupposes that the beneficiary of the measure exercises an economic activity, regardless of the beneficiary's legal status or means of financing. Under settled case-law, for the purposes of this provision, the criterion of trade being affected is met if the recipient firm carries on an economic activity involving trade between Member States. The mere fact that the aid strengthens the 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. Neither the fact that aid is relatively small in amount[4], nor the fact that the recipient is moderate in size or its share of the Community market very small[5], nor indeed the fact that the recipient does not carry out exports[6] or exports virtually all its production outside the Community[7] do anything to alter this conclusion.

12. Lastly, the measure must be specific or selective in that it favours "certain undertakings or the production of certain goods". The selective advantage involved here may derive from 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. However, the selective nature of a measure may be justified by "the nature or general scheme of the system"[8]. If so, the measure is not considered to be aid within the meaning of Article 92(1) of the Treaty. These various aspects are looked at below.

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3 Judgment of the Court of Justice in Case 248/84 *Germany* v *Commission* [1987] ECR 4013.

4 With the exception, however, of aid meeting the tests of the "*de minimis*" rule. See the Commission notice published in OJ C 68, 6.3.1996, p. 9.

5 Joined Cases C-278/92, C-279/92 and C-280/92 *Spain* v *Commission* [1994] ECR I-4103.

6 Case 102/87 *France* v *Commission* [1988] ECR 4067.

7 Case C-142/87 *Belgium* v *Commission* [1990] ECR I-959.

8 Case 173/73 *Italy* v *Commission* [1974] ECR 709.

Distinction between State aid and general measures

13. Tax measures which are open to all economic agents operating within a Member State are in principle general measures. They must be effectively open to all firms on an equal access basis, and they may not *de facto* be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, 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. Provided that they apply without distinction to all firms and to the production of all goods, the following measures do not constitute State aid:

- tax measures of a purely technical nature (for example, setting the rate of taxation, depreciation rules and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance);

- measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (research and development (R&D), the environment, training, employment).

14. The fact that some firms or some sectors benefit more than others from some of these tax measures does not necessarily mean that they are caught by the competition rules governing State aid. Thus, measures designed to reduce the taxation of labour for all firms have a relatively greater effect on labour-intensive industries than on capital-intensive industries, without necessarily constituting State aid. Similarly, tax incentives for environmental, R&D or training investment favour only the firms which undertake such investment, but again do not necessarily constitute State aid.

15. In a judgment delivered in 1974[9], the Court of Justice held that any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general system "*without there being any justification for this exemption on the basis of the nature or general scheme of this system*" constituted State aid. The judgment also states that "*Article 92 does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects*". The judgment also points out that the fact that the measure brings charges in the relevant sector more into line with those of its competitors in other Member States does not alter the fact that it is aid. Such divergences between tax systems - which, as pointed out above, are covered by Articles 100 to 102 - cannot be corrected by unilateral measures that target the firms which are most affected by the disparities between tax systems.

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9 See note 8.

16. The main criterion in applying Article 92(1) to a tax measure is therefore that the measure provides in favour of certain undertakings in the Member State an exception to the application of the tax system. The common system applicable should thus first be determined. It must then be examined whether the exception to the system or differentiations within that system are justified "by the nature or general scheme" of the tax system, that is to say, whether they derive directly from the basic or guiding principles of the tax system in the Member State concerned. If this is not the case, then State aid is involved.

The selectivity or specificity criterion

17. The Commission's decision-making practice so far shows that only measures whose scope extends to the entire territory of the State escape the specificity criterion laid down in Article 92(1). Measures which are *regional* or *local* in scope may favour certain undertakings, subject to the principles outlined in paragraph 16. The Treaty itself qualifies as aid measures which are intended to promote the economic development of a region. Article 92(3)(a) and (c) explicitly provides, in the case of this type of aid, for possible derogations from the general principle of incompatibility laid down in Article 92(1).

18. The Treaty clearly provides that a measure which is *sectorally* specific is caught by Article 92(1). Article 92(1) expressly includes the phrase "the production of certain goods" amongst the criteria determining whether there is aid that is subject to Commission monitoring. According to well-established practice and case law, a tax measure whose main effect is to promote one or more sectors of activity constitutes aid. The same applies to a measure that favours only national products which are exported[10]. Furthermore, the Commission has taken the view that a measure which targets all of the sectors that are subject to international competition constitutes aid[11]. A derogation from the base rate of corporation tax for an entire section of the economy therefore constitutes, except for certain cases[12], State aid, as the Commission decided for a measure concerning the whole of the manufacturing sector[13].

19. In several Member States, different tax rules apply depending on the status of the undertakings. Some public undertakings, for example, are exempt from local taxes or from company taxes. Such rules, which accord preferential treatment to undertakings having the legal status of public undertaking and carrying out an economic activity, may constitute State aid within the meaning of Article 92 of the Treaty.

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10 Joined Cases 6 and 11/69 *Commission* v *France* [1969] ECR 523.

11 Commission Decision 97/239/EC of 4 December 1996 in the "Maribel bis/ter" case, OJ L 95, 10.4.1997, p. 25 (currently *sub judice*, Case C-75/97).

12 In particular, agriculture and fisheries, see paragraph 27.

13 Commission Decision of 22 July 1998 in the "Irish Corporation Tax" case (SG(98)D/7209) not yet published.

20. 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 as referred to in Article 92(1).

Discretionary administrative practices

21. The discretionary practices of some tax authorities may also give rise to measures that are caught by Article 92. The Court of Justice acknowledges 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, in particular where exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria[14].

22. If in daily practice tax rules need to be interpreted, they cannot leave room for a discretionary treatment of undertakings. Every decision of the administration that departs from the general tax rules to the benefit of individual undertakings in principle leads to a presumption of State aid and must be analysed in detail. As far as administrative rulings merely contain an interpretation of general rules, they do not give rise to a presumption of aid. However, the opacity of the decisions taken by the authorities and the room for manoeuvre which they sometimes enjoy support the presumption that such is at any rate their effect in some instances. This does not make Member States any less able to provide their taxpayers with legal certainty and predictability on the application of general tax rules.

Justification of a derogation by "the nature or general scheme of the system"

23. The differential nature of some measures does not necessarily mean that they must be considered to be State aid. This is the case with measures whose economic rationale makes them necessary to the functioning and effectiveness of the tax system[15]. However, it is up to the Member State to provide such justification.

24. The progressive nature of an income tax scale or profit tax scale is justified by the redistributive purpose of the tax. Calculation of asset depreciation and stock valuation methods vary from one Member State to another, but such methods may be inherent in the tax systems to which they belong. In the same way, the arrangements for the collection of fiscal debts can differ from one Member State to the other. Lastly, some conditions may be justified by objective differences between taxpayers. However, 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. 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.

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14 Case C-241/94 *France* v *Commission* (Kimberly Clark Sopalin) [1996] ECR I-4551.

15 Commission Decision 96/369/EC of 13 March 1996 concerning fiscal aid given to German airlines in the form of a depreciation facility, OJ L 146, 20.6.1996, p. 42.

25. Obviously, profit tax cannot be levied if no profit is earned. It may thus be justified by the nature of the tax system that non-profit-making undertakings, such as foundations or associations, are specifically exempt from the taxes on profits if they cannot actually earn any profits. Furthermore, it may also be justified by the nature of the tax system that cooperatives which distribute all their profits to their members are not taxed at the level of the cooperative when tax is levied at the level of their members.

26. A distinction must be made between, on the one hand, the external objectives assigned to a particular tax scheme (in particular, social or regional objectives) and, on the other, the objectives which are inherent in the tax system itself. The whole purpose of the tax system is to collect revenue to finance state expenditure. Each firm is supposed to pay tax once only. It is therefore inherent in the logic of the tax system that taxes paid in the State in which the firm is resident for tax purposes should be taken into account. Certain exceptions to the tax rules are, however, 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.

27. Specific provisions that do not contain discretionary elements, 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 and general scheme of the system where, for example, they take account of specific accounting requirements or of the importance of land in assets which are specific to certain sectors; such provisions do not therefore constitute State aid. Lastly, the logic underlying certain specific provisions on the taxation of small and medium-sized enterprises (including small agricultural enterprises[16]) is comparable to that underlying the progressiveness of a tax scale.

C. Compatibility with the common market of State aid in the form of tax measures

28. If a tax measure constitutes aid that is caught by Article 92(1), it can nevertheless, like aid granted in other forms, qualify for one of the derogations from the principle of incompatibility with the common market provided for in Article 92(2) and (3). Furthermore, where the recipient - whether a private or public undertaking - has been entrusted by the State with the operation of services of general economic interest, the aid may also qualify for application of the provisions of Article 90 of the Treaty[17].

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16 Operators in the agricultural sector with no more than 10 annual work units.

17 Judgment of the Court of First Instance in Case T-106/95 *FFSA and others* v *Commission* [1997] ECR II-229. Order of the Court of Justice in Case C-174/97 P [1998] I-1303.

29. The Commission could not, however, authorise aid which proved to be in breach both of the rules laid down in the Treaty, particularly those relating to the ban on discrimination and to the right of establishment, and of the provisions of secondary law on taxation[18]. Such aspects may, in parallel, be the object of a separate procedure on the basis of Article 169. As is clear from case-law, those aspects of aid which are indissolubly linked to the object of the aid and which contravene specific provisions of the Treaty other than Articles 92 and 93 must however be examined in the light of the procedure under Article 93 as part of an overall examination of the compatibility or the incompatibility of the aid.

30. The qualification of a tax measure as harmful under the code of conduct does not affect its possible qualification as a State aid. However the assessment of the compatibility of fiscal aid with the common market will have to be made, taking into account, *inter alia*, the effects of aid that are brought to light in the application of the code of conduct.

31. Where a fiscal aid is granted in order to provide an incentive for firms to embark on certain specific projects (investment in particular) and where its intensity is limited with respect to the costs of carrying out the project, it is no different from a subsidy and may be accorded the same treatment. Nevertheless, such arrangements must lay down sufficiently transparent rules to enable the benefit conferred to be quantified.

32. In most cases, however, tax relief provisions are general in nature: they are not linked to the carrying-out of specific projects and reduce a firm's current expenditure without it being possible to assess the precise volume involved when the Commission carries out its *ex ante* examination. Such measures constitute "operating aid". Operating aid is in principle prohibited. The Commission authorises it at present only in exceptional cases and subject to certain conditions, for example in shipbuilding, certain types of environmental protection aid[19] and in regions, including ultra-peripheral regions, covered by the Article 92(3)(a) aid derogation provided that they are duly justified and their level is proportional to the handicaps they are intended to offset[20]. It must in principle (with the exception of the two categories of aid mantioned below) be degressive and limited in time. At present, operating aid can also be authorised in the form of transport aid in ultra-peripheral regions and in certain Nordic regions that are sparsely populated and are seriously handicapped in terms of accessibility. Operating aid may not be authorised where it represents aid for exports between Member States. As for State aid in favour of the maritime transport sector the specific rules for that sector apply[21].

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18 Case 74/76 *Iannelli* v *Meroni* [1977] ECR 557. See also Cases 73/79 "Sovraprezzo" [1980] ECR 1533, T-49/93 "SIDE" [1995] ECR II-2501 and Joined Cases C 142 and 143/80 "Salengo" [1981] ECR 1413.

19 Community guidelines on State aid for environmental protection, OJ C 72 10.3.1994, p. 3.

20 Guidelines on national regional aid, OJ C 74, 10.3.1998, p. 9.

21 Community guidelines on State aid to maritime transport, OJ C 205, 5.7.1997, p. 5.

33. If it is to be considered by the Commission to be compatible with the common market, State aid intended to promote the economic development of particular areas must be "in proportion to, and targeted at, the aims sought". For the examination of regional aid the criteria allow account to be taken of other possible effects, in particular of certain effects brought to light by the code of conduct. Where a derogation is granted on the basis of regional criteria, the Commission must ensure in particular that the relevant measures:

- contribute to regional development and relate to activities having a local impact. The establishment of off-shore activities does not, to the extent that their externalities on the local economy are low, normally provide satisfactory support for the local economy;

- relate to real regional handicaps. It is open to question whether there are any real regional handicaps for activities for which the additional costs have little incidence, such as for example the transport costs for financing activities, which lend themselves to tax avoidance;

- are examined in a Community context[22]. The Commission must in this respect take account of any negative effects which such measures may have on other Member States.

D. Procedures

34. Article 93(3) requires Member States to notify the Commission of all their "plans to grant or alter aid" and provides that any proposed measures may not be put into effect without the Commission's prior approval. This procedure applies to all aid, including tax aid.

35. If the Commission finds that State aid which has been put into effect in breach of this rule does not qualify for any of the exemptions provided for in the Treaty and is therefore incompatible with the common market, it requires the Member State to recover it, except where that would be contrary to a general principle of Community law, in particular legitimate expectations to which the Commission's behaviour can give rise. In the case of State aid in the form of tax measures, the amount to be covered is 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. Interest is added to this basic amount. The interest rate to be applied is equivalent to the reference rate used to calculate the grant equivalent of regional aid.

36. Article 93(1) states that the Commission "shall in cooperation with Member States, keep under constant review all systems of aid existing in those States". Such review extends to State aid in the form of tax measures. So as to allow such review to be carried out, the Member States are required to submit to the Commission every year reports on their existing State aid systems. In the case of tax relief or full or partial tax exemption, the reports must provide an estimate of budgetary revenue lost. Following its review, the Commission may, if it

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22 Case 730/79 *Philip Morris* v *Commission* [1980] ECR 2671.

considers that the scheme is not or is no longer compatible with the common market, propose that the Member State amend or abolish it.

E. Implementation

37. The Commission will, on the basis of the guidelines set out in this notice and as from the time of its publication, examine the plans for tax aid notified to it and tax aid illegally implemented in the Member States and will review existing systems. This notice is published for guidance purposes and is not exhaustive. The Commission will take account of all the specific circumstances in each individual case.

38. The Commission will review the application of this notice two years after its publication.