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FEATURED PERSPECTIVES

EU State Aid Rules and the Azores Cases

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On September 10, 2009, the Court of First Instance of the European Communities (CFI) delivered a judgment in case T-75/03, *Banco Comercial dos Açores v. Commission* (*BCA*). This judgment concerned an annulment action brought by the Azorean-based credit institution Banco Comercial dos Açores against the European Commission's Decision 2003/442/EC of December 11, 2002. This decision concerned adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores, specifically the reductions in the rates of income and corporation tax.[1] The referred scheme was established by Decree No. 2/99/A of January 20, 1999, of the regional legislative assembly of the Azores. The contested decision had already been the object of an annulment action lodged with the European Court of Justice by Portugal (case C-88/03, *Portuguese Republic v. Commission*, hereafter "the 2006 judgment") on the basis of partially similar grounds for annulment, which was dismissed on September 6, 2006.[2]

Both appeals raise the important question on the scope of article 87(1) of the EC Treaty: In what circumstances do variations in the national tax rate adopted solely for a designated geographical area of a member state fall under the definition of state aid? The question acquires particular importance in the context of the current movements toward devolution of powers to some member state regions, including devolution of taxation powers, and again raises the issue of the boundary between the state aid rules and the member states' exclusive competence in direct taxation. The 2006 judgment has been groundbreaking on this matter and was followed in 2008 by important jurisprudence of the European courts that developed it. In *BCA*, the CFI highlighted its interpretation of the scope of "direct and individual concern" for the purposes of determining standing under article 230(4) EC Treaty and of the principles of legal certainty and legitimate expectations in cases when reimbursement of aid was considered unlawful. In reality, BCA benefited from the regional regime and paid corporate income tax under a reduced rate (thus being considered a recipient of individual aid) within the context of the alleged aid scheme. Portugal has requested that BCA reimburse the difference between the ordinary tax rate and the rate applicable to companies operating in the Azores — a difference that varied between 10.2 percent and 7.5 percent depending on the fiscal year[3] — together with compensatory interests.

Facts

The Portuguese Constitution of April 1976, as amended, provides that the archipelagos of the Azores and Madeira constitute autonomous regions with political and administrative status and their own government bodies. In this context, the autonomous regions receive their own tax revenue as well as part of Portugal's state tax revenue, as established by a principle of

[1]OJ 2003 L 150, p. 52.

[2][2006] ECR I-7115.

[3]In 1999 the Portuguese ordinary corporate income tax (CIT) rate was 34 percent and 23.8 percent under the Azores regime; since 2004 the ordinary CIT rate has been 25 percent, while in the Azores the rate has been 17.5 percent.

national solidarity. Within the limits set by the Portuguese Constitution and Law 13/98 of February 24, 1998, the regional legislative assembly of the Azores adopted Decree 2/99/A, which approved for the Azores ''the exercise of tax competences at regional level and the exercise of the power of adaptation of state taxes.'' This decree provides for reduced rates of income and corporation tax applicable to all economic agents, whether natural or legal persons. The reductions in question were set at:

- 15 percent for 1999 and 20 percent from January 1, 2000, for income tax; and
- 30 percent for corporation tax.

Its applicability to the economic agents of the Azores region is automatic. The scheme was notified late by the Portuguese authorities (January 5, 2000) and entered into force without the authorization of the commission, thereby being considered non-notified aid. The commission qualified the referred infrastate measure as aid after concluding that it fulfilled the cumulative criteria under article 87(1) of the EC Treaty. The selectivity criterion was assessed in the light of the ''normal'' tax system applied in the Portuguese territory (hereafter ''reference framework''), and thus considered fulfilled,[4] given that the reductions in the tax rates constitute an advantage for firms situated in the Azores that other undertakings wishing to carry out similar economic operations in other areas of Portugal cannot enjoy. After examining the scheme in question in the light of the guidelines on regional aid, state aid in the field of direct taxation, and having considered the specificities of outermost regions, the commission concluded that the scheme met the conditions for being considered compatible with the common market, under the derogations of article 87(3)(a) of the EC Treaty and article 61(3)(a) of the EEA Agreement. Nevertheless, aid awarded to firms that carry on financial activities or activities of the ''intragroup services'' type (coordination, financial, or distribution centers) was considered by the commission as unlawful and that no principle of Community law exists that is opposed to recovery by the Portuguese authorities concerning the years 1999-2001. Soon after this decision had been adopted by the commission, the Portuguese tax authorities notified the financial institutions to reimburse the amounts ''unduly saved'' together with compensatory interest. As noted above, both Portugal and BCA lodged appeals with the European courts.

[4]In its notice on state aid in the field of direct taxation (OJ C 384, Dec. 10, 1998, pp. 3-9) and in its decisional practice, the commission considers that only measures whose scope extends to the entire territory of the state escape the specificity criterion laid down in article 87(1) of the EC Treaty, which itself qualifies as aid measures that are intended to promote the economic development of a region.

The Importance of the 2006 Case

In 2006 the ECJ adopted a groundbreaking reasoning in *Portuguese Republic v. Commission* by analyzing the existence of territorial selectivity of an infrastate measure.[5] The ECJ rejected the commission's interpretation of selectivity when measures apply to a given geographic area within a member state, thereby allowing the possibility that the reference framework is not necessarily the territory of the member state concerned. More precisely:

> it is appropriate . . . to examine whether that measure was adopted by that body in the exercise of powers sufficiently autonomous vis-à-vis the central power and, if appropriate, to examine whether that measure indeed applies to all the undertakings established in or all production of goods on the territory coming within the competence of that body.[6]

And after having identified three possible situations in which this question could arise, the ECJ concentrated on the third because it concerned asymmetrically devolved member states (as in the case in question) where regional or local authority adopts, in the exercise of sufficiently autonomous powers in relation to the central power, a tax rate lower than the national rate and that is applicable only to undertakings present in the territory within its competence. In this third situation, in order that a decision taken in such circumstances can be regarded as having been adopted in the exercise of sufficiently autonomous powers, the ECJ said that that decision must fulfill the following requirements:

- it must have been taken by a regional or local authority that has, from a constitutional point of view, a political and administrative status separate from that of the central government (autonomy from a constitutional point of view);
- it must have been adopted without the central government being able to directly intervene regarding its content (''procedural autonomy''); and
- the financial consequences of a reduction of the national tax rate for undertakings in the region

[5]*See* Linday-Poulsen, ''Regional Autonomy, Geographic Selectivity and Fiscal Aid: Between 'The Rock' and a Hard Place,'' *ECLR*, 2008, No. 1; and Elena García Aguado and Juan Jorge Piernas López, ''Comentario de la sentencia del Tribunal de Primera Instancia de 18 de diciembre de 2008 en los asuntos acumulados T-211/2004 y T-215/2004, Gobierno de Gibraltar c. Comisión de las Comunidades Europeas,'' *La Ley*, No. 8 Nueva Época — March/April 2009, p. 96.

[6]Para. 62 of the judgment.

must not be offset by aid or subsidies from other regions or central government (''economic autonomy'').[7]

When examining the Azores scheme, the ECJ considered that the first criteria was fulfilled but the third was not (it is not clear whether the ECJ analyzed the second criteria in isolation). In accordance with the interpretation of the principle of national solidarity as adopted by the ECJ, the central state contributes, along with the autonomous regional authorities, to the achievement of economic development and the correction of inequalities deriving from insularity and to economic and social convergence with the rest of the national territory. According to the ECJ, this joint contribution is closely linked with a centrally managed financing mechanism. It takes the form of budgetary transfers from the central state to the autonomous regions, which offset the reduction in tax revenue that may result in the Azores region (as provided for in Decree 2/99/A, the infrastate measure in question).

The *BCA* Judgment

In 2008 the above-mentioned perspectives of autonomy were further clarified in the *UGT/Rioja*[8] and *Gibraltar*[9] cases. One could wonder whether there was a widening of the scope of this new interpretation of territorial selectivity. For instance, it became clear that a causal link between the reduction in revenues and the offset by the central government was required in order to deny economic autonomy. On the basis of these jurisprudential developments, a new legal argument was presented during the oral hearing in the *BCA* case, which was set aside by the CFI. Article 30 of Law 13/98 expressly provides for the criteria for calculating budget transfers, thereby being established *ex ante* and irrespective of specific infrastate measures, which contradicts the idea of a direct link between the application of the solidarity principle as explained above and the same transfers. But the CFI (perhaps unexpectedly) raised the burden of proof by stating that there are several parameters in the legal provision and the applicant didn't prove the absence of the same link, without having explained how such proof should be presented. As for the other legal grounds submitted by the applicant concerning the commission's decision, the CFI confirmed the ECJ's 2006 judgment without making any reference to the jurisprudential developments since then.

The CFI also decided on two important procedural questions. The first concerned the scope of the concept of ''direct and individual concern'' for the purposes of assessing BCA's standing under article 230 of the EC Treaty. The commission alleged that in light of the Court's jurisprudence, an undertaking could not, in principle, contest a commission decision prohibiting a sectoral aid scheme solely by virtue of belonging to the sector in question and being a potential beneficiary of the scheme. In the commission's view, such a decision was a measure of general application covering situations that are determined objectively and entailing legal effects for a class of persons envisaged in a general and abstract manner. Therefore, the appeal should be considered inadmissible. The CFI did not follow the commission's reasoning and, as requested by BCA, based its reasoning on the *Sardegnia Lines* case.[10] The Court recalled that BCA had been an effective recipient of the aid and had been individually notified by the regional tax authorities to reimburse the aid. Consequently, BCA is individually concerned by the contested decision. This is undoubtedly a positive step by the European courts toward a more efficient judicial protection of private parties.

The second legal question related to the possibility of recipients of unlawful aid, which has automatically applied to them, invoking the violation of the principles of legal certainty and legitimate expectations when being notified by the national tax authorities to reimburse the amounts unduly received (with interest). The CFI adopted a conservative interpretation of these principles and raised the threshold imposed on private parties to demonstrate the violation of these principles.

Tax Consequences and Next Steps

Following the commission decision of December 11, 2002, and the ECJ decision of September 6, 2006, the Portuguese tax authorities notified taxpayers that they were considered to have received illegal state aid and were required to pay additional corporate income tax of previous years. Basically, the tax authorities made new tax assessments using the ordinary tax rate applicable to companies operating in Portugal, on the assumption that the rate used by the companies located in the Azores could not be applied, despite being set out as the applicable rate defined in the Portuguese official legal gazette. Taxpayers were obliged to pay these tax assessments to prevent the authorities from enforcing the assessments against them. If they should

[7] Paras. 63 to 67 of the judgment.

[8] Joined cases C-428-434/06, Sept. 11, 2008.

[9] Joined cases T-211/04 and T-215/04, *Government of Gibraltar and United Kingdom v. Commission of the European Communities*, Dec. 18, 2008. This judgment has been appealed to the ECJ in 2009 (joined cases C-106/09 P and C-107/09 P).

[10] The CFI referred to the ECJ's judgment of Oct. 19, 2000, *Italy and Sardegnia Lines v. Commission* (C-15/98 and C-105/99, ECR p. I-8855) in order to justify that it is necessary to determine whether a recipient of a state aid scheme in which recovery was ordered by the commission is also the effective recipient of an individual aid granted within the context of that same scheme (para. 45).

lose the litigation, the taxpayers would have to pay the so-called tax debt without further delay.

Some of these cases have already reached the Administrative Supreme Court. In this particular case in question,[11] the Administrative Supreme Court ruled that the case should be dismissed assuming that the ''tax assessment'' was already a mere executor act of the European Commission decision and, as such, could not be challenged in court. Curiously, however, while refusing to make an appraisal or an analysis about the substance of the case, the court concluded that the sole procedural step to be taken by taxpayers could be an action for damages against Portugal in the national courts.

The facts clearly show the existence of several arguments to be used against the state:

- The tax measure that qualified as an illegal state aid (reduction of a tax rate) was adopted as an initiative of the Azores and Portugal without any intervention of taxpayers.
- Taxpayers applied the corporate income tax rate that was defined by law; even if they had applied another one (for example, the ordinary rate), the tax authorities would have adjusted the rate (to apply the reduced rate).
- The principles of legality and of confidence in the legitimacy of state acts were the main criteria followed by taxpayers.
- The Portuguese Constitution forbids retroactive taxes or ''interpretations and applications'' that should have such effect.
- Portugal and the Azores did not notify the European Commission of the state aid (as it was considered by the ECJ and the CFI) in due time and imposed the reduced rates on taxpayers.
- Portugal disagreed with the European Commission and challenged its decision. Also, it never adopted any legislative or regulatory acts to prevent Portuguese companies from suffering damages from its own actions.
- The obligation to pay additional corporate income tax of previous years implies that companies pay unexpected taxes that were not imposed by law and in a completely different factual, economic, and financial situation. They will have to pay taxes for several years in a row. This CFI decision is not the end of the story for the state and taxpayers. Now national courts will probably be called on to rule on tax matters as well as liability consequences. ◆

[11]Administrative Supreme Court, file 1091/05, May 24, 2006.