Fiscal Autonomy, Investment Funds and State Aid: A Follow-Up

In this article, the author discusses the continuously developing area of State aid. In particular, the article focuses on the application of the State aid rules to autonomous regions and specialized investment fund regimes, in respect of which the recent Basque, Gibraltar and Italian cases have provided some clarification.

1. Introduction

The legal area of State aid is constantly under review, particularly in times of economic crisis. Apart from relaxing State aid rules to deal with the economic downturn, a 2005 initiative to simplify State aid rules and make them more effective changed some of the rules of the game in 2008 and 2009. These changes primarily deal with the State aid procedure and the approval of any ad hoc State aid or State aid schemes for financial institutions and "real economy" sectors of industry in distress. In this contribution, the author does not focus on these changes, but on developments in respect of defining what State aid is, in particular what tax measures fulfil the definition of State aid in Art. 87(1) of the EC Treaty. For this purpose the author has selected three European Court of Justice (ECJ) decisions. These decisions focus on the State aid boundaries of fiscal autonomy and the State aid treatment of tax regimes for specialized investment funds.

2. Fiscal Autonomy: The Basque Countries and Gibraltar

2.1. Introductory remarks

In its 2005 decision with regard to Portugal and the Azores, the ECJ identified three criteria for determining, with regard to autonomous regions, whether or not their level of autonomy would be sufficient to use the tax regime of that region as the benchmark for State aid review. In order for a financial benefit to be present (aid), it must be determined whether or not there is a benefit in comparison to the normal tax regime in a territory. The territory may refer to the Member State as a whole (the national/federal tax system), local bodies distributed evenly throughout the Member State's territory (provinces, Länder, municipalities, etc.) or to autonomous regions in a particular part of the Member State's territory that do not have an equivalent in other parts of the Member State. In respect of autonomous regions, the ECJ has ruled that a sufficient level of autonomy can be determined by means of three cumulative criteria: (1) political autonomy, i.e. a separate political and administrative status, (2) procedural autonomy, i.e. to be independent of the Member State in respect of budget and taxation decisions, and (3) financial and economic autonomy.

These criteria were further clarified in two decisions, the ECJ's decision in respect of the Basque countries and the Court of First Instance's (CFI) decision in respect of Gibraltar.

2.2. The Basque countries

The ECJ, on the matter of the presence of political autonomy and decision-making power, in the Basque countries judgment, pointed out that such powers may be shared by local authorities that, together, could qualify as an autonomous region. In this particular case the Historical Territorialities were competent in matters of taxation, while the Autonomous Community of the Basque Countries determined economic policy.

In reference to procedural autonomy of an autonomous body, meaning that the national government is prevented from interfering in tax matters of the autonomous area, the ECJ clarified that the mere possibility of review of decisions taken by a national court will not endanger this autonomy provided that the review decision is limited to interpreting the law establishing the limits of the areas of competence of such a body and cannot generally call into question the exercise of those powers within those limits.

Therefore, the Spanish national court may review whether or not the autonomous region acted within the limits of its competence as set out in the Spanish constitution. If the region did not act within those limits, the benchmark for assessing whether or not tax benefits have been granted may no longer be the tax system of the Historical Territorialities (and the Autonomous Community) but the general Spanish system. As a result, the...
Basque regime could then qualify as regional aid. Inevitably, judicial review of the exercise of taxing powers within the limits of the competence attributed to the region should be left to the local courts established by the autonomous body.

It is interesting to note that the Basque region committed itself by means of the 2002 Economic Agreement with Spain to comply with the general tax structure of the Spanish state, to respect "terminology and concepts" of the Spanish Tax Code and to comply with tax treaties concluded by Spain. The ECJ, however, noted that although there is a consultation and reconciliation committee to advise on compliance, the regional authorities would be able to adopt laws contrary to these general principles set out in the 2002 Economic Agreement without the Spanish state being able to intervene or impose the adoption of certain laws. As a result, the conditions for procedural decision-making autonomy still appear to be fulfilled. It is for the referring court to confirm this. The 2002 Economic Agreement also prescribed that the Historical Territories "shall maintain an overall effective fiscal pressure equivalent to that in force in the rest of the State", which seems hard to reconcile with the concept of autonomy, in particular in respect of tax matters. The ECJ, however, ruled

it is ... not in dispute that overall fiscal pressure is only one of the elements to be taken into consideration when tax laws are being adopted. Provided that they comply with that principle, the Historical Territories thus have the power to adopt tax provisions which differ in many respects from the provisions applicable in the rest of the State.7

The ECJ’s ruling is rather unclear in this respect. Either it assumes that this "fiscal pressure" limit is not enforceable by Spain vis-à-vis the Territories (like the general principles referred to above) or it assumes that the Territories are bound by this limit, yet still retain a sufficient degree of autonomy. The author would find the latter hard to accept.

As far as financial autonomy is concerned, an autonomous body should bear the financial consequences of any changes in its tax system, which should not be offset by any contribution from the national government or any other level of government outside that region. In the Basque case, the ECJ had to address the issue of quotas. The Autonomous Community of the Basque Country is obliged to pay a contribution to the Spanish state to cover the costs of areas of competence it did not assume.8 In addition to taking into account the relative weight of the Basque economy, in comparison to the Spanish economy as a whole, a number of adjustments were made to those quotas. The ECJ pointed out that

an undervaluation of the attribution rate is capable of constituting merely an indicator that the Historical Territories lack economic autonomy. There must be compensation, namely, a causal relationship between a tax measure adopted by the Foral [regional, RL] authorities and the amounts assumed by the Spanish State.9

It then ordered the national court to determine whether or not the political negotiations to set the quota and the method of calculation thereof may have had the effect of the Spanish state compensating for any subsidy or tax measure adopted by the Historical Territories, which may benefit undertakings. If so, the Historical Territories would not bear the full political and financial consequences of their actions and, therefore, lack sufficient autonomy.

Although the ECJ agreed with the Commission that other "hidden" compensatory payments may exist, especially in respect of a joint social security fund, the ECJ, referring to Advocate General Kokott’s opinion, made the national judge’s task more troublesome:

[...] the mere fact that it appears from a general examination of the financial relations between the central State and its infra-State bodies that there are financial transfers between the former and the latter, cannot, in itself, suffice to demonstrate that those bodies do not assume the financial consequences of the tax measures which they adopt and, accordingly, that they do not enjoy financial autonomy, since such transfers may take place for reasons unconnected with the tax measures.10

In doing so, the ECJ clarified that there should be an explicit link between a State aid scheme (tax measure) and any compensation received for such aid from the national government.

2.3. Gibraltar

2.3.1. The Gibraltar proposal

In its Gibraltar decision, the CFI had to deal with two issues: whether or not Gibraltar qualified as an autonomous region and whether its tax system qualified as the general, non-selective system applicable within its territory.11 Gibraltar proposed to abandon its corporation tax and revise its tax framework. In essence there would be a payroll tax, a business property occupation tax (property tax) and an annual registration fee for Gibraltar-based companies. An additional top-up tax (penalty tax) was introduced of about 4% to 6% of (commercial) profit for financial services and 35% for utility companies. In regards to the payroll tax, the property tax and the top-up tax the collective tax liability for these taxes would be capped at 15% of a company’s profit.

2.3.2. Gibraltar’s autonomy

First, the CFI had to rule on whether or not Gibraltar had a sufficient degree of autonomy vis-à-vis the United Kingdom in order to use the Gibraltar tax system as the

7. Id., Para. 106.
8. Id. The competencies exclusively awarded to the state were, amongst others, commercial, criminal, prison, social security and labour legislation (with some exceptions for local characteristics); the monetary system; the general planning of economic activity and state debt. As for the latter two, the ECJ did not address what the impact of those powers retained by the State could be in respect of establishing financial autonomy.
9. Id., Para. 129.
10. Id., Para. 135.
11. Gibraltar is subject to EC competition law, including the State aid rules, pursuant to Art 299(4) of the EC Treaty.
benchmark for State aid purposes. The Commission's decision was taken in March 2004 at a time when it was still convinced that regional autonomy should not be taken into consideration for State aid purposes. With the 2006 Portugal/Azores decision and the 2008 Spanish/Basque decision in mind, the CFI had to revisit the Commission's decision in this respect. It essentially ruled that Gibraltar met the three conditions for regional autonomy.

In its analysis, the CFI clarified some aspects of the three conditions set forth in the Portugal/Azores decision. It began by rejecting the Commission's argument that a fourth condition existed, which required the region in question to enjoy a degree of autonomy over the political and economic environment in which undertakings established in its territory operate that is comparable to the influence exercised by the central government of a Member State whose constitution does not provide for regional autonomy.12

The Commission argued the rationale behind this requirement, in the light of the Treaty rules on State aid, is that in order to establish whether certain undertakings benefit from a given advantage it is necessary to compare their situation with that of other undertakings operating in the same political and economic environment.13

The CFI found no support for such a condition in the Portugal/Azores decision.14

In respect of the presence of political and procedural autonomy, the Commission argued that Gibraltar's constitution allowed the governor to intervene in tax matters although that power has not been used in practice. The CFI, however, held that the power to draft and adopt tax legislation was in the hands of Gibraltar's Council of Ministers and its House of Assembly. An action by the governor, as a representative of the Queen, who is Queen of Gibraltar, is not on par with an intervention of the UK government. Although the CFI stressed several times that the governor never intervened in matters of taxation, we may wonder what the importance of this may be. If the governor did intervene in tax matters, the question may arise as to whether or not he acted on his own authority or received instructions to do so. But again, this is only a theoretical matter for the time being.15

In respect of financial and economic autonomy, the Commission pointed out that certain payments were made from the UK government to Gibraltar. The CFI pointed out – in line with the Basque decision – that such payment is only relevant when it offsets State aid awarded. The CFI then ruled that the UK's financial assistance had no causal link with the proposed tax reform under investigation. Even so, one may wonder whether or not a causal link should be overt at all. If a territory receives assistance to meet certain expenses it would normally have to cover itself, this may provide for some budgetary leverage that would allow for a lowering of taxes (or a lesser increase thereof) in the future. Despite the fact that some of the payments made to Gibraltar were rather extraordinary, the assistance also included a 2003 (Commission approved) UK finance venture capital scheme for small and medium-sized enterprises (SMEs) that was extended to the Gibraltar territory. The question arises, therefore, as to how much time should pass in order to establish the lack of a causal link between granting a tax benefit and any past or future compensation by the "national" (UK) government.16 This causal link condition will require further clarification from the Courts.

2.3.3. Gibraltar's normal tax system

As a result of the CFI's ruling on the matter of autonomy, the question arises what the proper benchmark for reference should be, i.e. it must be determined what the normal Gibraltar system is in order to establish whether or not any aid has been granted by introducing tax measures that provide for a more beneficial treatment vis-à-vis the normal system. The Commission argued that the proposed Gibraltar system, in itself, is materially selective:

[...the reform creates a hybrid system in the sense that the profit made by a company is a vital element in applying what is ostensibly a payroll tax and a business property occupation tax. ... For] certain companies, each element of that system works to remove liability to tax which would otherwise arise by virtue of the other element. More specifically, a company might be highly profitable, but if it took the form of what is presently classified as an 'exempt company' it would need neither premises nor employees and would accordingly be almost untaxed. Conversely, a company might have employees and occupy premises, but if it made no profits the tax reform would likewise leave it untaxed ... While, according to the applicants, labour and land are two factors of production in short supply in Gibraltar, this should lead to the conclusion that those scarce resources should be taxed without exemptions or thresholds so as to ensure that they are allocated to their most efficient use.17

To put this in context, the reform at issue was meant to replace Gibraltar's previous offshore regime. The Commission's approach, therefore, reflected its concern with harmful tax competition. This concern is, of course, not referred to explicitly in its State aid analysis. The Commission had support in this regard from the Kingdom of Spain, which intervened, arguing that the profit cap is an

13. Id.
15. Lindsay Poulsen has indicated that it is the "UK Secretary of State" that would be able to intervene in tax matters in accordance with Gibraltar's 1969 Constitution applicable at the time of the Commission's 2004 decision. See Lindsay-Poulsen, "Regional Autonomy, Geographic Selectivity and Fiscal Aid", European Competition Law Review 1 (2008), p. 48. Art. 37 of Gibraltar's former Constitution implied that the Queen – through her Secretary of State – could indeed disallow a law, even after the Governor's consent, which would suggest the (still) theoretical possibility of the UK government's interference with Gibraltar tax laws. It should be noted that this procedure seems to have been changed in Gibraltar's 2006 Constitution.
16. From 1978 to 1986, UK development aid had been granted, which, if granted in 2009 would indeed have put financial autonomy at stake. Given the 20 years that passed and the rather obvious absence of a causal link, the CFI did not address this issue any further. One might argue that any such aid may still have an impact on the budget today, if the alternative would have been for Gibraltar to finance such amount back in the 1980s by means of a 30-year governmental bond. The absence of such burden may provide Gibraltar with the financial leverage necessary to decide to revise the Gibraltar tax system as proposed.
element alien to the nature of the payroll tax and [property tax]. Many governments refrain from submitting their views in State aid procedures, especially when another Member State (or territory) is faced with a negative fiscal aid decision declaring a tax scheme incompatible with the Common Market. Court decisions in the field of State aid can, however, have an enormous impact and create settled case law for future reference and, therefore, it is advisable for governments, at times, to submit their views. That being said, the Spanish intervention must, of course, be reviewed against the political background of Gibraltar, which is at its back door. Its attempt to clarify that Gibraltar’s status as an autonomous area for State aid purposes should not change the international status of that territory, stems from Spain’s concern that Gibraltar will be treated “as another Member State”.

On the matter of the profit cap, the CFI pointed out that the Commission should have first established the normal or common tax regime within the territory, which it did not do, i.e. it should first be established whether or not the profit cap may be considered part of the nature or general scheme of Gibraltar’s proposed tax system. The CFI stressed that the application of the Community rules on State aid is without prejudice to the power of the Member States to decide on their economic policy and, therefore, on the tax system – and the common or “normal” regime under it – which they consider the most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production and economic sectors.

The government of Gibraltar reasoned that the profit cap is based on the principle of ability to pay. The concern was to avoid overtaxing companies in order to prevent layoffs, serious instability in its small economy and subsequent loss of tax revenue. It essentially argued that the profit cap is inherent to its normal tax system. The CFI ordered the Commission to re-examine the issue since it started from the presumption that a “classic” payroll tax and business property tax should be considered the starting point for its investigation, the profit cap being a derogation.

The mere assertion by the Commission that, in a tax system such as that proposed by the Gibraltar authorities, the more people a company employs and the more property it occupies, the greater the tax liability will have to be... is not sufficient to call into question the validity of the choice made by those authorities as to the elements constituting the common or “normal” regime under that tax system.

In the absence of a harmonized standard of what is a normal or common national tax regime, the CFI points out that a hybrid regime should not be disqualified from the outset as the Commission did.

The problem in this case, of course, is that Gibraltar’s regime does, at first glance, seem beneficial to offshore companies. In the Commission’s mindset “textbook taxes” are considered the standard, but Gibraltar may have found a way to slip through the cracks of the State aid system (or better: it simply walked through the main gate). If it decides to have a combined system and apply it to all sectors of industry and to all companies, regardless of any offshore or international activity, the Commission will have a very hard time coming up with a new and legally sound decision. The CFI does emphasize that the new reform should be considered by itself and that it should be reviewed independently from its predecessor (the exempt company regime), so it is irrelevant whether or not offshore companies would still be able to have a relatively low tax burden under the new regime similar to that under the old, incompatible regime.

The author does admit that the Gibraltar system will lead to a different level of taxation for companies with the same level of profit, depending on their reliance on the use of local Gibraltar property and staff. From a profit perspective, the new system will be a breach of horizontal tax neutrality, as argued by Rossi-Maccanico. However, the author does not agree that this will result in the Gibraltar system no longer being a general measure, since this assumes that traditional profit taxes are still the starting point of this State aid review.

3. Specialized Investment Funds

In March 2009, the CFI handed down two judgments that may have a considerable impact on the investment fund industry. These judgments concern appeals from the Italian government and from the Italian Association of Pension Funds, together with Fineco, an asset management company, in respect of a 2005 Commission decision on Italian investment funds.

Italian investment vehicles and pension funds would normally be subject to a 12.5% substitute tax on capital revenue accruing from investment vehicles they themselves invest in. This substitute tax would be withheld by the investment vehicle on behalf of their investors. In 2003, an amendment was introduced that effectively lowered the substitute tax to 5% for all investment vehicles, including all open-ended and closed-ended Italian funds (referred to in the judgment as “the historic Luxembourg funds”), open-ended investment companies (SICAVs) and comparable foreign investment vehicles, to the extent that they qualify and register as specialized investment vehicles.

In this particular case, the specialization of these vehicles was defined as investing in SMEs listed on a regulated European stock exchange. This particular specialization is of minor importance in assessing the impact of this

18. Id., Para. 140.
19. Id., Para. 74.
20. Id., Para. 146.
22. Id., Para. 178.
23. Id., Para. 186.
26. For prior coverage of the Italian SME Funds Decision by the author see "Investment Funds, Tax Planning and State Aid", European Taxation 12 (2006), pp. 565-569.
judgment, since the focus of the case is on tax measures requiring a particular specialization in investment policy, be it SMEs, risk or venture capital, environmental/green investments or otherwise.

The CFI's core reasoning is as follows:

It should be noted that aid may be selective for the purposes of Art. 87(1) EC even if it concerns a whole economic sector. In the present case, the measure at issue applies to the financial sector. Within that sector, it benefits only the undertakings carrying out the operations covered by that measure. As it does not apply to all economic operators, it cannot be regarded as a general measure of fiscal or economic policy. It is, in fact, an exception to the general tax scheme. The beneficiary managing undertakings derive an indirect benefit from advantages not provided for under the normal rules of the scheme and to which undertakings in the financial sector which do not perform management operations for specialised investment vehicles have no right. The measure at issue is thus also selective in respect of managing undertakings of specialised investment vehicles. That finding is not affected by the fact that certain fund managers may benefit from the advantage afforded by the measure at issue for some of their activities but not for others. The fact nevertheless remains that the measure at issue confers an advantage on them for certain specific activities, whereas other, non-specialised fund managers will not benefit from it.

State aid is considered present at two levels in this particular case. There is a benefit for the targets of the investment vehicles — the listed SMEs — whose shares are in higher demand and who have easier access to liquidity as a result of the fiscal attractiveness of investing in such companies. The same would be true for other specialized investments, such as investments in green activities, risk and venture capital, etc., albeit that for many of these categories criteria exist to establish whether or not such benefits could be approved under State aid rules.

For this contribution, it is the second level of aid that is more interesting. If legal personality of the investment vehicle is absent, the fund manager is considered to be a recipient of (indirect) aid because he will see an increase in management and entry fees awarded to him as a result of the increased attractiveness of investing in his specialized line of business. If the investment vehicle does have legal personality, it is the fund itself that may be the (indirect) beneficiary of increased fees. Nevertheless, with regard to vehicles with legal personality it must still be established whether or not they carry out an economic activity in order to qualify as an undertaking. This will depend on what kind of investment activities they carry on themselves and on whether or not they themselves are to be considered relatively passive investors. In its 2005 decision, the Commission referred to the ECI's VAT jurisprudence to establish that vehicles for collective investment normally qualify as undertakings as a result of carrying out an "economic activity" in the context of the EC Treaty. Although the CFI did not disallow the Commission's reference to this VAT jurisprudence it pointed out that the Commission's broad interpretation thereof "may in some aspects appear questionable or ambiguous" and "must not be read out of context but in light of the contested decision." The CFI essentially acknowledged that some (or even many) of the investment vehicles may qualify as undertakings but not all.

Regrettably, it did not give any specific guidance on what aspects of the Commission's analysis it did not agree with.

In the end, the CFI upheld the Commission's decision to order the recovery of aid from the specialized investment vehicles, i.e. from the Italian funds with legal personality (SICAVs) or — in the absence thereof — from the fund managers. It did point out that these beneficiaries of aid may have the option of subsequently recovering the additional taxes to be paid "from their investors or even from the State, in accordance with provisions of national law." Whether or not funds would actually decide to recover from their investors may be doubtful from a public relations perspective but, in essence, this will depend on finding a national legal basis for doing so. If the substitute tax is to be regarded as a tax levied on behalf of the investors (the investment vehicles and pension funds investing in specialized vehicles), as implied by the Commission, this remark is understandable. As far as recovery from the state is concerned, "recovery" should probably be understood as launching an action for damages. From a State aid point of view, the ECI's Unicredito judgment will probably result in such claims being unsuccessful given that a diligent businessman should be able to check whether or not the aid received is granted in conformity with the State aid procedure in order to avoid any risk of recovery and subsequent damages.

As far as recovery is concerned, the CFI upheld the decision to order the recovery of the difference between the 12.5% and 5% substitute tax. This is rather surprising given that the CFI itself determined that the actual benefit to these recipients was indirect and consisted of the increase in entry and management fees. It is this increase in fees only that qualifies as aid according to the CFI's own analysis. In respect of indirect aid, the calculation of the actual amount of aid can be challenging given that there may have been an autonomous increase in fees in addition to the increase induced by the reduced tax, but the Commission and the CFI cannot designate the dif-
ference in substitute tax as the recoverable amount since it has not been established that that difference, as such, is the aid. It is just a means of stimulating investors to invest in specialized vehicles, which in return results in aid through increased fees. ECJ case law does provide a basis for the applicants' claim that only the increase in fees can be the subject of the recovery order and not the difference in substitute tax awarded to its investors. In the Fonds Industriel de Modernisation case, private individuals were exempt from tax on savings put in a special account. Those savings were made available to a fund that would finance certain businesses, resulting in the granting of loans based on more favourable conditions. It was the difference in the interest rate paid to that fund and the market interest payable on regular loans that was the subject of recovery, not the tax benefit to the private investors. For this reason, the author disagrees with the CFI's decision to allow for the recovery of the full difference in substitute tax instead of the additional fees.

Although the CFI carefully avoided the issue of addressing the State aid compatibility of investment fund regimes in general, it is clear that the existence of separate or more beneficial tax regimes for specialized funds (and their investors) next to a general regime will, in essence, fall within the scope of Art. 87(1) of the EC Treaty. For this reason, it will become crucial for specialized funds to establish whether or not they themselves carry out an economic activity as defined by the ECJ. If so, they should pay particular attention to any special tax measures being duly notified and approved of by the Commission.

4. Conclusions

State aid is a continuously developing legal domain. This is due to both "unexpected" challenges posed by the current financial crisis and the Commission's commitment to simplifying and overhauling its State aid rules. The definition of State aid, however, remains a legal matter, subject to full review by the EU courts. In this respect, some important developments have been addressed. First, the Basque and Gibraltar cases provided some clarification in respect of establishing regional autonomy while, at the same time, raising new questions in respect of determining the presence or absence of a causal link between tax benefits granted by local authorities and any compensation received from the national government. Second, the CFI's ruling on an Italian tax regime for specialized investment vehicles provides guidance on the State aid susceptibility of tax regimes stimulating specialized investments, which may affect a number of investment fund regimes in other Member States.

38. See Associazione italiana del risparmio gestito and Fimco Asset Management, note 25, Para. 155, where the CFI, in Para. 156, touches upon the issue in order to focus on the case of the specialized regimes at hand.