Traditionally, banks’ basic role has been to act as the intermediary between depositors and borrowers. They have provided insurance, trust, and securities-dealing services through their subsidiaries, charging however specific additional costs. As financial markets change and innovate, the role and functions of banks are shifting as well. Traditionally, banks’ basic role has been to act as the intermediary between depositors and borrowers. The way banks fulfill this basic function has changed. Worldwide, the financial services’ marketplaces are in a state of general transformation, deregulation and consolidation. With the current pace of progress in information and communication technologies, the financial industry is set for major changes in the future. However, central bankers and regulators have started to increasingly worry about the risk of financial stability that may be lurking in the complex debt instruments created by the unregulated financial industry. Furthermore, a number of conflicts may arise when traditional banks promote the use of unregulated vehicles with a view to providing higher yields than normal, while charging, however, increasingly important fees.

In the Common Market, the need for adequate regulation of financial services is essentially driven by two conditions. On the one hand, the introduction of localization rules provides the legal framework for the cross-border provision of financial services. On the other hand, regulation is needed to govern the wave of consolidations, the emergence of new competitors for banks, the expanded choices for consumers, and their increasing level of sophistication. The increasing complexity of the financial products and of the institutions managing such products, finally demand higher level of specialization and the creation of dedicated corporate structures and special purpose vehicles such as holding companies to carry out transactions in the most efficient manner possible. Holding companies are companies which typically hold as durable investments substantive participations in other companies and are themselves participated by other companies, but also perform financial activities, as their activities include the management of the participations held and the maximization of their value mainly through their financial assistance to such companies. In an international context, holding companies are created by multinational enterprises to streamline their business structure so that ownership, management and coordination are concentrated in one single legal entity.

By allowing banks and insurances to form financial holdings, similarly to unregulated private funds, Member States hope that additional structural flexibility will promote competition and result in efficiency gains for their national financial sector. In general, it is expected that banks will reorganize their activities under a holding company structure which would help them to better compete with unregulated financial institutions, take advantage of innovations in financial markets and, combined with favorable tax rules, use the financial leverage to maximize profits and reduce taxation. Promotion of such special purpose vehicles such as holdings by a financial centre depends on the combination of economic factors such as the presence of industry participants and the availability of professional advisers and regulatory factors such as the...
attitude of the regulatory authorities including the tax authorities and the latitude of exchange regulation controls. As to the regulatory aspect of the localisation of financial services (3), given the freedom to provide services within the EU, the single market constitutes a perfectly integrated marketplace for EU providers. The classical features of a financial center are therefore linked to the know-how of its participants with regard to value creation in asset management, political and economic stability, the high quality of services provided, the protection of privacy and the strictness of its discipline to prevent abuse.

In addition to deregulation to promote competition and efficiency, national authorities have understood that the tax conditions are critical constituents of the success of a financial centre. Tax conditions are in fact a decisive factor in governing the location and success of any financial centre because they have a direct influence on the competitive or trading conditions of the financial services providers that choose to locate their business activities in the centre. Unlike deregulation, however, tax incentives do not promote efficiency, but rather alter the optimal allocation of financial investments through tax discounts aimed at hiding local production costs and inefficiencies. In other words, the preferential tax regimes for financial holdings may unfairly alter competition in the internal market by dramatically shifting the convenience balance in favor of unregulated, more expensive, and closely held private funds as opposed to transparent bank lending. It is noticeable that all financial centers of world importance enjoy certain local advantages with regard to regulations such as special surveillance and monitoring conditions, legislation on trusts and fiduciary companies, banking secrecy, and most of all taxation. While the former advantages do not involve State resources, the preferential tax regimes in favor of financial holdings hinge on the extraordinary renunciation to tax resources by national treasuries and may accordingly fall within the scope of application of State aid rules as the case of Luxembourg’s Exempt 1929 Holdings illustrates.

Only in 1991, Justice Tesauro had difficulty finding cases of State aid granted to banks (4), while nowadays it is quite common to refer to Commission decisions on State aids to the banking sector. The situation has substantively changed, thanks to the progressive liberalization in the EU, which prompted a higher degree of cross-border competition. In particular, the mutual recognition approach has gone against the anti-competitive effects of national regulations and provided the impetus for further harmonization. For example, a credit institution being licensed in a Member State with a universal banking regime (5) can conduct activities through a branch set in another Member State that does not allow its own credit institutions to conduct all the activities of a universal bank. To avoid negative competitive effects on the host country credit institutions, the latter Member State will also allow its credit institutions to carry out most of the activities listed in the Annex to the Second Banking Directive (listing the activities of a universal bank), thus accepting to harmonize its internal rules to the most advanced common standard. Arguably, essential harmonization combined with mutual recognition entails risks for the quality of the banking regulation as it may trigger a "regulatory race to the bottom", where institutions able to carry out a EU-wide business will opt for the jurisdictions with less rigid and expensive (more lax) regulatory and supervisory requirements. There are several arguments, however, indicating that regulatory competition within the EU is limited. The Directive’s requirement that a credit institution has its head office in its home Member State and that it actually operates the banking business there naturally discourages banks from “forum shopping”. In addition, the home regulators’ responsibility for depositors’ insurance suggests that retention of strict requirements is in the

(3) The localisation rules for financial services in the EU serve the purpose of defining the regulatory responsibility in the Single market and are only applicable to financial services provided by a provider which is incorporated in one of the EU Member States, and has accordingly been granted a so-called “single passport” by the supervisory authorities of the said Member State. The single passport gives to the “holder” the right to provide its services throughout the EU, subject as a rule only to the supervision of its home country supervisor. These rules have been enacted pursuant to a number of so-called “financial services directives” for the purpose of facilitating the exercise the freedom to provide services granted by the Treaty to nationals of the EU Member States, including the legal persons incorporated under the laws of the said Member State. As a result, localisation rules do not apply in case of services provided by companies established outside the EU to purchasers within the EU and in case of services provided by a so-called “third country” branch, i.e. a EU branch of a company established outside the EU to purchasers within the EU.


(5) There are three types of financial structure for banking activities that can be found in the EU: 1) The traditional universal banking system found in Germany and the Netherlands, whereby banks are licensed to engage in a full range of financial activities, including issuing and negotiating securities; 2) The hybrid system, like the one found in the UK after the so-called Big Bang, France and Greece; and 3) The Belgian model, whereby banks are subject to strict limitations which exclude involvement in the securities business.
interest of the home regulator. A lax of prudential framework increases the risk for ex-post reaction to financial crises and therefore the risk for possible losses on the deposit guarantee schemes or for the costs from lending of last resort (LOLR) operations (5). Finally, banking systems with higher standards and reputations have better access to capital and business markets.

Other forms of State intervention in support of the banking activities have resulted, however, in competition distortions, which have altered the credit market dynamics in the EU for many years. Member States have engaged a different form of anti-competitive race, that in the form of State aid to national banks, and financial intermediaries most notably involving rescue and restructuring assistance to ailing national champions, the granting of State guarantees for the national banking sector and various preferential tax regimes for financial holdings and financial products to improve the competitiveness of both traditional banking institutions and deregulated financial providers in various Member States. From a competition viewpoint, these forms of individual State aid and aid schemes are susceptible to greatly damage competition as far as they alter the level playing field between undertakings in the common market. Furthermore, excessive concentration of market power in few national banks and their public strength are of considerable concern as they may lead to excessive profits, distortion of credit policies, undue influence in lending and conflicts of interest. It was widely recognized that the banking sector retained some peculiarities influencing competition which regulators had to take into account.

To make sure that competition is not affected between EU providers it is necessary to avoid any undue alterations of the level playing field between regulated and unregulated financial intermediaries in the common market, even if these are established in different jurisdictions and subject to diverse tax rules. State aid rules (Article 87 and 88 EC) provide the Commission with the regulatory instrument to prevent and eliminate alterations of the level playing field deriving from public intervention, even through the tax system, without prejudice to Member States prerogatives in the field of taxation. Against this background, the Commission shall scrutinize all regulations of the financial services sector, with a view to limiting inappropriate State interventions, especially in the form of preferential tax regimes to prevent competition distortions incompatible with the correct functioning of the financial services’ market.

A first group of preferential tax regimes which may fall under State aid review concerns the application of reduced nominal tax rates to the revenues deriving from financial activities as opposed to the ordinary tax rates applicable to other companies. In its landmark decision on the International Financial Activities in the Netherlands (6), the Commission ruled that a derogatory tax reduction consisting in a partial tax exemption and tax deferral for interest deriving from inter-company loans within a multinational group constituted State aid incompatible with the common market. Certain favourable rules to determine taxable profits earned by financial intermediaries may result into extraordinary tax advantages proscribed under the State aid prohibition set by Article 87(1) EC.

The starting point to determine taxable profits is the Member States’ accounting rules. In most corporate tax systems, the accounting of the financial instruments traded by financial institutions largely depends on the nature of the instrument and the motives of the holder. A trader entering in an arrangement for hedging purposes may accrue the receipts and payments in its accounts evenly in the accounting periods in which they are effectively realised. Alternatively, a financial trader may mark-to-market the instruments, thus recognising unrealised gains and losses. Under certain legislations, mark-to-market accounting is elective and reserved to certain financial institutions whose accrued flexibility in determining the taxable income provide sizeable tax benefits. Member States may decide whether foreign exchange gains and losses arising in respect of monetary item contracts (i.e. money contract held as receivables or payables by a company for the purpose of its trade) enter or not into the computation of the trading income for corporate tax purposes and whether exchange gains or losses are realised or unrealised, while providing special rules for financial intermediaries. The existence of derogatory rules for financial intermediaries may influence the market for

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(5) LOLR is defined as the discretionary provision of liquidity to a financial institution (or the market as a whole) by the central bank in reaction to an adverse shock which causes an abnormal increase in demand for liquidity which cannot be met from an alternative source (other than the central bank). The LOLR mechanism aims at preventing liquidity problems from impairing the solvency of individual banks and the stability of the banking system without however distorting the conditions of competition (the loan must be repaid). Under the Second Banking Directive, it is for the home country to decide to act as LOLR if impairment of a branch solvency of the parent bank or that of other home banks due to their dealings with the branch or due to depositors’ panic.

the exchange of money contracts, with the creation of unjustified financial advantages for the intermediaries established in certain Member States.

It shall also be noted that the most common return on a financial asset is interest. The main fiscal concern for recipients of interest income is the limitation of withholding taxation imposed on interest payments. The availability of a broad income tax treaty network, which will generally reduce and sometimes eliminate the withholding tax on the interest received or distributed, is critical for the competitiveness of a financial centre. But the ordinary tax reliefs against withholding taxation are sometimes not enough and specific reimbursement of taxes or exemptions in respect to interest income deriving from foreign sources may grant monopolistic position to intermediaries established in certain Member States. Even recently, the Commission decided that a tax system where corporate income tax is only refunded to foreign shareholders of Maltese companies specifically receiving payments from abroad, including interest payments, constitutes incompatible aid and asked Malta to repeal the system in question, as it was found to alter fair competition between undertakings especially those operating in the financial sector (1).

Another competitive tax factor in the credit market is the deductibility of interest charges. Favorable rules governing tax deduction of interest expense are sometimes granted to enhance the after tax returns of special purpose vehicles. Specific special-purpose-vehicle regimes are accordingly designed to provide for “tax neutral”, meaning that their taxable income is effectively nil. This is achieved by reducing the business income through interest payments to the note holders and other costs incurred in connection with the operations of the special purpose vehicles, thanks to its flexibility in deducting interest expenses under the national tax legislation. In another landmark decision concerning the Corporate Treasury Centers in France (2), a special purpose vehicle entrusted with more flexibility in deducting interest expenses deriving from inter-company loans, the Commission ruled that a specific tax deduction granted to such centers constituted State aid and was incompatible with the Common Market.

Given the negative effects on competition that certain preferential tax regimes for financial holdings may determine in the credit market, the Commission carefully examines the forms of taxation relating to the financial intermediaries, with a view to limiting possible market distortions. The Commission’s practice in this field demonstrates that Member States’ derogatory tax rules for financial products, such as debt issuance notes, securitizations, collateralized debt obligations, assets covered securities and other asset repackaging transactions, may affect fair competition between financial centers in the EU, to the detriment of market efficiency. The higher returns derived from such financial products no longer reflect efficiency increases and managerial expertise in risk allocation, but rather the tax breaks granted by Member States. Inevitably, these special tax regimes artificially segregate the geographic markets where the tax benefits are unavailable to the detriment of market efficiency and freedom.

The Commission Decision on Luxembourg’s Financial Holding Regime

On 19th July 2006, following a five-year long cooperation procedure with Luxembourg, the Commission decided that the preferential tax regime in favour of the Exempt, Milliardaire and Financial Holdings of 1929 was incompatible with State aid rules (3). The scheme constituted an existing aid (4) granted under the Luxembourg’s Law (7)

(1) Commission Decision of 23 March 2006 on the tax incentives granted by Malta in favour of the International Trading Companies (ITC) and the Companies with Foreign Income (CFI). Under the Maltese tax system, companies divide their business earnings into two schedules, namely income from domestic and foreign sources. The foreign income account includes all income and capital gains derived from foreign assets and profits and from a branch, agency or permanent establishment located outside Malta. Maltese companies receiving foreign-source income allocate this income to a so-called foreign income account, which will be taxed at the standard corporate tax rate of 35%, similarly to the domestic income. However, unlike the domestic income, the foreign income is entitled to foreign tax credit relief with respect to taxes incurred abroad. Furthermore, when a Maltese company distributes the profits deriving from the foreign source income account to its non-Maltese shareholders, the latter receive an extraordinary tax refund on top of the foreign tax relief. The combination of the refund and the foreign tax relief on foreign-source profits may result in zero or minimal taxation (up to 6.25% effective tax rate) in Malta, in lieu of the ordinary 35% tax rate.


(3) The text of the letter to the Member State is published on the website of the European Commission: http://ec.europa.eu/comm/competition/state_aid/decisions/additional_docs.html.

of 31st July 1929 and subsequent modifications, because enacted before the Treaty entered in force. Although the scheme was very old, its specific tax advantages have become more and more used by private funds to set outside the regulated banking industry. For this reason the scheme was recently amended under the law of 21st June 2005, without altering its existing State aid nature however, as the tax exemption remained unchanged, to exclude the most blatant tax abuse structures.

Following an in depth investigation procedure, the Commission conclusively decided that the scheme constitutes incompatible State aid but has not asked the beneficiaries to repay the aid granted, considering its existing State aid nature. A Commission decision on existing aid schemes does not have retroactive effects and it accordingly does not demand to recover the aid from its beneficiaries. The decision on the 1929 Holdings however demanded that the aid is formally repealed by the end of 2006, while the aid effects must be definitely eliminated by the end of 2010 to allow the current beneficiaries to terminate their ongoing contractual obligations without incurring tax penalties.

Description of the scheme

Under the law of 31 July 1929, the Exempt 1929 Holdings are not subject to any direct taxes in Luxembourg, including the corporate and the municipal business taxes (11), and real estate (12) and the net worth (13) taxes. Accordingly, dividends, interest, royalties and capital gains earned by an Exempt 1929 Holding are not taxable in Luxembourg. Payments of dividends, royalties and interest made by an Exempt 1929 Holding are not subject to any withholding taxes (14). Companies established in Luxembourg can be registered as a 1929 Holding, provided that they exclusively engage in acquiring, holding and developing the value of any forms of participation in other Luxembourg or foreign companies, including providing loans, holding patents, and licensing copyright or know-how to the participated companies. An Exempt 1929 Holding is not allowed to have any industrial activities on its own account or to maintain a commercial establishment open to the public.

A particular form of Exempt 1929 Holding, is the Exempt Milliardaire Holding, which can be formed by means of a contribution of shares of foreign companies, or whose paid-up share capital and reserves amount to at least € 24 million (LUF 1 billion). The exempt status is also applicable under certain conditions to the so-called Exempt Financial Holdings, another classification of the Exempt 1929 Holdings, which enjoy more latitude in financing the activities of the subsidiaries or affiliates of the group to which the holding belongs. Companies are considered to be members of a group if they use a common denomination which constitutes the symbol of reciprocal dependence or if the companies of the same group hold a substantial participation (at least 25 percent) in their share capital and maintain continuous economic relations between them. With respect to intra-group financing the Financial Holdings may, similarly to the Milliardaire Holdings, carry out a greater range of activities than an ordinary Exempt 1929 Holding. While the other Exempt 1929 Holdings may only finance companies in which they hold a direct participation, the Financial Holdings may grant loans to any group member company.

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(11) Luxembourg resident companies and permanent establishments of foreign companies are subject to corporate income tax (impôt sur le revenu des collectivités) levied at the maximum rate of 22 percent, and to the municipal business tax (impôt commercial communal) levied at a variable rate depending on the municipality, but with an average of 7.5 percent, on the taxable income corresponding to the gross income less expenses excluding non deductible expenses such as direct taxes, hidden payments of dividends and directors' fees.

(12) A municipal tax levied on the value of real estate owned by undertakings.

(13) Luxembourg imposes a net worth tax on resident companies and on permanent establishments of foreign companies at the rate of 0.5 percent applied on the net assets as at 1 January of each year, as the difference between assets estimated at their fair market value and liabilities vis-à-vis third parties.

(14) Dividends are subject to withholding tax at the rate of 20 percent on the gross amount paid (25 percent if the withholding cost is borne by the payer), unless the Parent-Subsidiary Directive (90/435/EEC) applies. This withholding tax maybe reduced pursuant to treaty provisions. Interest is generally not subject to any withholding taxes, unless qualified as hidden dividends. This withholding tax maybe reduced pursuant to treaty provisions. Most types of royalties paid to non-resident beneficiaries are subject to withholding tax levied at the rate of 10 percent (11.11 percent if the withholding cost is borne by the payer). Luxembourg has recently enacted in its tax legislation the exemption provided for by Council Directive 49/2003/EC of 3 March 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (OJ L 157 of 26.6.2003, p. 49). This withholding tax maybe reduced or waived pursuant to treaty provisions.
Appraisal of preferential tax regimes for financial holdings

The preferential tax regimes for financial holdings tend to have broad application. Unlike the direct subsidies which are necessarily limited to a restricted number of beneficiaries (not least for budgetary reasons), the preferential tax regimes are set to attract the greatest possible number of beneficiaries at reduced or no cost for the treasury which would have not taxed the beneficiaries in the absence of the preferential tax regime. It is accordingly problematic to characterize them as State aid, with particular respect to proving the condition that the measures provide selective advantages in favor of certain undertakings or productions and that they affect competition and trade in a sense proscribed by Article 87. Application of State aid rules to taxation presents particular difficulties since the schemes of taxation tend to be expressed in general terms while they produce unequal effects on taxpayers according to the specific circumstances they are in.

Distinguishing legitimate tax preferences for holdings from forbidden State aid

In the light of the State aid definition given by the Court (15), State aid is present when State intervention alters the pre-existing competitive position between competing undertakings. When State intervention takes the form of a business tax reduction, taxation is treated as a special factor in the costs of production incurred by undertakings in the course of their business. A reduction of the tax imposed on certain undertakings accordingly alters the competitive standing of such undertakings vis-à-vis their competitors. Taxation is however treated as a constant where it is an element of general taxation, so that even if the effective rate of taxation is reduced by effect of a general tax reduction it remains constant as a factor in the State aid equation. On the other hand, where a proportion of the general tax is not charged on derogatory grounds, the effect is that of a variable and accordingly to alter the pre-existing cost structure of the beneficiary of the charge relief. A fundamental element in the determination of the presence of State aid thus rests in the definition of the general tax system, which is made by reference to the Member State's tax jurisdiction, since to constitute State aid a measure must be imputable to the Member State. The notion of general tax system includes the limitations, exclusions or exceptions from taxation, such as, for example (in the area of direct business taxation), the differential taxation applied on residence as opposed to the source criterion, or the differentiations between active and passive income. Such limitations are considered as part of the general tax system (the constant) and, as they define the fundamentals of a tax system of reference, they cannot be subject to State aid control (16).

In its Notice on State aid and direct business taxation (17), the Commission clarified that the main criterion in applying Article 87(1) EC to a tax measure is to prove that the measure provides in favor of certain undertakings in the Member State an (unjustified) exception to the application of the tax system (18). Under the above-mentioned Court judgment Commission v Italy (19), the tax system of reference should thus first be determined to decide whether an advantage has been granted, that is to say, whether the exception derives directly from the basic or guiding principles of the tax system concerned or whether it is a derogation from the fundamental issues that characterize the corporate taxation of a country, including the definition of what is included in the tax base, what the tax rates are, whether a company's profits are taxed twice or if there is an integration of taxation of these profits when received by the shareholder, how cross-border transactions are taxed, and how taxes are administered. Under this analysis, it is recognized that the exemption of the business income deriving from outbound investments as applied by many European countries does not derogate from the general tax system if it is part of the normative benchmark of a Member State provided by such country's legislation and its bilateral tax treaties. But it is often found that countries' legislation and tax treaties contain provisions that derogate from the benchmark or normative response to the fundamental tax issues mentioned above. These provisions are intended to provide subsidies and incentives to address specific economic objectives which are external to taxation, and have been labeled tax expenditures. They need to be examined as spending programs rather than tax provisions.

(16) Under the tax expenditure theory developed by Professors Surrey and McDaniel in the US, it is possible to identify a tax preference as derogation from the general tax system. The way to identify the benchmark or normative structure of a tax system is by defining the fundamental issues that characterize the corporate taxation of a country, including the definition of what is included in the tax base, what the tax rates are, whether a company's profits are taxed twice or if there is an integration of taxation of these profits when received by the shareholder, how cross-border transactions are taxed, and how taxes are administered. Under this analysis, it is recognized that the exemption of the business income deriving from outbound investments as applied by many European countries does not derogate from the general tax system if it is part of the normative benchmark of a Member State provided by such country's legislation and its bilateral tax treaties. But it is often found that countries' legislation and tax treaties contain provisions that derogate from the benchmark or normative response to the fundamental tax issues mentioned above. These provisions are intended to provide subsidies and incentives to address specific economic objectives which are external to taxation, and have been labeled tax expenditures. They need to be examined as spending programs rather than tax provisions.

(18) Paragraph 16 of the Commission Notice.
(19) Case C-173/73, Italy v Commission, paragraph 14. The tax system of reference can be found either with respect to a normative benchmark or with respect to a functional benchmark, which is more in line with the interpretation of the Court which excludes the presence of State aid if a tax measure is "justified by the logic and general scheme of the tax system". The distinction is more theoretical than practical because it is evident that the normative benchmark has to be determined with respect to the national tax system concerned (and may not be defined on the basis of Community principles which are not to be found in EC law) which must be interpreted in accordance with the general objectives or principles of the tax system in question.

tax system (20). Holding companies often benefit from the so-called participation exemption system which is a general method to provide relief against multiple taxations. All companies holding substantial participations in other companies are holding companies, which derive passive income from the participated companies and capital gains from the sale or exchange of the participations held, and further distribute such income to their shareholders both nationally and internationally. When the activity of a holding company is limited to holding the portfolio participations, the holding is named pure because it does not have any operating role (21). It should be noted however that for competition law purposes also a holding is a financial undertaking unless it can be proven that its activities are limited to the mere exercise of its rights as shareholder and the perception of the fruits of the participations held like a passive stock owner (22).

In most national jurisdictions, the dividends distributed by the participated companies to the holding companies and the gains realized from the sale of participations traditionally benefit from favorable taxation as opposed to ordinary business income, because the holding and the controlled companies are considered to constitute one economic entity having the form of a group of companies. If the dividends and the gains earned by a holding were subject to ordinary tax, the income derived by the controlled "operating" companies would be taxable a first time upon production, a second time when earned by the holding company as dividends or gains and a third time, upon further distribution to the holding’s shareholders, as dividends. To avoid multiple taxation of the profits realized at the level of the operating companies, the distributed dividends and the gains realized by a holding are either subject to reduced taxation or exempt in their entirety. Such preferential tax regimes however are not extraordinary in that they do not constitute derogation from the ordinary tax burden of companies, but rather the adaptation of the tax system to the specificity (multiple taxation) of the holding companies. In this respect, the exemption is justified by the nature or general scheme of the tax system and does not provide any derogatory advantage to the holdings.

In opening its formal State aid investigation with respect to the preferential tax regime in favor of Luxembourg’s Exempt 1929 Holdings, the Commission did not consider the tax exemption of 1929 Holdings as opposed to taxation of other companies in Luxembourg, but it rather examined whether the exemption granted to the 1929 Holdings was a derogation with respect to other holding companies. The Commission found that the former holdings are granted several specific advantages which are not justified by the objective of avoiding the multiple taxation incurred by holdings. For example, the most significant exemption granted to the Exempt 1929 Holdings is the one relative to the interest from inter-company loans to the participated companies or to other companies directly or indirectly related to the group to which the holding belongs. The Commission considered that such exemption constituted an exceptional advantage not available to other holdings in Luxembourg. The payments received are deductible expenses incurred by the paying companies and their exemption is therefore unrelated to any taxation applied at the level of the paying companies. It was evident that the exemption granted to the Exempt 1929 Holdings was an advantage at the expense of Luxembourg’s treasury, without any justification under Luxembourg’s tax system.

The specificity of preferential tax regimes for holdings

The specificity notion derives from the existence of a disparity of treatment between situations that, under the nature or general scheme of a given tax system, are in comparable legal and factual situations and should therefore be treated alike. Specificity is difficult to prove in case of preferential

(20) In its practice, the Commission recognizes this fundamental approach. Unlike in other areas of State intervention in the economy, taxation is a domain of ordinary State involvement and the tax systems are used to pursue important economic policy objectives. Of course Member States are subject to Treaty rules including the prohibition of granting State Aid in whatever form including taxation, but cannot be deprived of their fundamental autonomy in setting their tax systems in the way they consider most appropriate. To fall within the scope of application of State Aid review a State measure should accordingly constitute an exception from the application of the tax system with respect to its nature and general scheme. The Commission shall accordingly not question the preferences (exceptions, exclusions, etc.) which are directly provided by Member States under the nature or general scheme of their tax systems, rather such preferences fall outside the scope of application of State Aid rules because they are part of the normative benchmark.

(21) Non-operating financial holding companies are commonly found in most countries, and some jurisdictions go as far as to require the establishment of such holding companies when different non-banking businesses are bundled with banks. However, financial conglomerates in many countries have a variety of options in how they may organize their activities, and they have responded by choosing a variety of organizational structures. There is thus no empirical evidence that the holding company structure is necessarily more efficient than other structures, provided that rules governing all types of structures are similar.

(22) Judgment of the Court of 10 January 2006, Case C-222/04, Finanzv v Cassa di Risparmio di Firenze, not yet published, paragraphs 111 et seq.
regimes for holdings, because the advantage is not specifically granted to any industry or economic sector. The Commission found however that the scheme in question was not effectively open to the entire Luxembourg’s economy because it only favored certain specific corporate vehicles which essentially provide certain coordination and financial services to related companies in the same group, thus constituting typical instruments to grant private lending to closely held companies and as such was State aid.

In particular, the Commission found that the tax benefits granted to the Exempt 1929 Holdings were limited to certain undertakings only, characterised by their functions. This led to the conclusion that they were selective or specific in the sense proscribed by Article 87(1) EC. The Exempt 1929 Holdings’ scheme was de-jure and de-facto limited to Luxembourg’s companies carrying out a numerus clausus of activities, essentially having financial nature. In order to benefit from the exemption, the beneficiaries have to establish a separate entity dedicated to perform the eligible activities described under the 1929 legislation. The establishment of such structure involved additional costs in addition to the ordinary business expenses, including (i) the administrative cost of a new company, (ii) the cash or stock contribution to meet the minimum paid-in capital requirement, (iii) the capital duty imposed on the initial capital contributions (totalling 1 percent of the contributions’ value), (iv) the annual subscription tax (totalling 0,20 percent of the paid-up share capital and share premiums’ value), (v) the locking-in of resources dedicated to the set-up the holding, and (vi) the opportunity cost concerned with more productive use of capital. For the Commission, the presence of considerable additional costs related to the creation of the Exempt 1929 Holding effectively limited the exemption only to certain undertakings creating a dedicated structure in Luxembourg (23) and was therefore selective.

**Justification by the nature of the derogation**

If a tax preference is found to be selective, it may still be justified by the nature or general scheme of this system in relation to sectors being excluded, but only if necessary and proportionate to achieve the objective set forth by the measure (24). As observed by the Court, the question to be determined is whether under a particular statutory scheme a State measure is such as to favor certain undertakings (or certain productions) in comparison with other undertakings (or other productions), ‘which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question’ (25). Where the distinguishing criterion used by the national legislation at issue is justified by the nature or general scheme of that legislation, a selective measure is not in the nature of State Aid, while in case a justification is not provided the measure fulfills the selectivity requirement.

To illustrate, under a recent judgment (26), the Court upheld a Commission decision relating to the banking sector considering that a reduced tax rate for part of the profits earned by the Italian banks taking part in corporate reorganizations (27), was not justified by the specificities of the banking sector as the tax advantage in question was only available to banks carrying out certain transactions and was therefore not available to all companies in that sector (28).

According to Luxembourg, the Exempt 1929 Holdings’ scheme was also justified as a tax vehicle to encourage distributions of the profits accumulated by operating companies and avoid further taxation of such profits when received by certain holdings. Due to their non-taxable companies’ nature, the Exempt 1929 Holdings were accordingly excluded from the benefits of the Parent-Subsidiary Directive and of most bilateral conventions to avoid double taxation and prevent fiscal evasion. For Luxembourg, this justified a specific tax relief for the Exempt Holdings, which typically operate in a multinational context.

For the Commission, however, although in such an international context, there is often the problem

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of making good a holding company of the taxes withheld by the foreign State of a paying operating company, Luxembourg ordinarily provided a foreign tax credit relief with respect to the taxes paid abroad. This relief however could not exceed the Luxembourg’s tax imposed on that income and since a 1929 Holding’s income was fully exempt the scheme was more beneficial than the normal credit system (29). The Commission concluded that the need to provide relief from foreign tax paid could not justify the exemption in favour of the Exempt 1929 Holdings, and the specific nature of their tax regime was accordingly confirmed.

**Effects on competition and trade**

Under the settled case law of the Court, for a measure to distort competition it is sufficient that the recipient of the aid competes with other undertakings on markets open to competition (30) and a measure affects intra-Community trade when State financial aid strengthens the position of an undertaking compared with other undertakings competing in intra-Community trade (31). In this respect, the Commission considered that the 1929 Holdings were typically active in the financial sector as they perform specific business activities such as providing loans, issuing bonds, perform invoice discounting and managing financial assets in favour and/or with respect to both directly and indirectly controlled companies and other companies in a group to which an Exempt 1929 Holding belongs. Furthermore, the Exempt Financial Holdings and the Exempt Milliardaires Holdings enjoy high flexibility in exercising such financial activities even with respect to unrelated entities and can manage collective investment funds. The Exempt 1929 Holdings are clearly active in purchasing, managing and licensing patents with respect to directly and indirectly owned subsidiaries, or other companies in the group to which the holdings belong. Finally, the Exempt 1929 Holdings provide management, coordination and other intra-group services, which also constitute economic activities that can be provided by independent service providers in the market.

For the Commission, competition is distorted because the above indicated activities enjoy full exemption from various income taxes when performed by the Exempt Holdings, while being taxable when performed by independent providers exercising comparable business activities such as financing, factoring, managing intangibles and providing coordination services, outside of a group structure. In substance, for the Commission, in the relevant market of corporate services traditional banking lending is in competition with unregulated lending, and the higher yields of lenders and cost borne by companies for the latter services should solely reflect better services rather than incorporate a State premium in the form of reduced taxation. The Commission concluded that trade and competition could be affected in several ways because of the tax regime in favour of Luxembourg’s Exempt 1929 Holdings. The Commission furthermore found that the scheme could result in anticompetitive practices ranging from below-market financing of the Exempt Holdings’ affiliates to withholding of credit to the competitors of the affiliates. In conclusion, in competitive financial markets, financial intermediaries should not be subsidised to finance their affiliates nor should their position been strengthened to give them the power to injure the competitors of their affiliates. Furthermore, the geographic restrictions stemming from the limited jurisdiction of Luxembourg’s exemption may in fact enhance the availability of local credits and influence the development of secondary markets for credit in Luxembourg, to the detriment of the common market.

**Compatibility with the Common Market**

The Commission normally enjoys a certain discretion in applying the exceptions set forth by Article 87(3) EC and possible declare State aid to be compatible with the common market. Besides the case in which State aid is granted in compliance with the specific compatibility guidelines, pursuant to Article 87(3)(c) EC the Commission may authorize “aid to facilitate the development of certain economic activities ... where such aid does not affect trading conditions to an extent contrary to the common interest”. The Commission balances the positive effects of the aid on the economic development with the distortions involved in the light of the common interest, and may exceptionally authorize the aid, if the overall effect is positive.

While this is normally the case when the tax preference is State Aid to investments or to job creation (where the positive effects for the Aid recipients are more easily measures), it is not the case of the preferential tax regimes for holdings which constitute operating aid. Operating aid is aid that reduces the operation costs of its beneficiaries without producing durable economic developments or efficiency gains for its beneficiaries. Operating aid

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(29) This advantage is particularly relevant with respect to the Exempt Financial holdings and Milliardaires Holdings which enjoy accrued flexibility in providing loans to participated and affiliated companies, and in licensing intangibles.  
is normally forbidden because disproportionate with respect to its objectives and highly disruptive of fair competition.

Since the beginning of its probe, it seemed to the Commission that none of the derogations provided for in Article 87(2) and (3) EC could apply, because the aid scheme constituted operating aid, which did not appear to be linked with specific projects, but rather to reduce the holdings’ current expenditures without contributing to pursue any Community’s objectives. The Commission investigation confirmed that such fiscal aid regimes were indeed incompatible with the common market.

The Commission furthermore noted that, as confirmed by the case law of the Court (32), the simple fact that the preferential tax regime for the Exempt 1929 Holdings was available to companies registered in Luxembourg constituted a breach of the freedom of establishment of undertakings registered in other Member States. In this respect, the Commission could not authorise aid which is contrary to a specific provision of the Treaty. State aid, certain conditions of which contravene other provisions of the Treaty, cannot for this sole reason be considered by the Commission to be compatible with the common market (33) and accordingly the aid was considered by the Commission to be incompatible with the common market.

Procedure

With its decision, the Commission ruled that the 1929 Holdings’ scheme fulfilled all the relevant conditions to be considered operating State aid incompatible with the common market, as it afforded to its beneficiaries several derogatory tax exemptions translating into reduced tax liability, which are de-jure and de-facto reserved to special tax vehicles established in Luxembourg and exercising a select number of business activities including the provision of financial and licensing services to related companies in a multinational group and manage collective investment funds. The Commission concluded that in the relevant market of corporate services certain forms of unregulated lending benefited from higher yields than traditional banking lending because of the reduced taxation under the Luxembourg scheme for Exempt 1929 Holdings. As remedy, the Commission demanded Luxembourg to abolish the exempt status of the Exempt 1929 Holdings.

Phasing-out the existing holdings

Considering the existing aid nature of the scheme, it was possible for the Commission to grant a transitional period in order to avoid damaging Luxembourg’s financial marketplace, since the Exempt Holdings existing at the date of the Commission’s decision had reasonable expectations to believe in a non abrupt termination of a scheme in place since 1929. Under the case law of the Court of First Instance (34), “in accordance with the principle of legal certainty, the Commission is, as part of its constant review of existing aid, only empowered to require the elimination or modification of such aid within a period which it is to determine”. The Commission enjoys a discreetional power in granting a transitional period before an existing aid scheme is abolished, during which the aid can be lawfully implemented.

In exercising its discretion, the Commission had to motivate the decision to fix such a period. A motivation could only be based on the legitimate expectations of the existing beneficiaries as opposed to new holdings. The Luxembourg authorities had observed that such a long-lasting and open-ended tax exemption could not be repealed “from one day to the next” without provoking fundamental changes in the nature of Luxembourg’s tax system. The argument persuaded the Commission that while the preservation of an exemption system in favour of the 1929 Holdings was incompatible with the common market, its long-lasting nature (76 years without fundamental changes) provided legitimate reasons for the existing beneficiaries to maintain the exemption for some more time after it being declared incompatible State aid.

Account taken of other specific and factual elements presented by the Luxembourg’s authorities, the Commission decided, on the one hand, to demand the immediate elimination of this incompatible existing aid scheme, and on the other hand to leave the necessary time for Luxembourg to adapt its legislation and for the current beneficiaries to divest from the existing holding structures without suffering tax consequences.

The Commission accordingly concluded that it was appropriate to demand the most rapid elimination of the Exempt Holding regime and enjoined Luxembourg to amend its legislation by the end of 2006. The Commission also requested that no new holdings are created as of the date of notification of its decision. The Commission however

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considered that the current beneficiaries should not be deprived of their exempt status until the end of 2010, i.e. four years after the suppression of the scheme (end 2006). This transitory period was granted in order to give time to the holdings concerned to divest from the existing holding structures account taken of the fact that suppression of the tax exemption will greatly change the economics of the ongoing investments and will require a substantive restructuring of the corporate groups to which the holdings belong.

It was clear that the transitory period for the exempt status to end in 2010 was granted to the existing beneficiaries, these being the only ones to enjoy legitimate expectations to a future duration of the scheme. Considering the specific nature of the holding regime in question, the Commission imposed a special condition consisting in the immediate loss of the exempt status in case of a partial or total transfer of the stock of an existing holding to a new beneficiary. The clause was evidently targeted to avoid an abuse of the existing status which could take place if an exempt holding changes ownership. The Commission considers that in such a case the holding shall loose its exempt status because it no longer enjoys the expectations of an existing beneficiary. Luxembourg was mandated by the Commission to implement the decision by adopting the necessary rules in order to ensure the effective suppression of the scheme while preserving the legitimate expectations of its current beneficiaries and to progressively restructure Luxembourg's financial marketplace.