The Italian tax premium in favour of newly listed companies and the notion of selectivity relative to direct business taxation

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Background

A recent negative decision by the Commission of 16 March 2005 (1) on an Italian State aid scheme providing generous business tax incentives in favour of companies going listed on regulated stock exchanges in the EU offers some interesting insights into the Commission's process to distinguish between State aids and legitimate tax preferences.

It is known that the exact distinction between State aids and derogatory taxation is controversial. The Commission notice on the application of State aid rules to measures relating to direct business taxation (2) prepared the ground for an expansive role for the Commission to review Member States' proposed and existing business tax regimes, with a view to creating a level playing field for undertakings competing in the common market. This review has created some tension between the Commission and the Member States because of the unclear distinction between the effects-based notion of State aid and the variable effects that general tax measures produce on different groups of undertakings. The Commission (Doc. C(2004)434 of 9.2.2004) recently published an explanatory report on the implementation of the Commission notice on direct business taxation (3) without addressing this specific point.

The scheme in question provided the companies going listed on a regulated EU stock exchange with a double tax incentive consisting in the three-year corporate tax rate reduction and the extraordinary deduction of certain cost items incurred because of the listing transaction. The scheme was enacted by the Italian Government with its 2004 budget law (DL 269/2003) entering into force on 2 October 2003, the date of publication in the Italian OJ (4). The scheme was conceived as an urgent measure to quick-start the Italian economy following a period of slow growth. Accordingly, it targeted some select sectors of the Italian economy to drive the economic upturn of the country. The Commission immediately raised its concerns about the newly introduced incentives and requested Italy to provide the necessary information to establish the possible aid nature of the scheme. Notwithstanding this initial request, Italy converted the scheme into law (5). In February 2004, the Commission opened the formal investigation procedure, raising initial doubts about the aid nature of the scheme and its compatibility with the common market (6).

During the formal procedure, the Italian Government defended the legality of its scheme against the Commission review. In March 2005, however the Commission concluded that the scheme constituted State aid and that it was incompatible with the single market. Considering that the aid had been enacted without prior Commission approval, the Commission also ordered the recovery of the tax advantage illegally granted from its beneficiaries. In May 2005, Italy lodged an appeal before the Court of First Instance (Case T-211/05, pending) claiming the Commission's error in characterising the scheme in question as incompatible aid.

Granting tax breaks is attractive for Member States

The Commission is particularly mindful of the fact that in situations of slow economic growth and budgetary constraints, Member States increasingly rely on tax breaks to stimulate their economies and it is vigilant about the distortions that certain measure can provide to competition in the common market. State aid in the form of fiscal incentives is easier to manage by Governments and more efficient, in that it may be formulated as a general measure, although effectively designed to produce benefits for particular taxpayers according to their

(3) Published in the Europa website: http://europa.eu.int/comm/competition/state_aid/others/
individual circumstances and therefore targeted at sectors of the economy that Member States intend to strengthen.

In an attempt to stimulate the economy, the Italian budget law of 2004 enacted a general incentive for all companies going listed within the year. The scheme was formulated as a general measure, but it raised the question of whether its effects could be considered selective. In addressing this question, the Commission had to conduct a State aid analysis which typically involves a multiple-step examination.

With its notice on fiscal aids, the Commission clarified that the main criterion in applying Article 87(1) to a tax measure is to prove that the measure provides in favor of certain undertakings in the Member State an exception to the application of the tax system (1). The common system applicable should thus first be determined to decide whether an exception to the system is provided. According to the case law of the Court, it should be further examined if the exception within that system is justified by the nature or general scheme of such a system, that is to say, whether they derive directly from the basic or guiding principles of the tax system in the Member State concerned (2). If this is not the case, then selectivity is in principle involved, unless it can be justified because necessary and proportionate to reach the objectives set by the specific scheme (3). The latter means that the assessment of whether a tax scheme is selective is based on a familiar discrimination test whereby a differentiation in tax treatment must be objectively justified and may not go beyond what is warranted by the differences in the circumstances concerned with taxing non-comparable situations. As observed by the Court of Justice, 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’ (4). Where the distinguishing criterion used by the national legislation at issue is justified by the nature and/or general scheme of the legislation, a selective measure is not in the nature of State aid.

Examination of the tax premium for newly listed companies

The scheme consisted in two corporate tax incentives for companies going listed for the first time on a regulated stock exchange. First, pursuant to Article 11 of DL 269/2003, the companies going listed on a regulated European stock exchange by means of initial public offering (IPO) within the time-period between 2 October 2003 (the date of entry into force of the 2004 budget law) and 31 December 2004 could benefit from a tax premium consisting in three-year reduced corporate income tax rate of 20 percent in lieu of the 33 percent standard rate. Second, under Article 1(1)(d) of DL 269/2003, the amount of expenses incurred to go listed was excluded from the taxable income in the year of listing. The exclusion came on top of the ordinary deduction allowed for the costs involved with the IPO and had the effect of reducing the effective tax burden applied in the year of the listing.

Although formally open to all companies, the Commission had doubts that the scheme constituted a derogation from the general tax system and decided to open the formal investigation procedure. By taking this public step, the Commission intended to inform the financial markets concerned with the new listings of the recovery risks concerned with a possible finding that the scheme in question constituted State aid. Both the Italian authorities and Borsa Italiana Spa responded to the Commission’s invitation to comment criticizing the Commission tentative qualification of the scheme as State aid. According to them, the scheme was to be viewed as a general tax policy measure aimed at fostering the listing of Italian companies against the negative trend registered in the recent years, and to strengthen their capitalisation and competitiveness on the global markets; as such the scheme would fall outside the scope of State aid review. They claimed that the scheme was not selective, nor it affected competition because any undertaking could benefit from the premium by going listed in a European stock exchange. According to the Italian comments, the scheme was applicable across the board to all business sectors, industries and territories and as such it was not selective. Finally, the scheme was not affecting competition because of its limited duration and budget and because foreign companies were equally eligible to receive the tax premium when going listed abroad.

Solving the ambiguities: A comprehensive notion of fiscal aid

Following a thorough examination of the Italian arguments, the Commission concluded that the

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(1) Paragraph 16 of the Commission notice, indicated in footnote 2.
(2) Judgement of the Court of Justice of 2 July 1974, Case C-173/73, Italy v Commission 1974 [ECR], p. 709.
(4) Case C-143/99, paragraph 17.
measure was State aid within the meaning of Article 87(1). Pursuant to Article 87(1) the notion of aid is dissected into four or more distinct parts. Firstly, a State aid measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. Secondly, the advantage must be granted by the State or through State resources. Thirdly, the measure must affect competition and trade between Member States. Lastly, it must be specific or selective in that it favours certain undertakings or productions.

As these elements are closely interdependent, the Commission examination was a comprehensive one. It was impossible for the Commission to identify a benefit or advantage without identifying the group in relation to which such advantage was enjoyed and accordingly to address the problem of specificity presented by the expressions ‘certain undertakings’ and ‘certain goods’ provided in Article 87(1), without considering whether the advantage was granted by the State through its tax system, while the presence of a tax advantage was inseparable from ascertaining the specificity of the scheme. Similarly, the distortion competition and the effect on intra-Community trade were closely connected with the tax advantages provided and their specific character.

In the analysis conducted in this case, a substantive examination of the general principles of the national tax system was necessary to confute the Italian argument that the Commission was unduly intervening in an area traditionally reserved to Member States such as direct taxation to circumvent its obligation to regulate the competition distortions deriving from the differing Member States’ tax systems with the legislative means set forth by Articles 93 and 94 of the Treaty.

Selectivity and justification of specificity

In its review of the scheme, the Commission essentially considered that the measure provided selective advantages in favour of certain undertakings being able to go listed in the short period foreseen by the law. The tax premiums accordingly constituted exceptions from the general operation of the tax system. The Commission considered that both the tax rate reduction and the tax deduction described above were derogations because although in principle applicable to all companies going listed, there was no tax motivation for effective lower taxation when a company goes listed. In particular, the tax premium consisting in the tax rate reduction seemed unrelated to the listing and the extraordinary deduction was atypical of expenses that have already been deducted from the taxable income. The Commission accordingly concluded that the scheme in question constituted a tax incentive, because it reduced the effective taxation of the companies going listed. The scheme granted an economic advantage to its beneficiary by means of State resources and as far as it affected competition and intra community trade by favouring certain undertakings, it constituted State aid within the meaning of Article 87(1). The relevant issue was whether the tax premiums at hand were specific and distorted competition by favouring certain undertakings or productions in a way proscribed by Article 87(1).

Pursuant to the Commission practice, to be considered general a tax measure must be effectively open to all undertakings on an equal access basis and shall not be de facto reduced through any conditions that restrict its practical effect. Member States must and do remain at liberty to pursue policies aimed at creating a favourable economic climate. Measures which apply across the board to all sectors of the economy are, therefore, in principle permissible. Member States must not, however, favour certain individual undertakings, or even whole sectors of the economy, over others.

The Commission examines a possible State aid measure not in terms of the form that it takes, but in terms of its effects. For the Court of Justice, ‘the fact that the aid is not aimed at one or more specific recipients defined in advance, but that it is subject to a series of objective criteria pursuant to which it may be granted, within the framework of a pre-determined overall budget allocation, to an indefinite number of beneficiaries who are not initially individually identified, cannot suffice to call in question the selective nature of the measure and, accordingly, its classification as State aid’.

The Commission noted that the scheme in question was effectively selective because it excluded, for example, both the undertakings that were already listed and the undertakings that did not fulfill the conditions for being listed or that, in any event, did not go listed in that period. The exception did not seem to be justified by the nature of the system because a corporate tax system does not typically award deductions in excess of actual expenses incurred, nor it temporarily reduces the tax rate applicable to certain profits of companies going listed unless for general reasons such as administrative simplicity (e.g. forfeit deduction).

(1) Paragraph 9-12 of the Commission notice, indicated in footnote 2.


(3) Case T-55/99 Confederación Española de Transporte de Mercancías (CETM) v Commission of the European Communities 2000 [ECR], II-3207, paragraph 40.

recognised for expenses that are difficult to determine or to prove), or to ensure fiscal neutrality between companies being in objectively different conditions. None of these justifications were found for the incentives in question.

Italy objected that if a State aid measure must be appreciated on the basis of its effects, any tax preference may constitute aid and the distinction between taxation and State aid would become blurred. The Commission however explained that the tax incentives in question do 'not address any fundamental tax distinctions between the situations of listed as opposed to non-listed companies. In particular, since the scheme provides for a tax rate reduction applicable on the future profits earned by its beneficiaries, it is disproportionate because unrelated to the fact that such beneficiaries go listed, to their capital structures, and to other characteristics deriving from the listing' (1). In conclusion, the Commission showed that the scheme was de facto selective and that the tax premium could not be justified by the logic and general scheme of the system as the tax differentiations foreseen by the scheme was not targeted to any demarcations in the Italian tax system.

The two-pronged justification by the nature of the system

It should be noted that the Court of Justice devised a two-pronged doctrine with respect to the justification of a tax measure by the nature of the system. First, the Court considered that where a difference of treatment between undertakings is justified by reasons relating to the logic or general scheme of the system there is absence of aid (2), because there is an internal (tax) justification for a given fiscal preference. It is known that for the Court the notion provided by Article 87(1) ‘does not distinguish between the measures of State intervention by reference to their causes or their aims but defines them in relation to their effects’, however a selective measure can be justified by the nature or the general scheme of the tax system (3).

An example of justification by the nature or general scheme of the tax system is found in the judgment of the Court of 24 April 2004 (4) concerning the question whether the existence of different applicable rates for a tax on insurance premiums in the U.K. may create distortions of competition forbidden by Article 87(1). The Court held that,

even on the assumption that the introduction of a higher rate of tax for certain insurance premiums involved an advantage for operators offering contracts subject to the lower standard rate, the application of the higher rate of tax, in that case, was justified by the nature and the general scheme of the national system of taxation of insurance, and in particular by the objective of limiting tax avoidance to which those contracts were particularly exposed, and could not therefore be regarded as constituting aid (5).

Second, the Commission has to consider whether a selective measure can be justified by the logic of the scheme itself. This justification makes reference to an external or economic logic that is different from the internal or tax logic of the system. To be proven valid, the justification must be relatively broad and proportionate to the objective pursued by the scheme. To illustrate, in a landmark judgement of the Court concerning an energy tax reduction (6), the Court not only held, following the above-mentioned case law, that the condition of selectivity is not satisfied by a measure conferring an advantage on its recipient when this is justified by the nature or general scheme of the system of which it was part, but it also concluded that a selective advantage may in principle be justified by the specific logic of the scheme. In the particular case, the Court considered that the ecological considerations underlying a derogatory energy tax reduction in favour of the undertakings of the manufacturing sector may not justify treating the consumption of natural gas or electricity by undertakings supplying services differently than the consumption of such energy by undertakings manufacturing goods, because energy consumption by each of those sectors is equally damaging for the environment. The dictum confirms the principle that a tax derogation can be justified by the specificity of the measure, if its scope is sufficiently broad and targeted to the (external) objective pursued.

In reviewing the Italian tax incentives in favour of the newly listed companies, the Commission examined both possible justifications of the specific advantage provided by the scheme: first it established that the tax rebate at hand constituted a derogation from the general corporate tax rules applicable in Italy and that such a derogation did not descend from any material difference under the nature or general scheme of corporate taxation and as such it was not justified; second, it ascertained that, with particular respect to the extraordinary deduction granted, the scheme could not be justified by its own specific objectives because

(4) Judgment of the Court of 29.4.2004 in Case C-308/01, GIL Insurance.
(6) Case C-143/99, Adria-Wien Pipeline, paragraphs 42 to 54.
its short duration made it effectively inaccessible to many potential beneficiaries (1). The Commission observed that the burden of proof for such justifications rested on Italy, while no reasonable proofs were provided of the fact that the incentives were effectively targeted to the specific objective of promoting the listing of new companies.

The Commission considered a final objection raised by Italy with respect to the limited time-period of operation of the scheme. In particular, Italy observed that the reduced number of beneficiaries being eligible could be justified by budget constraints and would further substantiate the conclusion that the effect on competition of the measure was limited. The Commission rejected this argument because it considered that the limited budget of an incentive does not take away its aid character, nor it reduces the competition distortion deriving from the measure. In this respect, the Commission referred to the relevant case law of the Court (2) confirming that the only relevant consideration is whether a measure as it currently applies only to certain undertakings or certain economic sectors, and any plans to make it a general measure in the future are irrelevant.

What truly mattered for the Commission was that the tax premiums at hand determined an alteration (through taxation) of the pre-existing competitive position of certain undertakings being engaged in business activities open to international competition, and as such they constituted aid susceptible to affect competition.

**Effects on competition and trade**

**Geographical scope of tax preferences and effects on competition**

In its review, the Commission addressed an objection frequently raised by Member States when subject to State aid review of their tax preferences. According to Italy, the scheme did not amount to any specific advantage and could not have the effect of distorting EU competition and trade, because it reduced the tax of undertakings already subject to different levels of taxation.

In responding to this objection, the Commission noted that its review was solely concerned with the advantages that Italy granted to certain beneficiaries, without considering whether such advantages were aimed at compensating the local undertakings from a higher taxation vis-à-vis foreign undertakings. The Commission considered that a national fiscal measure, although formally general, constitutes aid if it affects more prominently certain national industrial sectors in view of promoting their competitiveness with respect to foreign competitors subject to lower charges.

Since the incentives were granted through the tax system, it mainly favoured Italian undertakings going listed because, while the tax premium applied to the worldwide profits incurred by the Italian undertakings, it only applied to the local profits of the foreign undertakings going listed, and also in this respect, the latter ones were put at a disadvantage. The Commission on this point observed that while the nature of the tax system would ordinarily justify this fiscal disparity, the fact that the scheme was an extraordinary incentive distinct from the normal operation of the Italian tax system disallowed the justification and cross-border competition was therefore affected.

The Commission confirmed its appraisal made on opening the formal investigation that the measure could distort competition and affect trade between Member States. Following the settled case law of the Court, according to which for a measure to distort competition it is sufficient that the recipient of the aid competes with other undertakings on markets open to competition (3), the Commission considered that the business activities carried out by the beneficiaries of the scheme could take place in international markets and involve trade and other business activities in markets where competition is intense.

In developing its analysis the Commission observed that by going listed on a regulated stock exchange companies seek to achieve several relevant financial objectives including among others (a) to increase and diversify the sources of corporate financing helping to pursue asset and stock acquisitions; (b) increase the financial standing of the listed company with respect to debt holders, suppliers and other creditors accepting the stock as a guarantee of debt; (c) obtain a market valuation for the company, so to facilitate at any given time merger and acquisition transactions to take place. The Commission concluded that by providing an extraordinary tax advantage for companies deciding to go listed, Italy improved their competitive conditions and their financial standings vis-à-vis other competitors not going listed and not subject to Italian taxation. Considering the calibre of the companies going listed and given that the above effects may favour the Italian beneficiaries operating in markets where intra-Community trade takes place, the Commission considered that the scheme affected trade and distorted competition. The

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(2) Case C-75/97 Kingdom of Belgium v Commission (Maribel bis/ter scheme), 1999 [ECR], p. I-3671, paragraphs 41-43.  
Commission moreover noted that, as of the day of its decision, a number of companies went listed on the Italian stock markets and became entitled to fiscal benefits being proportionate to the future profits earned in the following three years of operation. These companies belonged to various sectors ranging from manufacturing to public utilities, all open to international competition. The Commission accordingly held that these specific features of the beneficiaries was justifying the conclusion that advantages granted to them could affect intra-Community trade and competition.

Based on the projected earnings incurred by some beneficiaries before the listing over three years, the Commission established that each of the listed companies could benefit from considerable tax reductions. For example, the Commission calculated that the tax benefits which would be enjoyed by one beneficiary alone over the period 2004-2007 would potentially total € 75 million. However, because of the a limitation of benefits clause of Article 11 of DL 269/2003, the actual premium could not exceed € 11.7 million over the three-year period. In any event, the Commission could not rule out that the benefits accruing to any individual beneficiary would comply with the de minimis limitation. Considering that the beneficiaries are often leaders in Italy in their respective business sectors, the Commission concluded that the distortion of competition deriving from the scheme in the different sectors where the beneficiaries operate could be relevant.

Compatibility and notion of operating aid

The Commission observed that none of the exceptions provided for in Articles 87, paragraphs (2) and (3) of the Treaty, under which State aid may be considered compatible with the common market, applied in the present case.

It is interesting to note the Commission’s reasoning in indicating that the scheme constituted operating aid and for this reason alone could not be considered compatible with the common market. As an exception from a general principle, compatibility with the single market must be interpreted narrowly. The compatibility examination, however, requires the assessment of complex factual situations in which the Commission enjoys some latitude. Under the settled case law of the Court (1), it appears that Article 87(3) of the Treaty confers on the Commission a wide discretion to allow aid by way of derogation from the principle in Article 87(1) that State aid is incompatible with the common market. The Commission’s examination entails consideration and appreciation of complex economic facts and conditions. Since the Community judicature cannot substitute its own assessment of the facts, especially in the economic field, for that of the originator of such a decision, the Court must confine itself to checking that the rules on procedure and the statement of reasons have been complied with, that the facts are materially accurate and that there has been no manifest error of assessment or misuse of powers. Notwithstanding the discretion the Commission typically enjoys, it examined one by one the derogations to the general State aid prohibition provided by Article 87(2) and (3) and concluded that the tax relieves granted under the scheme in question were not covered by such derogations.

The Commission finally examined the regime at hand in the light of the derogation provided by Article 87, (3)(c). The latter provision empowers the Commission to authorise aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect the trading conditions to an extent that is contrary to the common interest. Also this derogation could not be accepted by the Commission, however, because the Commission observed that the tax advantages granted by the regime were not related to specific investments, to job creation or to specific projects, while they simply constituted a reduction of charges that should normally be borne by the beneficiaries concerned in the course of their business activities without contributing to achieving any Community objectives. The scheme had therefore to be considered as operating State aid and for this reason it was viewed to be incompatible with the common market.

Market distortion and recovery

What was at stake in this case was not a Member State ability to shape its tax system in the way it considered most appropriate, but rather a Member State providing disproportionate tax reductions to a select number of beneficiaries and having the effect of seriously distorting competition in the common market, without justification. It was critical for the Commission to put a rapid end to this harmful distortion of competition.

The Italian authorities put their tax premiums into effect without prior notification to the Commission and therefore they did not fulfil the stand-still obligation provided by Article 88(3) of the Treaty. In such circumstances, Article 14 of Council Regulation N° 659/1999 laying down the implementing rules for the application of Article 88 obliges the

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(1) Joined Cases of the Court of First Instance T-298 et al./97, T-1 et al./98 Alzetta Mauro and others v Commission of the European Communities, 2000 [ECR], II-2319.
Commission to order a Member State to recover the unlawful State aid from its beneficiaries to restore, as far as possible, the competitive position that existed before the aid was granted.

In the case at hand, the Commission, completed its procedure with a final negative decision shortly after the end of the year in which the scheme was put into effect (2004) and therefore before the tax liability of most beneficiaries had become definitive. The Commission accordingly made what was possible under the procedural rules to limit the market distortion. However, the Commission could not exclude that certain newly listed companies had already reduced their advance tax payments relative to the fiscal year 2004. Therefore, the Commission concluded that it was necessary to order the recovery of the aid already made available to the beneficiaries. The Commission accordingly demanded Italy to enjoin to the beneficiaries of the scheme, within the two months of the decision, to reimburse the aid with the relative interests (1) and to provide evidence that the recovery proceedings had initiated.

(1) Without prejudice, however, to the possibility that all or part of the aid granted in individual cases is considered as compatible aid, in particular under Article 5(b) of the Block Exemption Regulation in favour of SMEs.