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The Gibraltar Judgment and the Point on Selectivity in Fiscal Aids

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A recent judgment of the Court of First Instance (CFI) provides the latest interpretation of the controversial notion of selectivity with respect to state-aid review of business tax measures pursuant to Article 87(1) of the European Community Treaty.

Taxation was not the initial focus of the state-aid restrictions, but the European judicature has made it clear in some early judgments that the restriction applies to all forms of public aid including all kinds of relief from taxation normally imposed and that the restriction does not distinguish between measures of state intervention in respect to their causes or their aims but solely to their effects. However, all tax systems provide exceptions and derogations, and the distinction between legitimate or normal tax differentiations and state aids depends on the interpretation of the national framework concerned with the tax rules under examination, which effectively leaves a broad margin of technical appreciation to the Commission and creates greater practical uncertainties for national authorities and taxpayers alike.

The most important statements or findings of the Court with reference to the two issues relating respectively to the notions of geographic and material selectivity are illustrated, followed by a comprehensive review of the controversial notions of selectivity general measure and justification by the nature and scheme of the tax system, under the case law of the Court and the Commission practice.

1. Introduction

By its judgment of 18 December 2008 in Cases T-211/04 and T-215/04, *Government of Gibraltar v. Commission*,[1] the Court of First Instance (CFI) of the European Communities (ECs) annulled the Commission Decision 2005/261/EC of 30 March 2004,[2] prohibiting Gibraltar to enact its proposed company tax legislation that sought to make the British protectorate a more attractive offshore location for mobile business activities.

This judgment provides the latest interpretation by the European judicature of the controversial notion of selectivity with respect to state-aid review of business tax measures pursuant to Article 87, paragraph 1 of the EC Treaty.[3] The ruling is relevant in the context of establishing the interplay between state-aid prohibition and taxation but does not permit to answer the outstanding questions about the interpretation of controversial notions such as the general tax measure exception and the justification by the nature and scheme of the tax system. With the judgment in review, the Third Chamber of the CFI in extended composition has annulled the said Commission Decision in its entirety, finding that the Commission had infringed the duty to give reasons imposed on it by Article 253 of the EC Treaty with regard to establishing the analytical framework of reference relating to the determination of the selective character of Gibraltar's proposed company tax legislation. The CFI dictum concerns both the so-called regional and material elements of selectivity and is particularly noteworthy because the two notions are dealt in parallel, including the conclusions. However, although the ruling on regional selectivity is consistent with the prior case law on the point, the one on material selectivity is not.

The CFI judgment may not constitute the settled case law yet, since the Commission may appeal against the judgment that may be set aside by the European Court of Justice (ECJ), with the case being referred back to the CFI for a second judgment on the point of material selectivity.[4] For the moment, its dictum that a combined company tax system such as the one proposed by Gibraltar is not to be considered state aid is 'good law'.

Before discussing the delicate questions raised by the judgment, the factual and legal background of the dispute shall be illustrated (section 2) and the most important statements or findings of the CFI will be summarized with reference to the two issues dealt with by the CFI, relating respectively to the notions of geographic and material selectivity (section 3). On this basis, a comprehensive illustration of the controversial notions of selectivity, justification and general measure is provided in section 4.

1 Judgment in Case Nos. T-211/04 and T-215/04, *Government of Gibraltar v. Commission* [18 Dec. 2008], not yet in ECR.
2 OJ L 85 (2005): 1.
3 Specifically, Art. 87(1) of the EC Treaty 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 favoring 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'.
4 The judgment may be appealed within sixty days from the date of notification to the parties.

2. Background

The state-aid prohibition is contained in paragraph 1 of Article 87 of the EC Treaty, according to which state aid is any benefit that selectively favours certain undertakings or the production of certain goods, whereas a general benefit that assists all sectors or industries is not state aid because it constitutes a general measure that is unable to alter the level-playing field between undertakings. The EC Treaty also provides exceptions to the general prohibition on state aid. Paragraphs 2 and 3 of Article 87 of the EC Treaty, respectively, list types of aid that are deemed compatible and aids that the European Commission may declare compatible with the common market. One should keep in mind that such exceptions do not diminish the absolute significance of the state-aid prohibition, but rather define situations where an aid is admissible because it is aimed at objectives of common interest and is not excessively distortive, and therefore compatible with the common market. For example, under Article 87, paragraph 3, letter (c), which is the Treaty legal base for compatibility of most aids granted, state aid can be held to be compatible if it is aimed 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*'. This means that the possible characterization of a public measure has state aid preserves its legal relevance.

Article 88 of the EC Treaty outlines notification and adjudication procedures for all proposed measures of state aid with the potential to affect competition between the Member States.[5] Paragraph 3 of Article 88 of the EC Treaty states that the Commission must be informed, in sufficient time, to enable it to submit its comments, of any plans to grant or alter aid. If the Commission considers any such plan incompatible with the common market under Article 87 of the EC Treaty, it will, without delay, initiate the procedures provided for in paragraph 2 of Article 88 of the EC Treaty. The Member State concerned must not put its proposed measures into effect until this procedure has resulted in a final decision.

Although tax incentives were not the initial focus of the state-aid restrictions, the ECJ made it clear in its dictum in *Italian Republic v. Commission* (hereinafter '*Italy v. Commission*')[6] that Article 87 of the EC Treaty applies to all forms of public aid including, in principle, all kinds of relief from taxation that that would otherwise be imposed. Such an interpretation is also coherent with the principle, stated by that judgment, that the prohibition provided by Article 87, paragraph 1 does not distinguish between measures of state intervention by reference to their causes or their aims but solely to their effects.[7] However, it is true that all tax systems provide exceptions and derogations, and the distinction between 'legitimate' or 'normal' tax differentiations and state aids depends on the interpretation of the national framework concerned with the tax rules under examination, which effectively leaves a broad margin of technical appreciation to the Commission and creates greater practical uncertainties for national authorities and taxpayers alike. In *Italy v. Commission*, the ECJ has therefore ruled that to be termed 'aid' a tax measure must confer on certain recipients an advantage that exempts (fully or partially) them from charges that are normally borne from their budgets '*without there being any justification for this exemption on the basis of the nature or general scheme of this system*'.[8] Against the aforementioned substantive and procedural backgrounds, it is the choice of the national authorities to notify their tax systems to the Commission, pursuant to Article 88, paragraph 3 of the EC Treaty, or to implement their planned tax reforms without consulting the Commission, however at their risk. State-aid review of direct business tax measures has received an impetus following the Commission adoption in 1998 of specific guidelines relating to the application of the Community rules on state aid to direct business taxation measures[9] and the coordinated package of state-aid review carried out with respect to tax schemes enacted by Member States to attract the location of mobile business activities and intra-group functions from 2001 to 2006.[10]

In August 2002, following prior state-aid proceedings against the special tax regimes in Gibraltar for exempt and qualifying companies, which the Commission had determined to be incompatible aid favouring Gibraltar's offshore sector,[11] the United Kingdom, on Gibraltar's behalf, notified to the Commission a proposed company tax reform. The reform was aimed at replacing the special tax regimes for exempt and qualifying companies, which had been declared incompatible with the common market with a combined system of different direct taxes on companies, including payroll, registration, and property taxes. The general nature of the combined system was described by the United Kingdom to be that of regressive taxation of the profitable use of property and employees in Gibraltar (see in particular paragraphs 37 and 40 of the contested Decision).

More particularly, the proposed reform was based on the following main elements:

– A payroll tax in the amount of GBP 3,000 per person employed in Gibraltar, payable by profit-making companies taxable in Gibraltar (a payroll tax).

[5] Note that according to the notorious dictum in the judgment in Case No. C-730/79, *Philip Morris Holland v. Commission* [17 Sep. 1980] ECR 2671, paras 11–12, all advantages granted to undertakings operating in market open to competition are presumed to affect competition. Nor does the Commission need to prove that trade is concretely affected as ruled in the judgment in Joined Case Nos. T-298, 312, 313, 315, and 600–607/97, *Alzetta Mauro v. Commission* [15 June 2000] ECR II-2319, paras 49–50.

[6] Judgment in Case No. 173/73, *Italian Republic v. Commission* [2 July 1974] ECR I-709, paras 36–39.

[7] Ibid., para. 13.

[8] Ibid., para. 15.

[9] OJ C 384 (1998): 3.

[10] For comprehensive illustration of the main fiscal state-aid cases of the package, see P. Rossi-Maccanico, 'Commentary of State Aid Review of Multinational Tax Regimes', *European State Aid Law Quarterly* I (2007): 25–41.

[11] For the exempt company regime, see the notice published in OJ C 228 (2005): 9 on acceptance of appropriate measures proposed on 19 Jan. 2005. For the qualifying company regime, see the Commission Decision 2005/78/EC in OJ L 29 (2005): 24.

- A business property occupation tax at a given percentage per estate occupied in Gibraltar, also payable by profit-making companies taxable in Gibraltar (a property tax).
- A cap on property and payroll taxes combined for companies taxable in Gibraltar to 15% of their profits, so that profits of taxable undertakings will only pay the payroll and the property taxes if their virtual tax liability does not exceed 15% of their taxable profits calculated in accordance with internationally accepted accounting principles. If the tax liability exceeds 15% of the company profits, the companies would be subjected to 15% tax on their taxable profits, and the property and payroll taxed credited against the 15% profit tax (a 15% profit cap).
- A surtax in addition to the payroll and property taxes would be payable by companies carrying out certain designated activities, namely those being active in the financial services and utility sectors. In particular, financial service companies would be charged a top-up tax on the profits from financial service activities at the rate of 8% of the profits, in addition to the said payroll and property taxes, capped however to the maximum at an aggregate tax of 15% of their profits. Utility companies would be charged a top-up tax of 35% on profits from utility activities (such as supply of water, electricity, and so forth) in addition to the payroll and property taxes as capped to 15% of their profits. The overall tax liability for this sector will be capped at an aggregate tax of 35% of their profits.

Although the notification concerned the entire proposed company tax reform, which would have become the only system of company taxation in Gibraltar, the Commission accepted to review it under the EC rules on state aid on the ground that it concerned Gibraltar, which is only a part of the United Kingdom, and accordingly was to be considered as regionally, that is geographically, selective under the recognized doctrine on regional aid. Paragraph 17 of the said Commission guidelines on the application of state-aid rules to measures relating to direct business taxation indeed provides that the Commission's decision-making practice had shown that only measures whose scope extends to the entire territory of a Member State could escape the specificity criterion laid down in Article 87 of the EC Treaty and accordingly tax measures that are regional or local in scope may favour certain undertakings. The regional selectivity doctrine is generally based on the assumption that the EC Treaty itself qualifies as aid measures that are intended to promote the economic development of a region. Article 87, paragraph 3, letters (a) and (c) explicitly provide, in the case of this type of aid, possible derogations from the general principle of incompatibility laid down in Article 87 of the EC Treaty and would indirectly confirm that any advantage granted in respect to only a part of a Member State is state aid because it is selective.[12]

In its notification, the United Kingdom maintained, however, that Gibraltar was not part of a Member State, and that Community law was applied to Gibraltar only by virtue of Article 299, paragraph 4 of the EC Treaty (see paragraph 56 of the contested Decision). For the United Kingdom, the doctrine of regional selectivity would be inapplicable because Gibraltar is a separate tax jurisdiction, and therefore, any form of public intervention is to be assessed with reference to the local contexts rather than the United Kingdom. This meant that the tax system enacted in Gibraltar could not be considered per-se selective just because it is different from the one enforced by the United Kingdom. The main argument used by Gibraltar to prove that its tax system was truly autonomous was that, in the absence of the system, companies in Gibraltar would not automatically be taxed under the United Kingdom rules (see paragraph 54 of the Decision). The United Kingdom also maintained that, with its reform, Gibraltar intended to provide for a well-balanced company tax system adapted to its specific economic situation, which was to be considered as the only tax system of reference, with all its particularities and specificities to accept.

However, on 30 March 2004, following a long examination, the Commission eventually adopted the contested Decision 2005/261/EC,[13] stating that Gibraltar's proposed company tax system constituted incompatible state aid because it is both regionally and materially selective. In particular, the Commission had considered that the proposed company tax regime was regionally selective essentially because it provided for a system of company taxation under which the enterprises in Gibraltar are generally taxed at a lower rate than those in the United Kingdom. Although fiscally separate from Gibraltar, the United Kingdom and its protectorate were subject to state-aid provisions. Moreover, Gibraltar was still, in part, financially dependent from transfers from the United Kingdom budget to finance some of its public expenditures (see paragraphs 98 to 127 of the Decision), so that the ability to reduce taxation in Gibraltar was for the Commission imputable to the United Kingdom. The system has also been found to be materially selective essentially because of the following:

(1) The requirement to make a profit before incurring any payroll and property tax liabilities conferred an advantage on unprofitable companies. According to the Commission, the exemption of unprofitable companies from payroll and property taxes would selectively favour the unprofitable companies and could not be justified by the nature or general scheme of the payroll and property taxes (see paragraphs 128 to 133 of the Decision).
(2) The 15% cap on liability to payroll and property taxes conferred an advantage on those undertakings to which it applies. The Commission concluded that the profit cap would selectively favour 'those companies that benefit from its application', which was by and large identified as Gibraltar's offshore sector as opposed to its onshore sector (see paragraphs 134 to 141 of the Decision).
(3) The payroll and property taxes favoured those undertakings with lesser amounts of employees

[12] For an analysis of the selectivity criterion in fiscal aid measures, see P. Rossi-Maccanico, 'The Specificity Criterion', *EC Tax Review* 16, no. 2 (2007): 90-103.

[13] OJ L 85 (2005): 1.

> and property in Gibraltar. For the Commission, a system targeting only employment and commercial use of real estate in a context such as that of Gibraltar '*does not enjoy the same general character as the taxation of companies' profits*' and would accordingly favour the companies that do not have employees or estates (see paragraphs 142 to 145 of the Decision).

The governments of Gibraltar and the United Kingdom filed actions for annulment against the Commission, claiming the breach of its obligation to provide adequate reasons for the Decision.

3. Analysis of the Judgment

The ruling by which the CFI has annulled the Commission Decision contains a detailed motivation, essentially concluding that the Commission had erred in its selectivity assessment by failing to ascertain the correct system of reference in determining the regionally aid character of Gibraltar's proposed tax reform (see paragraph 115 of the judgment). In particular, the CFI has found that the correct system of reference to assess the reform was the one set up by Gibraltar with its reform, rather than the one of the United Kingdom, in accordance with the so-called '*Azores*' judgment that has set three conditions of institutional, procedural, and economic autonomy to recognize that the system of reference is regional rather than national, in order to determine the state-aid nature of local tax rules.[14]

Concerning regional (i.e., geographical) selectivity, the CFI considered that company tax system in question applied only to the taxable undertakings in Gibraltar and naturally comprised different schedules and exemptions than those in force in the United Kingdom, but this was not sufficient for the Commission to assume that the tax framework of reference was the one of the United Kingdom, excluding a priori that Gibraltar does not form part of the United Kingdom and that Gibraltar and the United Kingdom lack a common tax system. First, the CFI rejected the Commission's argument that the reference framework, that is, the general system against which the selective nature of a measure must be assessed, can only be the Member State except in cases of symmetric devolution of tax powers (when a central tax relating to a given type of tax ceases to exist as a result of the devolution of the tax powers to regions within a Member State).

For the CFI, the main question was whether Gibraltar fulfilled the three criteria developed by the ECJ in the *Azores* judgment to determine whether the autonomy of an infrastate body is sufficient to consider that tax measures adopted by it constitute an independent tax jurisdiction from that of the Member State. First, the regional authority must have, from a constitutional point of view, a political and administrative status separate from that of the central government. Second, the measures would have to be adopted without the central government being able to directly intervene regarding its content. Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or the central government. The CFI concluded that Gibraltar fulfilled all three requirements, rejecting the Commission's plea that the test implied a fourth condition, namely that the infrastate body must occupy a fundamental role in the definition of the political and economic environment in which the undertakings present on the territory within its jurisdiction operate.

As to the notion of material selectivity, the CFI built its criticism on the previous finding that the assessment of the tax reform had to be done with respect to Gibraltar's tax system including all its specificities, and concluded that the Commission had also erred in establishing the existence of an advantage or derogation from such a system. For the CFI, none of the three aspects of the notified tax reform found to be aid by the Commission could be considered conferring an advantage, as the Commission had not demonstrated that they constituted derogations from a common or normal system of reference (see paragraph 185 of the judgment).

With respect to the aforementioned motives 1 and 2, the CFI has held that the Commission's implicit reference to a general system in identifying the derogation, namely the requirements to make profit and the cap on profits, was flawed because the latter two features could together be considered as constitutive elements of a general system in their own right rather then derogations. Indeed, given Gibraltar's argument that it taxes resources such as labour and land, which are scarce in Gibraltar, but avoids taxing taxpayers earning low income in Gibraltar to avoid repressing economic activity, it was legitimate for Gibraltar to make profitable employment and property occupation the basis of taxation instead of employment and property occupation in general. Concerning motive 3, the CFI has again held that the Commission was wrong in concluding that the tax system based on payroll and property is an exception from the appropriate system of taxation of company profits. First, there is no other company tax system that would be applicable in the absence of the one proposed by Gibraltar, and, second, given Gibraltar's specific economic situation and the lack of harmonization of corporate taxes on a community level and the prerogatives of Member States in the area of direct taxation,[15] the tax system devised by Gibraltar can be considered a system of general application suited best to the economy of that particular jurisdiction (see paragraph 146 of the judgment).

[14] Judgment in Case No. C-88/03, *Portuguese Republic v. Commission* [6 Sept. 2006], ECR I-7115, para. 67.

[15] See, to this effect: Judgment in Case No. C-204/90, *Hanns-Martin Bachmann v. Belgian State* [28 Jan. 1992] ECR I 249, para. 23; Judgment in Case No. C-374/04, *Test Claimants in Class IV of the ACT Group Litigation* [12 Dec. 2006] ECR I 11673, para. 50; and Case No. T-67/94, *Ladbroke Racing v. Commission* [1998] ECR II 1, para. 54; see also the opinion of Advocate General Poiares Maduro in Case No. C-446/03, *Marks & Spencer* [2005] ECR I 10837, paras 23 and 24.

We understand that in the judgment in review the CFI has only concluded that the Commission had failed to establish what elements of that system constitute exceptions that could favour certain undertakings or productions, leaving still open the question of whether Gibraltar's proposed tax reform contain a state-aid element or not. It would appear that excluding the profits earned by Gibraltar undertakings that do not employ workers and use property locally from the same company tax to which other undertakings with comparable workers and property operating within Gibraltar are subject would provide for an exceptional tax advantage to the former companies that seems to fall under the scope of application the state-aid prohibition.

The Commission may decide to bring an appeal before the ECJ or issue a new negative Decision improving its rationale, while, on the other hand, replacing the annulled decision with a positive one declaring that Gibraltar's tax reform is compatible with the common market and can be put into effect seems contrary to its prior practice.

4. The Point on Selectivity, General Tax Measures, and Justification

The Gibraltar judgment touches on the recurrent question of the limits of the notion of state aid as opposed to permissible preferential taxation. This is a question that was already addressed early on by the Court in its dictum in the *Italy v. Commission* judgment.[16] There are important considerations stemming from that judgment of more than thirty years ago, which are still valid today.

For a tax measure to be considered state aid, it is irrelevant if it derogates from the pre-existing standard or norm, or if it significantly reduces taxation normally applicable in other tax systems. Member States are free to reform their tax systems, and state aid may only derive from an unjustified differentiation or derogation within the tax system of reference as applicable to the geographic jurisdiction concerned. In *Italy v. Commission*, the ECJ observes that many public interventions may have the effects of favouring the undertakings in a Member State's jurisdiction. However, when it comes to tax measures, only those derogating from the normal application of the tax system of which they form part may be characterized as state aid, since only such measures relieve certain beneficiaries '*from the financial charges arising from the normal application of the general system of compulsory contributions imposed by law*'.[17] In other words, the assessment of an advantage is to be made with respect to the jurisdictional system of reference and not by carrying out a comparative analysis with other systems, and while the inter-State distortions of competition may only be eliminated by the harmonization of the relevant national legislations, the remedy against intra-State distortions is state-aid control as provided by Articles 87 and 88 of the EC Treaty.[18] Advocate General Darmon[19] has clarified that:

> If the level of fiscal and social obligations incumbent on undertakings in one Member State is appreciably lower than it is in other States, a situation of that kind, which undoubtedly affects competition, may be resolved by applying Articles 99 to 102 of the EEC Treaty. In other words, a general advantage conferred by national legislation of one sort or another cannot be caught by means of Article 92(1).

It derives that the Treaty sets a clear demarcation between state-aid review pursuant to Articles 87 and 88 of the EC Treaty and harmonization pursuant to Articles 93 to 97 of the EC Treaty. The distinction rests on the advantage or derogation criterion, which is a jurisdictional criterion.

It derives that the selective or specific nature of a tax measure shall be assessed with respect to the territorial system of reference. The definition of exception from system of reference helps in illustrating the notion of advantage, which is separate, however, from the one of selectivity. While the notion of tax advantage or derogation derives from an exception from the system of charges normally applied in the jurisdiction of reference, the notion of selectivity refers to the formulation of Article 87, paragraph 1, stating that an aid is any public measure '*favouring certain undertakings or the production of certain goods*'. In applying this notion to tax measures, since Article 87 concerns '*measures in any form whatsoever*', one should look at the effects of a measure rather than its objectives. This effect-based doctrine solicits an extremely large interpretation of the notion of selectivity, which encompasses almost all tax advantages, but not all. Under this large interpretation, not only is a tax measure selective when it applies to certain undertakings individually or subjectively concerned because identified by their subjective characters (e.g., a tax reduction for the banking sector, or for the small and medium enterprises), but it is also selective if it applies to certain objective situations or conditions (e.g., a tax credit for new investments). In this last case, since selectivity is defined by reference to the objective rather than subjective scope of the measure, one understands that fiscal selectivity is derived indirectly rather than directly. This is, for example, the case of a regional investment scheme, which is selective because granted in respect to certain investments carried out in a region although effectively open to all the undertakings; what matters is that only those undertakings which carry out such investments are favoured.

On the other hand, to fulfil the requirement that to be termed 'aid' a measure must favour certain undertakings or productions, the scope of the derogation should permit to identify at least indirectly certain individual beneficiaries, being the undertakings affected by the measure. There are therefore two exceptions to the said effect-based doctrine as indicated by the Commission Notice on fiscal aids: the exclusion

16 Judgment in Case No. 173/73, *Italy v. Commission* [2 July 1974] ECR 709.

17 Ibid., para. 3.

18 Ibid., paras 36–39.

19 Opinion delivered in Joint Case Nos. C-71/91 and C-72/91, *Sloman Neptun* [17 Mar. 1992], para. 62.

of general measures, and the justification of selectivity by the nature of the scheme. While the second exception derives from the dictum of *Italy v. Commission* about aid being tax exemptions favouring certain undertakings '*without there being any justification for this exemption on the basis of the nature or general scheme of this system*',[20] the first one is only foreseen by the aforementioned paragraph 13 of the Commission Notice on fiscal aids, stating that:

> [t]ax 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.

Paragraph 14 of the Notice further stresses that if a tax measure is general:

> [t]he 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.

The notion of general tax measure can be illustrated by reference to the recent Commission Decision relative to a tax credit notified by Spain in favour of investments to develop intangible assets.[21] Under the notified aid in question, pursuant to certain conditions, the company tax base of companies could be reduced by allowing for 50% of the gross revenues deriving from certain intangible assets (patents and so forth) to be deducted. The deduction was limited to five times the cost of the investments made in research and development. The Commission has concluded that measure was not selective because the scheme was open to any undertaking subject to corporate taxation in Spain that incurred expenses to develop intangible assets, independently from its size, legal structure and sector in which it operates can be the beneficiary. For the Commission, the measure did not strengthen the position of any particular class of undertakings in relation to others competing in intra-Community trade and applied without distinction to all economic operators. Hence to justify the conflict with effect-based doctrine, the Commission seems having implied that an indefinite number of sectors can have an interest in developing patentable inventions, designs or models, plans or secret formulas or processes as well as industrial, commercial, or scientific experience. Most importantly, the Commission seems having justified the measure because it did not directly derogate from the logic of the company tax system where expenses and investments made in connection with profit-making activities are deductible at variable rates and intensities. In the case in question, the advantage consisted in a deduction from income of the revenues derived from development of intangible in relation with expenses incurred. The measure was considered not to provide a selective advantage in that the distinction between undertakings was based on general expenses incurred rather than certain activities being carried out.

This precedent indicates that, although it is necessary to prove a direct or indirect effect on certain undertakings to determine state aid, there are no clear safe-haven rules as to how general an advantage is required in order to be considered a general tax measure, because the effect-based doctrine stipulates that the provision of objective conditions for a tax advantage to be granted can indirectly favour some beneficiaries. One may then question how in practice the effect-based doctrine relating to the objective selectivity in the tax system can be reconciled with Member States prerogatives '*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*' as stated at paragraph 13 of the Commission Notice. The author believes that, the Court has set a relatively clear distinction by ruling that the selective character of a measure can be justified by the nature or scheme of the system. This justification corresponds to the third part of the three-prong test on fiscal aid mentioned at paragraph 23 of the Commission Notice. As recognized by the doctrine,[22] the notion of justification is not particularly clear, and there are few illustrations of cases where the Commission has recognized that the justification could apply.[23] One shall examine how this justification can be appropriately invoked to exclude the inherent selective nature of a tax reduction. From the *Adria-Wien Pipeline* (hereinafter '*Adria-Wien*') dictum, it

20 Judgment in Case No. 173/73, *Italy v. Commission* [2 July 1974], ECR 709, para. 15.

21 See the Commission Decision not to raise objection of 13 Feb. 2008 relative to the notified Aid No. 480/07, Patent box, Spain, published in JO C /80/2008.

22 For comprehensive analysis of the notion of selectivity in fiscal-aid cases, see P. Rossi-Maccanico, 'State Aid Review of Business Tax Measures', *European State Aid Law Quarterly* II (2007): 215–230; and C. Micheau, 'Tax Selectivity in State Aid Review: A Debatable Case Practice', *EC Tax Review* 6 (2008): 276–284.

23 One rare illustration may be found in the Commission Decision of 5 June 2002 on the fiscal aid scheme enacted by Italy in favour of joint stock companies with municipal shareholdings (OJ L (24 Mar. 2003): 21), which were exempted from transfer taxes for assets contributed into such companies. Although the company tax exemption was found to be state aid, the transfer tax exemption was justified by the nature of the system. For the Commission, although in general, the transfer tax is applied to the creation of a new economic entity or to the transfer of assets between different economic entities, in the case in question, the municipality undertakings benefiting from the transfer tax exemption were substantially the same economic entities operating before the transformation into joint-stock companies, except with a different legal form. The author believes, however, that the principle of tax neutrality, invoked by the Commission to justify this exemption, may not justify a derogation from a tax that is normally applied to all transfers, including those involving a mere change of legal form, and that accordingly seems to be a mere privilege individually conferred to private undertakings because of their municipal shareholdings.

would appear that an exception can be justified by the logic of the scheme if it applies generally to all operators which are in the same factual and legal situation in view of certain specific objectives pursued.[24] The *Adria-Wien* dictum is that the main (but not the only) question to be determined in establishing selectivity is whether, under a particular statutory scheme, a measure is such as to favour certain undertakings in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question.

Even if a tax measure has the effect of differentiating between undertakings, and therefore confers an advantage to its recipient, the differentiation for the *Adria-Wien* judgment may be justified by the nature or general scheme of the system of which it is a part.[25] However, a differentiation based on different legal and factual situations may not be sufficient to exclude selectivity. Indeed, as stipulated by the *Azores* dictum,[26] an objective different context, although necessary, is not alone sufficient to define the justification, because a distinction must be made between, on the one hand, the objectives attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives and only the differentiations resulting from inherent objectives of the tax system of reference are able to justify selectivity. On the other hand, the advantages resulting from objectives external to the system are not. Since only the inherent and objective differentiations are acceptable in justifying a tax preference, there is a second test in addition to the one developed by *Adria-Wien*, which needs to be satisfied before concluding that selectivity is justified.

Against this background, one may conclude that the justification results from a two-prong test being based, on the one hand, on an objective or internal criterion by which the differential treatment is justified by different conditions, and, on the other hand, an external or teleological criterion by which the differentiated treatment is justified by its inherent coherence within the nature of the scheme. This latter criterion is obviously more complicated in terms of finding the inherent coherence of the exception with respect to the system and is sometimes referred to as the technical justification. In this respect, paragraph 13 of the Commission Notice on fiscal aids also refers to tax measures of a purely technical nature (setting the rate of taxation, depreciation rules and rules on loss carry-overs, provisions to prevent double taxation or tax avoidance, and so forth), or to 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, and so forth).[27]

A persuasive illustration of a specific derogation from a general system of charges being justified by the nature of the scheme is provided by a recent judgment law of the CFI in the *Netherlands v. Commission* (hereinafter '*NOx*') case.[28] In this case, the CFI has annulled a Commission Decision that had declared a regime of allocation of emission certificates to companies emitting large quantities of gas under the general emission trading system to be an aid compatible with the common market. The Netherlands, however, appealed the Decision, considering that the allocation of emission certificates for large emitters of gases was not an aid but rather a general measure justified by the same emission trading system. The CFI has eventually concluded that the allocation was indeed an advantage awarded to large polluters but it was justified by the nature of the scheme because it was made under objective criteria and in accordance with the emission trading system.[29] The CFI has recognized that to be justified as a general measure a reduction of charges normally applied shall be open to all possible beneficiaries in the comparable legal and factual situations set by the regime and not conflict with the general aims of the system.[30] In particular, for the CFI, the allocation of emission certificates free of charge was a general measure because: (1) the advantage/derogation granted was justified by the objective different conditions of the undertakings with considerable emissions vis-à-vis those with reduced emissions, and (2) the advantage was granted in accordance with the objective of the emission trading system to reduce emissions.

In sum, to determine whether a favourable tax regime is indeed justified by the nature of the scheme, it is critical to establish that a tax advantage is granted on the basis of objective conditions

24 Judgment in Case No. C-143/99, *Adria-Wien Pipeline* [8 Nov. 2001] ECR I-8365, para. 41.

25 Ibid., para. 42.

26 Judgment in Case No. C-88/03, *Azores* [6 Sep. 2006], ECR I-07115, para. 81.

27 The functioning of the inherent coherence test is illustrated by a recent Commission decision relating to State aid C 15/07 implemented by Italy on the tax incentives in favour of certain restructured banks with respect to preferential taxation of capital gains. As indicated at para. 20 of the Commission Decision 2008/711/EC of 11 Mar. 2008 '[i]t should be noted that capital gains are particular items of income, which, unlike ordinary income, reflect an economic surplus matured over time, while its tax recognition is necessarily a one-time operation. For this reason, capital gains realised by companies are not only deferred until the time of the tax realignment of the value of the relative assets, but are also subject to a preferential tax in lieu of the ordinary company tax. The preferential tax is an advantage as the company concerned not only pays a lower tax on the gains but can distribute such gains as dividends to its shareholders, which give right to a tax credit or exemption for the corporate taxes paid. The tax advantage deriving from the substitute tax is however justified by the fiscal technique in view of the specificity of capital gains as income vis-à-vis ordinary earnings'.

28 Judgment in Case No. T-233/04, *Netherlands v. Commission* [10 Apr. 2008], not yet in ECR.

29 Ibid., para. 99.

30 It should be noted that the judgment is not the settled case law yet as the Commission has appealed against the judgment, asking the ECJ to set aside the judgment delivered by the CFI in Case No. T-233/04 (Case No. C-279/08 P). The Commission has submitted that the CFI was wrong to conclude that the disputed measure is not selective, that is to say, that it does not favour certain undertakings within the meaning of Art. 87 of the EC Treaty. For the Commission, the CFI has also erred in concluding that, even if the measure were selective, it would still not constitute state aid in view of its purpose and on the ground that that measure would be justified by the nature and general scheme of the system.

(e.g., the comparable legal and factual situations). According to this first consistency test, if it is established that potential beneficiaries of a favourable tax regime are effectively excluded from it while being in comparable legal and factual situations than the actual beneficiaries, the regime shall be considered selective. If, however, the regime truly governs special situations or arrangements differing from the norm, then the first part of the justification test is satisfied. The justification test then implies that the derogation is consistent or descends from the nature of the scheme. According to the second consistency test, the derogation or special tax regime must be in accordance with the general objective and nature of the tax system of reference and therefore be justified by the nature or general scheme of the system.[31]

The above-indicated conclusions are, however, far from being settled. As the Gibraltar judgment indicates, the European judicature has yet to reach a point of equilibrium between Member States' freedom to shape their tax systems in the way they deem most appropriate and the internal coherence which is required to avoid granting state aid.

Another precedent of the CFI, the *British Aggregates Association v. Commission* (hereinafter '*British Aggregates Association*') case,[32] is of a certain relevance for the justification test. The case concerned a fiscal scheme relieving the spoils of certain minerals and certain exports from the United Kingdom from a tax levied on virgin aggregate. The objective of the scheme was to discourage the excessive extraction of virgin aggregate, a nonrenewable natural resource and whose extraction was polluting. The tax relief measures aimed at supporting the use of recycled aggregate and other alternatives to virgin aggregate. By its Decision C (2002) 1478 final of 24 April 2002, the Commission had not raised any objection against this aggregate levy. After establishing that the measure was selective, it justified the selectivity by the nature of the scheme in light of the environmental considerations invoked. By this judgment, the CFI has also confirmed that the tax scheme did not constitute state aid. However, it held that the environmental levy was an autonomous tax that included environmental goals and a specific tax base. Accordingly, environmental levies could not, in principle, be related to any overall tax logic and, therefore, were not considered as selective since:

> they constitute by their nature specific measures adopted by the Member States as part of their environmental policies, a field in which they retain their powers. In the absence of measures for harmonization, it is for the Commission, when assessing an environmental levy for the purposes of the Community rules on state aid, to take account of the environmental protection requirements referred to in Article 6 EC.[33]

The judgment has been appealed by the association that had brought the complaint against the Commission on the grounds that the CFI had erred in ruling that a specific tax reduction could be justified by the nature of the scheme.[34] On 17 July 2008, the Advocate General Mengozzi, delivered a negative opinion on the CFI judgment, stating that:

> certain conclusions are reached which would not have been permissible if that examination had been based on the criteria of the nature and general structure of the tax regime at issue, in accordance with the case-law (…). In effect, starting from the premises that the Member States are free, when defining the scope of an environmental levy, to balance the various interests at stake, the CFI ultimately accepts that the existence of possible inconsistencies or differences in treatment may be justified even if based on objectives unconnected with the protection of the environment and, consequently, unrelated to the internal logic of the measure in question (paragraphs 80–99 of the opinion).

By a recent judgment,[35] the ECJ has found that, in rejecting the complaint brought against the *British Aggregates Association* levy by its Decision of 2002, the Commission would have had to provide the complainant with an adequate explanation of the reasons for which the facts and points of law put forward in the complaint have failed to demonstrate the existence of state aid. For this reason, the ECJ has annulled the prior judgment of 16 September 2006 in the light of the grounds that the CFI had erred in law in concluding that the contested decision was adequately reasoned. The case has been referred back to the CFI for a new judgment.

The above-described controversy shows that the matter of the classification of a special tax measure based on objective conditions as state aid or as a general measure is still very unsettled. One may consider that the interpretation of the justification of a tax measure by the nature of the scheme based on objective conditions was intended by the ECJ to clarify the effect-based notion of selectivity but, in practice, it came to afflict the Commission practice since the *Adria-Wien* judgment. The *Adria-Wien* dictum was eventually reconsidered by the ECJ especially by the case law on regional autonomy (Azores, La Rioja),

31 The above-illustrated dual consistency test reminds the consistency test devised by the case law of the Supreme Court to determine if a given tax rule of a Federated State of the United States of America is in breach of the Commerce Clause (and the Due Process Clause) of the US Constitution. The conceptual issue is similar to the one of determining the state aid character of a tax measure. Given that the Federated States have original fiscal autonomy in setting the tax system they consider most appropriate, and considered that in principle there is no common standard of reference which can be used to determine if the tax rule in exam is inappropriately discriminating against inter-state or foreign commerce and is therefore in breach of the Commerce Clause, the Supreme Court has ruled (*Container Corporation of America v. Franchise Tax Board of California* [1983], 463 US 159, 103 S. Ct. 2933, 77 L. Ed. 2d 545) that: '[a]n apportionment formula [the system of company taxation in review] must, under both the Due Process and Commerce Clauses be fair. The first and again obvious component of fairness in an apportionment formula is what might be called internal consistency – that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency – the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated'.

32 Judgment in Case No. T-210/02, *British Aggregates Association v. Commission* [13 Sept. 2006], ECR II-2789.

33 Ibid., paras 116–117.

34 Judgment in Case No. C-487/06 P, *British Aggregates Association* [22 Dec. 2008].

35 Ibid., not yet in ECR.

stressing that only the inherent nature of a scheme can justify specific objective conditions. The CFI, traditionally closer to business and stricter to the Commission, has tried to bridge that gap with the most recent judgments (*British Aggregates Association* and the *NOx* cases), but the appeals against these judgments are still pending. Finally, the Gibraltar judgment departs from the prior line of the CFI and stresses the issue of fiscal autonomy of a jurisdiction in setting up general tax preferences. The judgment seems to grant too much freedom to Member States in defining the tax differences they consider appropriate, and it is therefore probable that it will be reversed by the ECJ if appealed.

In its turn, the Commission is currently confronted with two particularly hard tax cases dealing with the question of selectivity.

In the Dutch interest box case,[36] the question of the justified character of a tax derogation from the nature of the scheme is raised once again. The Groepsrentebox is a tax scheme notified by the Netherlands, which provides for taxation, at a lower corporate tax rate (approximately 5% instead of the 25.5% standard rate for business income), of the net positive balance of interest received and paid on loans to affiliated companies, plus the interest received on a special investment reserve. This favourable taxation is limited by virtue of a cap calculated as a percentage of the amount of equity financing in the concerned company (currently at 5.3%) to avoid excessive benefits. The scheme provides an advantage (derogation from the company tax) which may hardly be justified by the nature of the tax scheme because interest income derived from affiliated companies is taxed at a lower effective company tax rate even when it constitutes active or business income. The scheme applies to all intra-group interest arrangements of groups operating in the Netherlands irrespective of their sector or industry of operation including however the financial sector, which is disproportionately favoured by the measure. The seems not to be justified as a measure to consolidate the tax liability within a group, because it does not achieve that effect. In opening the formal investigation procedure, the Commission seems to object that the scheme is selective because it favours cross-border payments as opposed to domestic ones. By inference, the advantage would indirectly favour certain providers of in-bound captive interest payments, which in the same state-aid practice of the Commission relative to fiscal schemes[37] has been considered a business activity per se.

In the Spanish tax amortization of goodwill case,[38] the Commission has raised the issue of whether an unjustified tax derogation based on objective conditions shall be considered selective or a general measure. Spain enacted the goodwill amortization scheme in 2002 without prior notification to the Commission. The scheme consists in the possibility for a Spanish company to amortize over twenty years the financial goodwill deriving from the acquisition of a qualifying shareholding in a foreign company. The measure provides an advantage or derogation from normal tax rules on amortization corresponding to the tax saving on the extra price paid by the Spanish acquirer for the purchase of the foreign company shares as opposed to the market value of the purchased company. The tax advantage applies, however, to all qualifying share acquisitions irrespective of the industry or sector of the acquisition. In opening the formal investigation procedure, the Commission has raised the question of whether the measure is selective because it only applies to purchases of qualifying shareholding (5%, foreign target company, the company has to conduct an active business abroad and not in Spain), and it facilitates the creation of holding companies in Spain.

The two cases are still undecided, and the Commission has the possibility to clarify the process to define the notion of fiscal selectivity. In conclusion, one derives that the selectivity of a tax preference is definable in terms of an unjustified breach of tax neutrality within the geographic jurisdiction of reference that subjectively or objectively favours some undertakings over others. In particular, selectivity derives from establishing an unjustified discrimination between comparable legal and factual situations in the light of the inherent objectives of the system. Like in a familiar comparability test, the justification implies that, on the one hand, a discrimination is established with reference situations that are effectively comparable, while on the other hand, a justification stems from the inherent consistency of the specific, objective situations defining the same discrimination with respect to the nature or scheme of the system. Therefore, an exception is only justified if it is inherently consistent with the nature of the scheme; that is, if it constitutes a specification (a subsystem) of the system adapting the general taxation to the specificities of its particular conditions.

36 See the opening of formal investigation procedure relative to Aid No. C-4/07, Groepsrentebox, published in GUCE C 66/2007.

37 See, among other cases, the Commission Decision 2006/940/EC of 19 Jul. 2006 on the aid scheme C 3/2006 implemented by Luxembourg for 1929 holding companies and billionaire holding companies, OJ L 366 (2000).

38 See the opening of formal investigation procedure relative to Aid No. C-45/07, Amortization of Goodwill, published in GUCE C 311/2007.