Tax Related Difficulties of State Aid Rules

Dr Raymond H.C. Luja*

1. Introduction

In this discussion paper I will address some unresolved issues in regard to the application of state aid law in the field of taxation. From the onset it must be pointed out that there are no rules on ‘fiscal’ state aid. EU law does provide for rules on state aid, be it subsidies, tax incentives or otherwise. These general rules must be implemented in a tax setting which brings to bear some particular tax related difficulties. This paper will set out some of those.

I have selected a number of issues for further discussion. These issues are bound to become the subject of court proceedings in near future. In paragraph 2 I will address the question whether limitation of tax benefits to groups as such may lead to selectivity. Then in 3 I will go into the position of investment fund regimes under state aid rules. In 4 I will address some matters that will arise now that the ECJ opened up to recognising regional autonomy in state aid cases. In 5 the issue of asymmetric VAT cases will be put in a state aid perspective. The unenviable position of the tax payer that expects his incentive to qualify as state aid will be addressed in 6. Then in 7 I briefly single out one recent US development that may be of interest to put the EU’s concept of state aid control into perspective. Some concluding remarks and a summary of issues for further discussion follow in paragraph 8.

For background information on state aid in general and fiscal state aid in particular I refer to the European Commission’s 1998 Notice on the application of state aid rules in regard to business taxation.† Although there have been numerous developments in regard to details this Communication still provides a basic overview.

* Professor of Comparative Tax Law, Maastricht University, the Netherlands; Tax Consultant at the EU Tax Law Group of Loyens & Loeff, Amsterdam. The author may be contacted at Raymond.Luja@belastr.unimaas.nl. This paper was updated on April 23, 2007.

2. Are facilities limited to intra-group activities selective as such?

In order for a tax incentive to meet the definition of state aid (Article 87(1) EC) it must fulfil a number of criteria:

1) A financial benefit must be present (i.e. the ‘incentive’).
2) The benefit must be granted by the state or out of state resources; the latter is rather easily settled when tax revenue is at stake. Any benefit must be attributable to the state (i.e. the state should not be under a clear and precise obligation of Community law to grant a tax benefit).
3) The benefit should (threaten to) distort competition and (potentially) affect trade between Member States; this is the ‘raison d'être’ of state aid control.
4) The benefit should only be available to certain undertaking (or the production of certain goods, i.e. certain sectors of industry), hence not generally available.

A tax incentive that meets these four criteria is regarded to be ‘incompatible with the common market’, i.e. prohibited by EU law, unless otherwise provided by the EC Treaty. The latter does allow certain benefits to be granted for a number of purposes like, for instance, promoting the development of less developed regions as provided for in Article 87(3) EC. Thus, the EC Treaty does not contain an unequivocal prohibition of state aid; it is for this reason that a state aid supervision procedure is in place that allows the Commission to determine whether the criteria for ‘compatibility’ with the common market are met.

In regard to tax incentives it is the fourth criteria – the presence of ‘selectivity’ – that gives most cause for concern. In this paragraph I would like to focus on a (potential) new form of selectivity that the Commission is trying to put in place.

Upon opening two recent formal investigations the European Commission has argued that providing tax benefits to enterprises that need to be part of a group of companies may give rise to selectivity. The question whether an intra-group benefit as such results in selectivity has never been answered by the ECJ, although the ECJ did rule on a large number of cases where intra-group incentives were at issue. In cases with intra-group tax benefits, selectivity was considered present based on something other than the group limitation. In most cases
there was sector related selectivity (for instance, benefits for the financial sector), regional selectivity (in case of applicability of the benefits in a certain region of a Member State) or size-related selectivity (like limitations to either multinationals or SMEs).

An important indicator of the Commission’s view on group taxation is its February 2006 decision to open a formal investigation into the Luxembourg 1929 holding regime where the Commission considered:

“ce régime semble être de facto reserve aux seules activités intragroupe, ce qui confirme le caractère sél[e]ctif du régime.”

It then pointed out that additional requirements in respect to the kind of financial activities performed and the need for considerable financial resources to qualify also gave rise to selectivity in this case. In the final decision the intra-group factor was no longer addressed as a factor that gave rise to selectivity by itself.

Thereafter, in a February 2007 press release concerning a Dutch tax incentive for intra-group interest payments, the Commission argued again:

“Although [the incentive] appears to be open to all companies, the measure would de facto benefit only groups of companies and not individual companies.”

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2 OJ C 78/2 of 31 March 2006, Para. 73. This preliminary line of thought was then also reflected in respect of the element of affecting competition and trade where the Commission considered that exempting intra-group services would be detrimental to third party service providers who would be taxed on the benefits received upon providing similar services to such group. This consideration was not included in the final decision. (Ibid., Para. 77: “La concurrence semble être faussée parce que les activités de services précitées jouissent d'une exonération complète de divers impôts sur le revenu lorsqu'elles sont exercées par des holdings 1929 exonérées, alors qu'elles sont imposables lorsqu'elles sont exercées par des prestataires indépendants aux activités économiques comparables, comme le financement, l'affacturage, la gestion de biens immatériels et la fourniture de services intragroupe, hors d'une structure de groupe à laquelle appartiennent les holdings exonérées.”)

3 Press Release IP/07/154 of 7 February 2007. The Dutch regime would allow groups to deduct and include intra-group interest paid/received effectively at 5% within certain limits.
After defining this first reason for selectivity, the Commission added that the Dutch regime seemed to be tax neutral for Dutch-only groups and would therefore be likely to attract only multinational groups.\textsuperscript{4} Notwithstanding the latter, it will be interesting to see whether the Commission will maintain the first part of its reasoning – the selectivity of group tax incentives as such – in the final decision in this case. If so, this line of reasoning could bring other group tax incentives into the scope of state aid review. In March 2007 the Commission used a similar line of reasoning upon opening an investigation into a comparable Hungarian intra-group interest incentive.\textsuperscript{5}

Intra-group benefits are widespread within the EU, like group consolidation and group relief schemes. If profits on intra-group transactions are not taken into account for tax purposes, one might wonder whether the temporary cash-flow benefit – up to the realisation of profits in a third-party transaction and the subsequent taxation thereof – may suddenly be suspect from a state aid point of view if we follow the Commission’s line of thought. The same may be true if, in the absence of a group consolidation regime, special tax benefits apply to intra-group transactions like royalty and/or interest payments or the intra-group carry-over of losses (an issue that the ECJ was called upon to address in a number of non-state aid cases).

In its 1998 Communication the Commission reasoned that:

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  \item Ibid. The Commission reasons that in domestic situations taxing and deducting interest at 5% would not be near being as attractive as international situations were interest could be deducted by one group company abroad at a higher rate in most cases and be taxable at only 5% by another company in the Netherlands. This state aid approach towards disparities in tax rates is also a rather new development and I tend to disagree with it. Yet, I am not going to argue the Dutch case here and leave the Commission’s statement on the multinational focus of the proposed regime as it is, since I just use this case to point out the intra-group factor as such. A Dutch version of the full decision to open the formal investigation has been published in OJ C 66 of 22 March 2007, pp. 30-34.
  \item Press Release IP/07/375 of 21 March 2007. The Hungarian regime would allow the recipient to include only half of the intra-group interest in the taxable base and the debtor to deduct only half of it. In the Hungarian case the Commission also pointed out that small companies (as well as financial companies) were excluded upfront from the application of the regime, which could indeed give rise to state aid issues. Also, the Commission seemed concerned about the possibility to opt-out of the Hungarian regime on a yearly basis. Given that this opt-out is available to every taxpayer, one might wonder what the Commission’s intentions were to include this in its press release to argue that selectivity is present.
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“Some tax benefits are on occasion restricted to certain types of undertakings, to some of their functions (intra-group services, intermediation or coordination) […]. In so far as they favour certain undertakings […], they may constitute aid”.  

Then in its 2004 implementation report:

“In accordance with this principle the Commission has found measures reserved for certain types of intra-group transaction to be selective.”

I argue that there is no such principle that would warrant this interpretation of the selectivity requirement; benefits available to, for instance, intra-group financial services are not selective per se if all groups have equal access to these benefits without any restriction on the size of these groups, their location, their line of activities, their economic strength, their geographical spreading, etcetera. The original 1998 notice does seem to reflect this correctly; only in so far as tax benefits to intra-group services favour certain undertakings there may be a state aid argument. To my knowledge, the negative decisions rendered by the Commission after 1998 on group incentives all covered incentives with additional restrictions.

We therefore need definite clarification by the ECJ on whether limiting benefits to enterprises that are part of a group may give rise to selectivity as such, as suggested by the Commission. From my perspective, an intra-group limitation should not, but as one of several limitations it just may tip the scale in court.

3. **Do fund regimes lead to sector specific tax benefits?**

The Commission’s approach to fund regimes is rather equivocal. Article 87(1) of the EC Treaty clearly states that:

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“Save as otherwise provided in this Treaty, 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.”

It follows from VAT jurisprudence, especially the BBL and EDM cases, that the collective investment of capital raised from the public by means of the assembling and management of portfolios consisting of transferable securities on a fee-basis on behalf of the subscribers may constitute an economic activity. The same is true for receiving interest resulting from the placements of monies received from clients in the course of managing their properties, taking account of the fact that such interest does not arise from the simple ownership of the asset. I.e. an investment fund may provide services as a managing agent with the commercial purpose of maximising return on investment for its clients. Many (incorporated) funds will carry out economic activities like these. Funds that carry out economic activities as defined in these and other VAT cases may be considered to be ‘undertakings’ as stated in Article 87(1) EC.

The expertise brought together in investment funds and the services rendered by these funds (among other the option to share risk by spreading one’s money over a number of selected companies instead of investing in one single company oneself) are of value to private investors. Investment funds may be considered part of an important commercial sector of industry, or better, be considered to be a sector of industry by themselves. In this respect we need to keep in mind that providing tax benefits to a certain line of business or trade could give rise to selectivity.

In a 2005 decision on an Italian special fund regime the European Commission did affirm the above by considering that:

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9 Emphasis added.
10 See ECJ C-8/03, Banque Bruxelles Lambert SA v Belgian State (BBL), ECR 2004, I-10157.
12 Also see the Commission’s Italian Funds Decision of 6 September 2005, OJ L 268/1 of 27 September 2006: “The Commission considers that specialised investment vehicles perform an economic activity and constitute undertakings within the meaning of Article 87(1). This is confirmed by the case law of the Court in the VAT field.”
“in some cases, investment vehicles are undertakings within the meaning of Article 87 of the Treaty and may accordingly benefit from the tax reduction [...]. In particular, [the Commission] considers that, even if specialised investment vehicles do not benefit directly from the tax reduction granted to their investors, they nonetheless receive an indirect economic benefit in so far as the tax reduction on investments in specialised vehicles prompts investors to buy shares in such vehicles, thereby providing additional liquidity and extra income in terms of entry and management fees. [...] The Commission accordingly considers that a tax advantage provided to investors investing in specialized investment vehicles favours the vehicles themselves as undertakings when they have corporate form or the undertakings managing such vehicles when they have contractual form. In particular, the increased demand for shares of specialized investment vehicles leads to an increase in the management and entry fees charged by the vehicles or by the undertakings managing them.”13

This is the most elaborate reasoning the Commission provided on its position on funds. In the past it already gave similar indications in other state aid investigation. Also in the 2006 risk capital guidelines it stated that:

“In general, the Commission considers that an investment fund or an investment vehicle is an intermediary vehicle for the transfer of aid to investors and/or enterprises in which investment is made, rather than being a beneficiary of aid itself. However, measures such as fiscal measures or other measures involving direct transfers in favour of an investment vehicle or an existing fund with numerous and diverse investors with the character of an independent enterprise may constitute aid unless the investment is made on terms which would be acceptable to a normal economic operator in a market economy and therefore provide no advantage to the [vehicle or fund]”.14

It is true that undertakings may receive state aid indirectly, for instance by favouring their potential investors. If the state provides tax benefits to private investors who invest in a certain domestic sector of industry, then this may be beneficial to the undertakings invested

13 Ibid., Para. 39.
in, if those investors are willing to invest in that undertaking at more favourable conditions as a result of the tax benefits they receive.\textsuperscript{15}

In the Italian case just cited, the Commission was concerned about a more favourable tax regime for certain funds that was introduced beside an already existing (general) fund regime in Italy. The general regime basically provided for a 12.5\% tax on operating revenue that substituted the regular corporation tax. The special regime would lower this percentage to 5\% for funds that invested most of their assets in small and medium sized enterprises (SMEs). In this case the Commission took the general fund regime as the basis for its comparison to determine that certain specialised funds were treated more favourably than other funds. From my perspective this is not the right comparison. The benchmark should be the normal (corporation) tax treatment of companies regardless of their sector of industry.

To put the Commission’s words in another perspective, if dividends out of a normal, listed company are taxed while dividends out of investment funds are not taxed or to a lesser degree, such fund may receive “an indirect economic benefit in so far as the tax reduction on investments in [these funds] prompts investors to buy shares in such vehicles, thereby providing additional liquidity”.\textsuperscript{16} Similarly, if a regime is put in place to tax the net capital gain out of investment funds more favourably than similar gains from stocks in other listed companies, potential investors may decide to put their money into such fund because of the tax benefit while they ordinarily would have chosen to invest in competing investment funds abroad or to buy stocks or bonds of a number of companies directly.

In my opinion, most commercial investment funds may qualify as undertakings therefore a \textit{prima facie} case for state aid can be made in most cases of favourable tax treatment of such funds, since the other elements (benefit, selectivity, threat of distortion of competition and

\textsuperscript{15} See, for instance, the French ‘Fonds Industriel de Modernisation’ case, where individuals were entitled to a tax exemption for interest out of a special savings fund that used such savings to finance loans to certain French undertakings (ECJ 102/87 of 13 July 1988, \textit{France v Commission}, ECR 1988, I-4082) and a German scheme providing for a favourable tax treatment of capital gain out of the selling of shares if such gain would be reinvested in shares of certain firms in former Eastern Germany or former West-Berlin (ECJ C-156/98 of 19 September 2000, \textit{Germany v Commission}, ECR 2000, I-6857).

trade) are rather easily fulfilled. The political objective for such tax treatment is not relevant in this respect, because Article 87(1) EC provides for an objective definition of state aid. Depending on its purpose a special tax regime may be declared compatible with the Common Market in line with Articles 87 (2) or (3) EC, although I see no such basis for most general investment fund regimes. Specialised fund structures aimed at stimulating investment and employment in less developed regions of the EU, at stimulating the environment, culture etc., may still qualify for approval under Article 87(3) EC, provided that they are proven effective for such purpose with the least extent of distortion of competition and trade possible. This is for the Commission to determine.

If we strictly apply the definition of state aid as provided in Article 87 (1) EC, many tax regimes for investment funds could match this definition. Yet, despite of the billions of Euros involved in this particular sector of industry an EU-wide review of the compatibility of investment fund regimes with primary EU law is not very likely, though warranted. There will be little political support for such action, since most Member States maintain special tax provisions for investment funds in one way or another.

4. Where does regional autonomy end (or start)?

In a 2006 Portuguese case the ECJ created an opening to invoke regional autonomy to contradict a claim of ‘regional selectivity’. If, for instance, a national corporation tax would

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17 Member States might try to argue that reducing the tax burden on funds is necessary because of the particular characteristics of their tax system. They could, for instance, point out the need for transparency in order to prevent taxing investment profits twice, at the level of the fund (being to a certain extent an intermediary as well as a service provider) and at the level of the individual investor. The question then to be answered is whether reducing the tax burden on funds to reduce double taxation is an acceptable justification resulting from the ‘nature or general scheme of the tax system’, i.e. the ‘logic of the tax system’ in which case no (selective) benefit will be deemed present. In my opinion, this will be rather unsuccessful. See, among other, ECJ 173/73 of 2 July 1974, Italy v Commission, ECR 1974, 709, Para. 15; ECJ C-53/00 of 22 November 2001, Ferring v Acoss, ECR 2001, I 9067, Para. 17; ECJ C-143/99 of 8 November 2001, Adria-Wien Pipeline, ECR 2001, I-8365, Para. 42.

18 Some of these provisions are merely meant to address particular characteristics of fund structures in order to prevent anti-abuse provisions from taking effect unintended and do not give cause for concern. ECJ C-88/03 of 6 September 2006, Portuguese Republic v. Commission of the European Communities, not yet published. For views to the contrary see, among other, A-G Saggio’s opinion of 1 July 1999 in
provide for particular tax benefits that are limited to companies established in a certain part of the territory of a Member State, such limitation would normally lead to regional selectivity. But what if an autonomous regional authority would be empowered to set a corporation tax rate for the region that is lower than the rate normally applicable in the Member State? The basic question that has to be answered is to what extent autonomous regional or local authorities are at liberty to set their own tax policy. The ECJ considered:

“It is possible that an infra-State body enjoys a legal and factual status which makes it sufficiently autonomous in relation to the central government of a Member State, with the result that, by the measures it adopts, it is that body and not the central government which plays a fundamental role in the definition of the political and economic environment in which undertakings operate. In such a case it is the area in which the infra-State body responsible for the measure exercises its powers, and not the country as a whole, that constitutes the relevant context for the assessment of whether a measure adopted by such a body favours certain undertakings in comparison with others in a comparable legal and factual situation, having regard to the objective pursued by the measure or the legal system concerned.”

The main issue to be settled is whether local governments have a sufficient level of autonomy in order to invoke regional autonomy. The ECJ provided for three conditions that have to be fulfilled. First, the sub-national authority concerned must have a separate political and administrative status, i.e. it should be competent to deal with its own (fiscal) affairs and be politically and financially held accountable. Second, a decision with regard to reducing the tax rate for the region concerned, as in the case in question, must have been adopted without the

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joint cases C-400/97 to C-402/97, Para. 37: “Der Umstand, dass die in Rede stehenden Massnahmen von Gebietskörperschaften mit ausschliesslicher Zuständigkeit im Sinne des nationalen Rechts erlassen worden sind, dürfte vielmehr, wie die Kommission ausführt, einen rein formalen Gesichtspunkt darstellen, der nicht dafür ausreicht, die Vorzugsbehandlung der Unternehmen zu rechtfertigen, die vom Geltungsbereich der örtlichen Reglungen erfasst werden. Anderfalls könnte der Staat leicht die Anwendung des Gemeinschaftsrecht über staatliche Beihilfen in einem Teil seines Hoheitsgebiets dadurch verhindern, dass er Änderungen an der internen Zuständigkeitsverteilung auf bestimmten Gebieten vornimmt und sich auf diese Weise auf die allgemeine Natur der betreffenden Massnahme für ein bestimmtes Gebiet beruft.” (case withdrawn after opinion was rendered)

ECJ C-88/03, ibid., Para. 58. This case only concerned local tax rates, but a similar line of reasoning may be used in respect of autonomous tax policy, which includes setting the tax base.
central government being able to directly intervene. Third, the financial consequences of the decision must not be offset by financial aid from other regions or the central government.\textsuperscript{21}

The main issue is what ‘offset’ means? There should probably be a direct link between the introduction of a tax incentive and any compensation received. Autonomous regional governments may still receive general contributions from the Member State; they should not lose their autonomy simply because part of their budget is financed by a transfer of sums out of the national budget. In my mind, there is still room for budgetary transfers as long as there is no direct link between an increase in the transfer from the national budget and regionally initiated tax expenditure or spending increases.

If, for instance, the national government transfers € 50 million per year to an autonomous authority, such a transfer by itself would probably not be detrimental to actual autonomy. But what if an autonomous government decides to lower the corporation tax rate – a € 10 million expenditure as of 2007 – and the national government decides to increase the sum transferred to € 55 million in 2010, would this be an ‘offset’ despite the delay and the absence of an immediate causal relationship? Or would there only be an ‘offset’ in case the national government is constitutionally obliged to give compensation out of solidarity, like in the Portuguese case? And what if an autonomous government would be obliged to transfer 10% of revenue out of local income and corporation taxes to the national government to cover defence and foreign policy expenditure? Would a decrease in local tax revenue and the subsequent reduction of the sum transferred also be an ‘offset’ (in the absence of safeguards to prevent such effect)? These issues still remain to be decided.

In the aforementioned Portuguese case, the position of the Azores was at issue. In the pending Gibraltar case (T-211/04) the relationship between Gibraltar and the UK is at issue, and in seven nearly identical cases (C-428/06 through C-434/06) it is the position of several autonomous communities in Spain. In these Spanish cases, the question has been referred whether certain local autonomous communities may set a lower rate of tax and introduce special tax deductions next to a tax-base otherwise similar to the normal Spanish tax base.

\textsuperscript{21}ECJ C-88/03, ibid., Para. 67. Also see the Opinion of A-G Geelhoed in this case of 20 October 2005, Paras. 53-54.
Without focussing on Spain in particular, provided that regional authorities meet the criteria of autonomy it should not matter whether they are at liberty to use the normal national tax system as a starting point to copy-paste the tax base. It could matter, however, if the national government obliges them to use its tax base and only allows for certain alterations since this could indicate that a sufficient degree of autonomy is lacking. I.e. if the national government may not intervene in respect to the tax rate and deductions, while being allowed to determine what parts of income are to be included or excluded from the tax base per se, does this leave sufficient ‘autonomy’ to the region involved? And what if tax rates must be set within limits defined by the national government? These and other issues must still to be clarified by the Community’s courts.

5. **Art. 87 EC as primary law: how does/should it influence asymmetric VAT cases?**

VAT liability may be a benefit as well as a burden to enterprises. The role state aid may play in cases of failure to timely implement VAT Directives may be a particular one.

What if national law decrees that an activity is exempt from VAT while the EU’s VAT Directive clearly provides that it shouldn’t be? In such a case the deduction of input VAT will normally be refused by the national authorities in accordance with national law, since there is no VAT due on output either. May an enterprise that carries out such activities now rely on the Directive in order to be entitled to a deduction of input VAT? Taking account of the ECJ’s jurisprudence one is inclined to give an affirmative answer, although Advocate-General Kokott rightly points out a particular problem in the *VDP* case:

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22 Also see the Opinion of A-G Geelhoed in case C-88/03 of 20 October 2005, Para. 59: “a merely formal empowerment of regional authorities to act in the taxation sphere subject to conditions defined by central government, without […] true autonomous decision-making […], would not be enough to remove a measure from the scope of Article 87(1) EC.”


24 Opinion in case C-401/05 delivered on 6 September 2006, para. 95-97, emphasis and footnotes omitted.
“If it is not possible to interpret national law in conformity with […] the Sixth Directive, an individual may rely directly on the directive to acquire a right to deduct input tax. […] However, ‘asymmetrical reliance’ on the directive is not in principle possible, that is to say a taxable person may not assert the right to deduct input tax without paying tax on the output transactions. […] A central principle of the VAT systems is that right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct. […] However, where a taxable person supplies services to another taxable person who uses them for an exempt transaction, the other taxable person is not entitled to deduct the input VAT paid, except in the cases expressly provided for in the relevant directives. […] In the case of supplies within the territory of the country which are exempt from tax as a result of the improper implementation of the directive, it would be contrary to this principle if input tax were nevertheless deductible in respect of these supplies. Consequently, to assert the right to deduct input tax on the basis of the directive, a taxable person must at the same time request to be treated as a taxable person. […] In this regard, national procedural law must ensure that an individual is able to assert his rights flowing from the directive. On the other hand, it would not be a solution for a taxable person to derive from the interpretation of the directive an advantage which is contrary to the principles of the directive itself.”

The ECJ did not address this particular issue. I agree with the Advocate-General that if the undertaking involved wants to be treated in conformity with the VAT Directive, it cannot be allowed to claim a deduction in input VAT alone and rely on national law to refrain from paying output VAT. But what to do about the fact that national law does not provide a legal basis for taxing the output (due to the failure to transpose the Directive correctly)? In some Member States this may give rise to constitutional issues.

In domestic situations non-compliance with the VAT Directive may lead to a number of potential state aid cases.25

25 Apart from the potential cases below, the author would like to refer to the Austrian Heiser case in which the ECJ ruled that upon the transition of a subject-to-tax to a tax-exempt status of activities, the national non-application of the Directive provisions on adjustment of initially deducted VAT for a certain sector of industry constituted state aid: “[Article 87 EC] must be interpreted as meaning that a rule […] providing that the changeover for medical practitioners from taxable to exempt status for the purposes of VAT does not, in relation to goods that continue to be used in the business, entail the reduction of
(1) An activity is deemed subject to VAT under national law, while being exempt under the Directive. A benefit may arise if the deductible input VAT exceeds the output VAT due.

(2) An activity is deemed exempt from VAT under national law, while being subject to VAT under the Directive. A benefit may arise if the taxable person is enabled to deduct the input VAT without being liable to output VAT.

(3) An activity is deemed exempt from VAT under national law, while being subject to VAT under the Directive. A benefit may arise if the non-collected output VAT would have exceeded the non-deductible input VAT.26

Situation (2) may be the outcome of an asymmetrical domestic situation where a national legal basis for tax liability (output VAT) is missing while the deduction of input VAT is claimed in line with the Directive. In this situation it is the national law that gives rise to this benefit. Since the definition of state aid in Article 87(1) EC is an objective one, it is not necessary to proof that the national legislator had the intention of creating this kind of benefit. A benefit is created out of state resources, applicable only to enterprises carrying out certain ‘exempt’ activities. Given the fact that the exemption is not warranted by EU secondary legislation, the resulting benefit is still attributable to the state.27

The question thus to be answered by the ECJ is whether an enterprise may rely on a Directive to benefit from the input VAT deduction whilst the levying of tax on the output VAT is impossible under national law, if such a claim would result in an Article 87(1) EC benefit? In

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26 Although the output VAT is collected from third parties and set of against VAT payments to third parties, this seller would be able to sell his products or services at a lower price than his competitors because of this benefit.

27 Should the VAT Directive allow for an asymmetrical deduction of input VAT, then this would probably take away the state aid character of this benefit now that this asymmetry would not be attributable to the state, which would merely comply with a clear and precise obligation under community law. Thus, mutatis mutandis, the Court of First Instance (CFI) in T-351/02 of 5 April 2006, Deutsche Bahn AG v Commission, Para. 102, ECR 2006, II-1047.
my opinion, the national courts should follow Advocate-General Kokott’s suggestion to prevent this issue from arising.28

6. **How to protect beneficiaries of aid against themselves and their governments?**

EC state aid procedure is not flawless, especially when it concerns the protection of beneficiaries. The ECJ has stated that a diligent businessman should normally be able to determine whether proper state aid procedure has been followed.29 But what to do with the (well advised) businessman who sincerely doubts the state aid compatibility of a tax incentive he is about to claim?

Only the Member State’s government is competent to notify a tax incentive to the European Commission. There is no system in place that allows beneficiaries to get the Commission to affirm whether a tax incentive constitutes state aid or not. The (potential) beneficiary may try its luck at the national government involved, hoping that the government will officially notify the incentive to the Commission. In case of an existing tax incentive the latter is rather unlikely. As a result of notification the stand-still provision of Article 88(3) EC takes effect, which forbids Member States to introduce the notified incentive until a final decision has been taken by the Commission. This would also affect other tax payers that have claimed or are

28 Notwithstanding other potential problems like the fact that output VAT will not have been collected because of the national exemption. Companies are unlikely to proceed in national court if they expect to pay VAT on balance. Given that no output VAT will have been collected in case of a misplaced exemption, the national courts could consider to limit the input VAT deduction to the VAT receivable on balance (input VAT minus non-collected output VAT) in order to uphold the objectives and principles of the VAT Directive.

29 ECJ C-5/89 of 20 September 1990 *Commission v Germany*, ECR 1990-3437, Para. 14. Also see C-24/95 of 20 March 1997, *Land Rheinland-Pfalz v Alcan Deutschland*, ECR 1997, I-1591, Paras. 25 and 43: “[U]ndertakings to which aid has been granted may not, in principle, entertain a legitimate expectation that the aid is lawful unless it has been granted in compliance with the procedure laid down in that article. A diligent businessman should normally be able to determine whether that procedure has been followed [… ] Community law requires the competent authority to revoke a decision granting unlawful aid, in accordance with a final decision of the Commission declaring the aid incompatible with the common market and ordering recovery, even if the competent authority is responsible for the illegality of the aid decision to such a degree that revocation appears to be a breach of good faith towards the recipient, where the latter could not have had a legitimate expectation that the aid was lawful because the procedure laid down in [Article 88(3) EC] had not been followed.”
about to claim the same incentive, hence the government’s potential lack of enthusiasm for notification. Another option is to file a formal complaint in Brussels, but as a potential beneficiary this is rather unlikely and maybe even inadmissible.

If our beneficiary cannot convince the government to notify, he may be tempted to go along and claim his tax incentive anyway, especially when his competitors are unaware of potential state aid issues (or have decided to accept the risk of paying back the incentive plus interest) and thus receive similar tax benefits that may put him out of business. For a businessman driven into a corner this is, to some extent, an understandable course of action especially when he really is in doubt and not sure whether the incentive actually constitutes state aid.

In this respect I would like to emphasise the importance of the often neglected option available to governments to notify tax incentives that they consider not to be state aid, just for reasons of legal certainty. The downside to this process of exchanging information is that pending the notification and the subsequent investigation a stand-still will be in effect that prevents the Member States from implementing its proposed (and allegedly non-aid) incentive. Those national governments that are aware of this option seem rather reluctant to use it because of this delay. Moreover, a notification of a ‘non-aid’ measure is likely to attract the special attention of the Commission as well as political attention, both domestically and abroad.

In my opinion a system should be in place that would allow a potential beneficiary access to the Commission to get a decision, such as opening up the ‘complaint’ procedure of Article 20(2) of the Procedural Regulation to beneficiaries asking for a ‘no aid’ decision. The main drawback to this it is the potential massive amount of requests. Yet, we should keep in mind

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31 Art. 20(2) of Council Regulation (EC) 659/1999 of 22 March 1999 laying down detailed rules for the application of Article 93 [now 88] of the EC Treaty, OJ L 83/1 of 27 March 1999: “Any interested party may inform the Commission of any alleged unlawful aid and any alleged misuse of aid. Where the Commission considers that on the basis of the information in its possession there are insufficient grounds for taking a view on the case, it shall inform the interested party thereof. Where the Commission takes a decision on a case concerning the subject matter of the information supplied, it shall send a copy of that decision to the interested party.”
that the legal position of the national legislator on state aid compatibility of a tax incentive cannot normally give rise to legitimate expectations without the backing of the Commission.

An alternative would be to allow the beneficiary to ask the national court to order the notification of a measure if there is any doubt about the state aid character of a tax incentive.\textsuperscript{32} It would then be up to the national court to decide on the suspension of the tax incentive for all parties involved. The national court should normally order the suspension of the measure if it decides to order the government to notify. A stand-still would normally be in place once a measure is notified to the Commission (Article 88(3) EC), yet in case of a notification of a ‘non-aid’ measure – allegedly out of the scope of Article 87(1) EC – one might argue that this does not apply. It is still up to the ECJ to clarify whether this vicious circle causes a loophole in the application of the stand-still provision.\textsuperscript{33}

7. **Should we benchmark the EU’s state aid regime?**

In legal discussions on the EU’s state aid system the need for such a system is often taken for granted, as is the process of ex ante control by the Commission. A state aid system is deemed necessary to protect the proper functioning of the internal market and intra-community competition and trade, yet the European Union seems to be the only group of countries that has such an elaborate and clearly defined system in place. The United States, for instance, seem to get along without such a stringent regime quite well. The main uncertain factor here seems to be the extent of the US Constitution’s Commerce Clause restrictions in matters of tax incentives.\textsuperscript{34}

\textsuperscript{32} For competitors of state aid recipients this has already been promoted by the Commission in 1995(!); see its Notice on cooperation between national courts and the Commission in the state aid field, OJ C 312/8 of 23 November 2005, in particular Para. 10.

\textsuperscript{33} It must be pointed out that the Commission is empowered to issue a suspension injunction in accordance with Article 11(1) of the Procedural regulation (659/1999).

In the United States the Dormant Commerce Clause doctrine comes closest to resembling a limitation on tax incentives affecting trade and competition between states. The scope of the dormant commerce clause seems rather limited from a European perspective. The Commerce Clause authorises Congress to regulate commerce among the several states, which, according to the Supreme Court, implies that the states are limited in their right to tax interstate commerce. One of the criteria that states need to take into account in this respect is that a state tax should not discriminate against interstate commerce.\(^{35}\)

In 2006 the controversial ‘Cuno’ case addressed, among other, the issue of investment tax incentives that kept in-state companies from (potentially) leaving to another state. According to the US Court of Appeals for the Sixth Circuit, such incentive could restrict interstate commerce, now that the in-state companies would be inclined not to cross the state border with its new investments (like in production plants). Yet, it would still be allowed to attract out-of-state companies with the same investment tax incentive, because those companies would be crossing state borders by doing so.\(^{36}\) Although this case made it all up to the US Supreme Court in order to test this opinion, it was vacated in respect to the former.\(^{37}\) The Circuit Court erred by considering the merits of the case, because the plaintiffs – a group of taxpayers acting against a major tax credit that the State of Ohio granted DaimlerChrysler – did not establish their standing in federal court. It thus remains doubtful whether state or federal courts will follow the Sixth Circuit Court on the merits.

The US Supreme Court basically rules out putting subsidies under the Dormant Commerce Clause doctrine as long as those subsidies are funded out of general state revenue.\(^{38}\) In

\(^{35}\) This is only one of several requirements first put forward by the US Supreme Court in *Complete Auto Transit, Inc. v. Brady*, 430 US 274 279 (1977). For the purpose of this discussion paper I will not go into the other requirements and the impact of subsequent Supreme Court rulings.


contrast, the EC state aid regime covers both subsidies as well as tax incentives, because both may have similar effects on trade and competition (although back in the 1960’s and 70’s it has been argued that tax incentives were not intended to be covered by state aid control until the ECJ set the record straight).

The ‘Cuno’ developments have triggered a number of American colleagues to investigate parallels between the (relative lack of) US restrictions on state tax incentives that may affect interstate trade and the EU’s state aid regime. On the other hand, because of the relatively proper functioning of the state aid regime in Europe, the US developments still seem to arouse only limited interest with European academics. The proposed Economic Development Act of 2005 – intended in part to undo any restrictions on state tax incentives to compete for business resulting from the Cuno judgment – will be a nice treat for European academics should it ever be put into law. It will allow the US states to keep competing among themselves through the use of economic development incentives like tax breaks, within certain constitutional limits; whether there is a need for such incentives may still be determined by the states themselves.

### 8. Concluding remarks

In this discussion paper I have briefly raised a number of issues for further discussion that have yet to be clarified in future state aid decisions and judgements.

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269, 278 (1988): “Direct subsidization of domestic industry does not ordinarily run afoul of [the Commerce Clause] prohibition”. This difference between taxes and subsidies is discussed in depth by E.A. Zelinsky (see footnote 34).


The first conceptual issue is whether tax incentives providing benefits to groups are to be regarded selective as such, because individual, single enterprises are not in a position to claim such benefits. The second point at issue is the impact of the VAT definition of economic activity in the field of state aid; strict adherence to VAT jurisprudence will probably put most investment fund regimes within the scope of state aid procedure because such funds often qualify as undertakings. As for the third issue, regional autonomy versus regional selectivity, the recent Portugal case has given a welcome opening for claims of autonomy despite the (necessarily) strict conditions to establish such autonomy. The financial interdependence between autonomous regions and the national government will be of major importance in this respect and will give cause to a new series of ECJ judgements to clarify these financial conditions. Fourth, as for VAT it is yet unclear whether state aid may play its part in cases of asymmetrical implementation of VAT legislation where deduction of input tax is possible while no output tax is due because of flaws in national legislation implementing the Community’s VAT Directive. As for the fifth issue – the lack of legal protection of the diligent businessman who does doubt his tax incentive and who wants to play by the book – it is up to the European Commission and the Community’s Courts to take appropriate action. In this respect a potential loophole in the stand-still provision of Article 88(3) EC was pointed out that may arise when Member States decide to notify aid as being a ‘non aid’ measure not meeting the criteria of Article 87(1) EC.

Comparative research into state aid law should not be limited to reviewing its implementation in EU Member States and the impact state aid law has on Member States’ tax policy. It is necessary to reflect on the concept of state aid control by looking at other unions/federations of states that also (try to) maintain a common market. The EU’s rather well defined concept of state aid and its procedure of (pro-)active supranational supervision by the Commission are rather unique. In the next years the US developments in respect of the Dormant Commerce Clause doctrine and its application on tax incentives affecting interstate competition will probably provide an occasion for joint pan-European/US research despite of the differences in the political frameworks and the division of taxing powers in the US and the EU.