

COMMISSION

COMMISSION DECISION

of 11 December 2002

on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax

(notified under document number C(2002) 4487)

(Only the Portuguese text is authentic)

(Text with EEA relevance)

(2003/442/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 88(2) thereof,

Having regard to the Agreement on the European Economic Area, and in particular Article 62(1)(a) thereof,

Having called on interested parties to submit their comments pursuant to those Articles ⁽¹⁾, and having regard to those comments,

Whereas:

I. PROCEDURE

- (1) By letter No 18 of 5 January 2000 from the Portuguese Permanent Representation, registered as received by the Commission on 10 January 2000, the Portuguese authorities notified the Commission of a scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores. Since this notification arrived late, in response to a request for information from the Commission in letter D/65111 of 7 December 1999 sent to the Portuguese Permanent Representation following articles in the press, and since the scheme in question was thought to have entered into force before being authorised by the Commission, the scheme was entered in the register of non-notified aid.
- (2) By letters D/51013 of 6 March 2000, D/53849 of 17 July 2000 and D/50739 of 19 February 2001, and by reminders D/52933 of 19 July 2001 and D/54133 of 9 October 2001 sent to the Portuguese Permanent Representation, the Commission departments requested additional information. The Portuguese authorities replied by letters 488 of 2 May 2000, 548 of 16 May 2000, 871 of 22 August 2000, 1864 of 13 June 2001, 2827 of 25 September 2001 and 44 of 9 January 2002 from their Permanent Representation, registered as received by the Commission on 3 May 2000, 18 May 2000, 23 August 2000, 19 June 2001, 1 October 2001 and 11 January 2002 respectively.

⁽¹⁾ OJ C 127, 29.5.2002, p. 16.

- (3) By letter SG (2002) D/229609 of 26 April 2002, the Commission informed the Portuguese Government that, after examining the information supplied by the Portuguese authorities on the scheme in question, it had decided under Articles 87 and 88 of the EC Treaty and Articles 61 and 62 of the EEA Agreement not to raise any objections to the part of the scheme which concerns reductions in the tax base and income tax credits and to initiate the procedure laid down in Article 88(2) of the Treaty in respect of the part of the scheme which concerns reductions in the rates of income and corporation tax. The Commission also invited the Portuguese authorities to submit their comments and to provide all such information as could help to assess the part of the scheme in question within one month of the date of receipt of that letter.
- (4) The Commission's decision not to raise objections to part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores, considering it to be compatible with the Treaty, and to initiate the formal investigation procedure in relation to another part of the scheme in question was published in the *Official Journal of the European Communities* ⁽²⁾. Interested parties were invited to submit their comments to the Commission on the scheme in question within one month of the date of publication.
- (5) By letter 1548 of 30 May 2002 from the Portuguese Permanent Representation, registered as received by the Commission on 31 May 2002, the Portuguese authorities sent the Commission their comments.
- (6) The Commission also received comments from the Regional Government of the Åland Islands (Finland). It forwarded them to Portugal by letter D/53729 of 16 July 2002, sent to its Permanent Representation, giving it the opportunity to react. Its response was received by letter 2355 of 23 August 2002 from the Portuguese Permanent Representation, registered as received by the Commission on 27 August 2002.

II. DESCRIPTION OF THE MEASURE IN RESPECT OF WHICH THE COMMISSION INITIATED THE PROCEDURE

- (7) Under the Constitution of the Portuguese Republic, the Azores and Madeira are autonomous regions which have administrative and financial autonomy. By Law No 13/98 of 24 February 1998 on the finances of the autonomous regions, the Portuguese State precisely defined the conditions of that financial autonomy. The Law sets out the principles and objectives of regional financial autonomy, provides for the finances of the autonomous regions to be coordinated with central government finances, and establishes the principle of national solidarity and the obligation for the central government and the autonomous regions to cooperate. The Law lays down in particular that personal income tax (IRS) and corporation tax (IRC) constitute revenue of the autonomous regions, under the conditions it determines itself. Under Article 37 of the Law, the regional legislative assemblies are authorised to reduce the rates of income and corporation tax applicable there up to a maximum of 30 % of those laid down by national legislation.
- (8) By Regional Legislative Decree No 2/99/A of 20 January 1999 the regional authorities adopted the arrangements for adapting the national tax system to the region's specific characteristics under the powers devolved to them in the matter. The decree took effect on 1 January 1999 and includes in particular a part concerning reductions in the rates of income and corporation tax.
- (9) The abovementioned tax reductions apply automatically to all economic operators (natural and legal persons), and according to the Portuguese authorities are intended among other things to allow firms in the Azores to overcome the structural handicaps resulting from their location in an insular and outermost region. They include in particular a reduction in the rate of personal income tax (IRS) of 20 % (15 % for 1999) and a reduction in the rate of corporation tax (IRC) of 30 % for taxpayers in the region. The budgetary cost of the reductions, as measured by the resulting tax shortfalls, is put at some EUR 26,25 million a year by the Portuguese authorities.

⁽²⁾ See footnote 1.

- (10) In view of the characteristics of this part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores, the Commission first observed that the guidelines on national regional aid ⁽³⁾ lay down the general principle that regional aid aimed at reducing a firm's current expenses (operating aid) is prohibited, although, exceptionally, such aid may be granted in regions eligible under the derogation in Article 87(3)(a) of the Treaty 'provided that it is justified in terms of its contribution to regional development, and its nature and its level is proportional to the handicaps it seeks to alleviate' (point 4.15). The same principles and conditions were reiterated by the Commission in points 32 and 33 of its notice on the application of the State aid rules to measures relating to direct business taxation ⁽⁴⁾.
- (11) The Commission also noted that the guidelines on national regional aid nevertheless stipulate that in the outermost regions qualifying for exemption under Article 87(3)(a) and (c) 'aid which is not both progressively reduced and limited in time may be authorised in so far as it is intended to offset the additional costs arising in the pursuit of economic activity from the factors identified in Article 299(2) of the Treaty, the permanence and combination of which severely restrain the development of such regions (remoteness, insularity, small size, difficult topography and climate and economic dependence on a few products)' (point 4.16.2). Under the guidelines, 'it is the task of the Member State to determine the amount of the additional costs and to prove that they are linked to the factors identified in Article 299(2)'. Lastly, 'the proposed aid will have to be justified in terms of its contribution to regional development, and its nature; its level will have to be proportional to the additional costs it is intended to offset'.
- (12) In order to demonstrate that the tax reductions complied with the conditions laid down in the guidelines regarding operating aid, the Portuguese authorities first examined a number of financial indicators relating to a sample of 1 083 firms subject to corporation tax (IRC), 100 of which were located in the Azores. For all the indicators taken (sales profitability, financial independence, overall solvency and return on equity), the firms located in the Azores had substantially lower values than those located on the mainland of Portugal (depending on the weighting method applied, the difference ranged from 29,2 % to 76,15 %).
- (13) The Portuguese authorities also presented to the Commission an econometric study based on the data relating to 1997 for the same sample of firms. In terms of the regression carried out, the firms' profits were allegedly explained by the value added per capita (considered as an indicator of the level of technological development and the skills of human resources), the number of workers (as an indicator of the size of each undertaking), the sector of activity and the location of the firms concerned. In particular, and after correcting the results by sample selection procedures designed to account for the presence in the sample of firms that recorded losses, it was found that, other things being equal, the profits of the firms located in the Azores were, on average, 33,6 % lower than those of the other firms. In so far as such a difference might not seem to be entirely attributable to the additional transport costs facing firms in the Azores when they have to obtain raw materials or distribute their products, the Portuguese authorities took the view that it stemmed from all the factors specific to the region's nature as an outermost region. Under the circumstances, the Portuguese authorities considered in particular that the abovementioned tax reductions were justified in view of the additional costs arising in the pursuit of economic activity from the factors identified in Article 299(2) of the Treaty and that their level was proportional to those costs.
- (14) The Commission pointed out that the aforementioned study still did not allow it to verify at that stage whether the abovementioned tax reductions were justified in terms of their contribution to regional development and their nature, or whether their level was proportional to the additional costs they were intended to offset. In this connection, the Commission provisionally highlighted in particular three possible limitations of the model used by the Portuguese authorities:
- first, it was likely that the effect of the location of firms on profits varied in terms of the sector of activity concerned. In this case, the relevance of which was highlighted in particular by the 'new economic geography', bearing the importance of intercompany relations in mind as regards access to economies of scale, it would probably be preferable to carry out an estimation of several independent models,

⁽³⁾ OJ C 74, 10.3.1998, p. 9 and OJ C 258, 9.9.2000, p. 5.

⁽⁴⁾ OJ C 384, 10.12.1998, p. 3.

- second, it did not seem possible to rule out a priori the possibility that the regression applied was over-adjusted. Value added per worker might itself be a function of the number of workers, the sector of activity and the location of the firms concerned, and it was not clear from the data transmitted by the Portuguese authorities on this aspect whether all the tests required to take into account any multicollinearity of the exogenous variables (or a hypothetical heteroscedasticity of the model) had been carried out,
 - lastly, the basic sample taken did not include any firm active in the financial sector. The fact that banking institutions and insurance firms (the bulk of the financial sector in the Azores) were not taken into account could, in principle, limit significantly the scope of the results obtained.
- (15) Under the circumstances, the Commission provisionally took the view that the Portuguese authorities had not provided it with sufficient information to demonstrate that the tax reductions were, by their nature and level, such as to alleviate the specific problems of the Azores, particularly as regards mobile activities (notably financial services and firms of the 'intra-group services' or 'coordination centre' type), for which the existence of real regional handicaps counts for very little when it comes to deciding where to set up in business. Consequently, the Commission could not, at that stage, consider the abovementioned tax reductions to be in this respect compatible with the relevant provisions of the guidelines on national regional aid and, for this reason, it had doubts as to their compatibility with the Treaty.
- (16) Accordingly, the Commission in particular questioned whether the tax reductions were consistent with the targeting and proportionality criteria laid down in its notice on the application of the State aid rules to measures relating to direct business taxation, and in particular point 33, which stipulates that 'it is open to question whether there are any real regional handicaps for activities for which the additional costs have little incidence, such as for example the additional transport costs for financing activities, which lend themselves to tax avoidance'. In so far as it was still not in possession of quantified data enabling it to measure objectively the level of the additional costs supposedly facing financial firms liable for tax in the Azores, the Commission was also unable at that stage to consider such tax reductions to be compatible in this respect with the relevant provisions of the guidelines on national regional aid.

III. COMMENTS SUBMITTED BY THE PORTUGUESE AUTHORITIES

- (17) The comments submitted by the Portuguese authorities under the formal investigation procedure were generally limited to justifying the methodology applied in the econometric study presented to the Commission, by means of examples taken from recent economic literature. They pointed out on the one hand that the general insufficiency of reliable statistical data on the relevant variables significantly limited the choice of samples available to carry out this type of regression, and that the estimation of independent sectoral models would therefore only lead to results of no great significance. They specified on the other hand that any multicollinearity could be ruled out in view of the results themselves and the levels of statistical importance of the regression parameters adopted, and they took the view that the omission of any exogenous variable, particularly value added per worker, would mean that the results would be subject to omitted variable bias and their degree of reliability would be significantly reduced.
- (18) The Portuguese authorities meanwhile attributed the absence of firms from the financial sector among those in the basic sample merely to a lack of statistical data on the sector, accordingly acknowledging that it was not possible for them to demonstrate rigorously in relation to such activities that the tax reductions in question were, by their nature and level, such as to resolve the specific problems of the Azores.

- (19) Although they believed that financial-sector operators could also be affected by the handicaps associated with their location in the Azores, bearing in mind notably the essentially regional scope of their activities, the Portuguese authorities stated that they were prepared to make the legislative adjustments necessary to ensure that the abovementioned tax reductions complied with the rules applicable to State aid, namely excluding financial activities from their scope. They also indicated that, since 'intra-group services' activities (coordination, financial and distribution centres) did not exist in the Portuguese legal system, they were de facto excluded from the benefit of this measure.

IV. COMMENTS FROM INTERESTED PARTIES AND RESPONSE OF THE PORTUGUESE AUTHORITIES

- (20) The Regional Government of the Åland Islands claimed interested-party status under the constitutional autonomy devolved to this Finnish region, particularly in certain tax matters. In this respect the Government of the Åland Islands took the view that the geographic specificity of a tax measure was not sufficient for it to be considered as State aid if such a measure was implemented by an autonomous region (considered as a tax jurisdiction in its own right), under its own powers in the matter, was applied without distinction to all firms in the region and did not include any material specificity. In this way the income and corporation tax reductions implemented by the Azores region with the aim of adapting the national tax system to the specific characteristics of the region should, according to the Government of the Åland Islands, be considered as a general measure.
- (21) The comments submitted by the Regional Government of the Åland Islands were endorsed by the Portuguese authorities in the response they sent to the Commission. They pointed out in particular that according to the Portuguese Constitution the Azores region was an autonomous region which enjoyed administrative and financial autonomy, and they took the view that, in so far as the measures for adapting the national tax system were approved by the region under its own powers in the matter, the tax reductions in question should be seen as a general measure dependent on national tax policy.

V. ASSESSMENT

- (22) The Commission examined the comments submitted both by the Portuguese authorities and by interested parties during the formal investigation procedure.
- (23) As regards the nature of the tax reductions under analysis, which according to the comments of the Regional Government of the Åland Islands and the subsequent comments of the Portuguese authorities should be considered as a general measure, the Commission would point out in particular the four criteria for defining State aid within the meaning of Article 87(1) of the Treaty. First, the measure in question should give its beneficiaries an advantage which relieves them of charges that are normally borne from their budgets. Second, such an advantage should be granted by the State or through State resources, irrespective of its form. Third, the measure concerned should affect competition and trade between Member States. Lastly, the measure must be specific or selective in that it favours certain firms or products.

- (24) In view of the abovementioned criteria for defining State aid, the Commission would point out in particular that:
- as stressed in point 9 of its notice on the application of the State aid rules to measures relating to direct business taxation, 'the advantage may be provided through a reduction in the firm's tax burden in various ways, including (...) a total or partial reduction in the amount of tax'. In so far as the tax reductions in question apply to firms, therefore, they provide an advantage which relieves them of charges that are normally borne from their budgets,

 - granting a tax reduction involves a loss of tax revenue, which under point 10 of the notice on the application of the State aid rules to measures relating to direct business taxation 'is equivalent to consumption of State resources in the form of fiscal expenditure'. In so far as this principle also applies to aid granted by regional or local bodies in the Member States⁽⁵⁾, the tax reductions in question are granted through State resources, i.e. resources which in the Portuguese public finance system are allotted to the Autonomous Region of the Azores,

 - the criterion of competition and trade between Member States being affected presupposes that the beneficiary of the measure pursues an economic activity, regardless of the beneficiary's legal status or means of financing. Under settled case-law the criterion of trade being affected is met since the recipient firms carry on an economic activity involving trade between Member States, this conclusion not being altered by the relatively small amount of the aid⁽⁶⁾, the moderate size of the recipient or its very small share of the Community market, or even the fact that the recipient does not carry out exports or exports virtually all its production outside the Community⁽⁷⁾. In view of the extent of its sectoral scope and in so far as at least some of the firms concerned will carry on an activity involving trade between Member States, this is the case of the tax reductions under analysis,

 - as pointed out in point 17 of the notice on the application of the State aid rules to measures relating to direct business taxation, 'the Commission's decision-making practice so far shows that only measures whose scope extends to the entire territory of the State escape the specificity criterion laid down in Article 87(1)' and 'the Treaty itself qualifies as aid measures which are intended to promote the economic development of a region'⁽⁸⁾. Although these measures apply automatically to all economic operators liable for tax in the Azores, without introducing any difference in treatment in favour of one or more sectors of activity, the abovementioned tax reductions 'are intended exclusively for companies situated in a particular region of the Member State in question and constitute for them an advantage which companies intending to carry out similar economic operations in other areas in the same State cannot enjoy'⁽⁹⁾. In this case the abovementioned tax reductions do in fact favour firms taxed in the Azores, in comparison with all other Portuguese firms.

⁽⁵⁾ See in particular the judgment of the Court of Justice in Case C-248/84 *Germany v Commission* (1987) ECR 4013.

⁽⁶⁾ With the exception, however, of aid awarded under the conditions laid down in Commission Regulation (EC) No 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the Treaty to *de minimis* aid (OJ L 10, 13.1.2001, p. 30).

⁽⁷⁾ See in particular the judgments of the Court of Justice in Case C-102/87 *France v Commission* (1988) ECR 4067, Case C-142/87 *Belgium v Commission* (1990) ECR I-959 and Joined Cases C-278/92, C-279/92 and C-280/92 *Spain v Commission* (1994) ECR I-4103.

⁽⁸⁾ See in particular Commission decisions on State aid Cases C-55/01 (insurance companies specific to the Åland Islands, OJ C 309, 6.11.2001, p. 4) and C-52/01 (Gibraltar eligible firms scheme, OJ C 26, 30.1.2002, p. 9), and Commission Decision 93/337/EEC of 10 May 1993 on tax concessions for investment in the Basque Country (OJ L 134, 3.6.1993, p. 25).

⁽⁹⁾ Conclusions of Mr Advocate General Saggio in Joined Cases C-400/97, C-401/97 and C-402/97 (2000) ECR I-1073.

- (25) The Portuguese authorities and the intervener disagree with the view that the measure is selective, i.e. that it favours 'certain firms or certain products'. They accept that, rather than all Portuguese firms, the tax benefits concerned only apply to firms that carry on activity in part of Portuguese territory, which makes them territorially selective. They nevertheless argue that a distinction should be drawn between cases in which the State grants tax benefits of limited scope to part of national territory and cases in which such benefits are granted by an infra-State regional authority for the part of the territory that falls within its jurisdiction: the former are selective because their scope is limited to some of the firms under State jurisdiction, while the latter are general measures since they apply to all firms under the jurisdiction of the regional authority.
- (26) The Commission considers first that the element of selectivity in the concept of aid is based on a comparison between the advantageous treatment granted to certain firms and the treatment that applies to other firms in the same reference framework. The definition of this framework takes on added importance in the case of tax measures since the very existence of an advantage can only be established in relation to taxation defined as normal. In theory it follows both from the general scheme of the Treaty, which concerns aid granted by the State or through State resources, and from the fundamental role the central authorities of the Member States play in defining the political and economic environment in which firms operate, thanks to the measures they adopt, the services they provide and possibly the financial transfers they make, that the framework in which such a comparison should be made is the economy of the Member State. In this respect the text of the Treaty itself, which classifies measures intended 'to promote the economic development' of a particular region (Article 87(3)(a) and (c)) as State aid that may be considered to be compatible, indicates that benefits whose scope is limited to part of the territory of the State subject to the rules on aid may constitute selective benefits. It is clear that if the reference context for assessing the territorial selectivity of a measure is the territory in which it applies, measures that benefit all the firms in the territory would by definition become general measures. The settled practice of the Commission, confirmed by the Court of Justice, on the contrary consists of classifying as aid tax schemes applicable in particular regions or territories which are favourable in comparison to the general scheme of a Member State⁽¹⁰⁾.
- (27) Second, the Portuguese authorities' argument according to which benefits of limited territorial scope become general measures in the region concerned simply because they are established by the regional rather than by the central authority, and that they apply throughout the territory under the region's jurisdiction, cannot be reconciled with the concept of aid. This concept is objective, covering all aid that reduces the charges that are normally borne from the budget of one or more firms in various forms, regardless of its purpose, justification or objective or the status of the public authority that establishes it or whose budget bears the charge. A distinction based solely on the body that decides the measure would remove all effectiveness from Article 87 of the Treaty, which seeks to cover the measures concerned exclusively according to their effects on competition and Community trade⁽¹¹⁾. Such aid therefore cannot be treated differently from measures which have the same objectives, use the same resources and have the same effects on trade and competition, according only to the formal criterion of the degree of autonomy of the infra-State authority that establishes it. According to the abovementioned conclusions of Mr Advocate General Saggio in Joined Cases C-400/97, C-401/97 and C-402/97, 'the fact that the measures at issue were adopted by regional

⁽¹⁰⁾ See in particular, in the case of measures adopted by central authorities, the Commission Decision of 21 May 1997, aid N 847/96, on the creation of priority outermost regions and measures on improved economic access in the French Overseas Territories (OJ C 245, 12.8.1997), the Commission Decision of 16 December 1997, aid N 144/A/96, on the scheme of regional aid to investment and operating aid which amends the economic and tax system of the Canary Islands (OJ C 65, 28.2.1998) and Commission Decision 2002/780/EC of 28 February 2001 on the aid scheme 'Investment allowance 1999', which Germany is planning to implement for certain undertakings in the new *Länder*, including Berlin (OJ L 282, 19.10.2002, p. 15). See also Commission Decision 98/476/EC of 21 January 1998 on tax concessions granted under Article 52(8) of the German Income Tax Act (*Einkommensteuergesetz*) (OJ L 212, 30.7.1998, p. 50), on which the Court of Justice delivered judgment on 19 September 2000 in Case C-156/98 *Germany v Commission* (2000) ECR I-6857.

⁽¹¹⁾ Case 173/73 *Italy v Commission* (1974) ECR 713, Case 323/82 *Intermills v Commission* (1984) ECR 3809 and Case C-248/84 *Germany v Commission*, op. cit.

authorities with exclusive competence under national law is (...) merely a matter of form, which is not sufficient to justify the preferential treatment reserved to companies which fall under the provincial laws. If this were not the case, the State could easily avoid the application, in part of its own territory, of provisions of Community law on State aid simply by making changes to the internal allocation of competence on certain matters, thus raising the general nature, for that territory, of the measure in question'.

- (28) It should be noted that in the case in point the national legislator began by authorising the regional legislator to grant the tax reductions concerned; on the basis of this authorisation, the regional legislator then actually introduced the reductions. This mechanism produces the same effects as if the benefits were granted directly by the national authorities, as was already the case in the past with other aid schemes in favour of firms in the Azores ⁽¹²⁾.
- (29) The Commission points out that the use of a purely institutional criterion to differentiate 'aid' from 'general measures' would inevitably lead to differences in treatment in the application of the rules on aid to Member States, according to whether they had adopted a centralised or decentralised model of allocating tax competence (or other competence, such as in the area of social security). If the Portuguese authorities' argument were accepted, Member States whose internal administrative organisation allowed certain regional authorities below State level to make changes to the general tax system in the form of tax benefits applicable to firms that operated in the respective regions would escape the rules on aid in relation to those regions and measures.
- (30) The Commission considers that if measures completely identical in their objectives, technique and effects were not subject to the same rules it would be contrary to equal treatment and would create serious distortions in the functioning of the common market. The application of the rules on aid to regional tax benefits should be based on objective criteria and cannot depend on a purely institutional factor such as the application at a particular time of more or less extensive tax autonomy in favour of an infra-State authority of more or less broad territorial scope. If this technique were generalised it would undermine equality in applying the rules on State aid and therefore render them ineffective.
- (31) In the Commission's approach the tax autonomy of the regional authority that grants the benefits has never been considered as a factor that would make it possible not to regard measures as aid. In Decision 93/337/EEC, recognition that 'the competent institutions in each of the three Basque provinces may, under certain conditions, maintain, establish and regulate the tax system within their territory' did not prevent the Commission from finding that the tax benefits in question created by the three provinces were covered by Article 87(1) and from declaring them incompatible because they did not comply with the rules on regional and sectoral aid in particular ⁽¹³⁾. In subsequent decisions on tax concession schemes implemented by autonomous tax authorities the Commission, while taking the view that the measures examined constituted aid because of their material selectivity, expressly left open the possibility of examining their territorial selectivity ⁽¹⁴⁾. This being the case, it should also be noted that the present Decision does not concern a mechanism that would allow all local authorities of a particular level (regions, districts or others) to introduce and levy local taxes with no reference at all to national taxation. On the contrary, the case in point involves a reduction applicable solely in the Azores in the rate of tax established by national legislation and applicable on the mainland of Portugal. Under the circumstances, the measure adopted by the regional authorities clearly constitutes a derogation from the national tax system.

⁽¹²⁾ See in particular aid N 143/93, tax measures in favour of the free zones of Madeira and Santa Maria.

⁽¹³⁾ See in this respect the judgment of the Court in Joined Cases T-127/99, T-129/99 and T-148/99 *Territorio Histórico de Álava and Others v Commission* (2002) ECR II-1275, at paragraph 237.

⁽¹⁴⁾ See in particular the Decisions of 20 December 2001, Cases C-58/2000, C-59/2000 and C-60/2000, tax concessions in the form of exemption from corporation tax for certain firms recently set up in the province of Álava.

- (32) Lastly, the Commission would stress that classing these measures as aid does not call into question the tax autonomy of the regions, as laid down in the Portuguese Constitution and applied by the Portuguese legislator in 1998 and by the regional legislator in 1999. It seeks merely to ensure that, in cases where such regions exercise their autonomy by reducing the amount of tax levied at national level, the tax benefits granted thereby comply with the Community rules on regional aid and the other applicable frameworks on the basis of equality throughout Community territory, and does not presume because of this that such benefits are compatible with the common market.
- (33) Nor can the Commission take the view that the abovementioned tax reductions are justified by the nature or the general scheme of the Portuguese tax system, or that because of their economic rationality they are necessary or functional in relation to the effectiveness of that system. In particular, in so far as these reductions do not derive from applying principles such as proportionality or progressive taxation, since on the contrary they favour firms in a specific region regardless of their financial situation, the objectives of regional development attributed to them cannot be considered to be inherent in the Portuguese tax system.
- (34) In view of the above and the characteristics of the part of the scheme that adapts the national tax system to the specific characteristics of the Autonomous Region of the Azores which is subject to the formal investigation procedure, the Commission therefore considers that the reductions in the rates of income and corporation tax in question constitute State aid within the meaning of Article 87(1) of the EC Treaty and Article 61(1) of the EEA Agreement. The tax reductions constitute aid awarded through State resources and, since they apply to firms, they are such as to affect trade between Member States and threaten to distort competition by favouring certain undertakings.
- (35) Under the circumstances, and bearing in mind that the aid is continuous in nature and, according to the Portuguese authorities, has the objective of overcoming permanent structural handicaps resulting from the insularity of the Azores and the region's remoteness from mainland economic centres by reducing firms' current expenses, the Commission considers in particular that the aid concerned constitutes operating aid which, although granted in an outermost region which until the end of 2006 is fully eligible under Article 87(3)(a) of the Treaty and Article 61(3)(a) of the EEA Agreement, is not limited in time and is not guaranteed to be progressively reduced. Such aid can therefore only be authorised if it is intended to offset the additional costs arising in the pursuit of economic activity from the handicaps identified in Article 299(2) of the Treaty, in compliance with the conditions laid down in the guidelines on national regional aid as regards operating aid and point 4.16.2 in particular.
- (36) In this respect the Commission would first point out that the Azores region is made up of nine islands which are approximately 1 500 km from the nearest mainland territory and which have a total area slightly exceeding 2 300 km²; according to the Portuguese authorities and because of the small size of regional markets, this substantially limits the possibilities of achieving economies of scale allowing regional firms to attain the necessary levels of competitiveness and at the same time generates significant additional costs as regards production and access to markets. In view also of the reduced level of development achieved by the region (GDP per inhabitant was 52,6 % of the Community average in 1998 to 2000), it is effectively amongst the least developed in the European Union.
- (37) In the light of the results of the study transmitted to it and the comments submitted by the Portuguese authorities in that connection under the formal investigation procedure on firms that operate outside the financial sector, the Commission would also point out that:
- having regard to the difficulty in objectively calculating the incidence of each factor referred to in Article 299(2) of the Treaty on the increase in costs of economic activity and in so far as the abovementioned tax reductions do not apply only to one or more specific sectors but cover the regional economy as a whole, it would seem to be acceptable in principle to assess them in abstract terms. The Portuguese authorities may thus have demonstrated the existence of the aforesaid additional costs as a whole, indirectly quantifying their importance,

- a 30 % reduction in IRC would simultaneously enable the disadvantage affecting firms in the Azores, as quantified by their profit levels, to be reduced by 9,3 percentage points (from 33,6 % to 24,3 %). Since the compensation for the additional costs associated with the fact that it is an outermost region would thereby be limited to around 27,7 % of their absolute value and bearing in mind that such a reduction should allow recipients to improve their financial situation, releasing the resources necessary for them to carry on their activities in less difficult conditions, the aid envisaged would thus be justified according to its contribution to regional development,
 - in average terms, in view of the average value of the amount of IRC paid by firms taxed in the region over the last five years (EUR 23 500 according to the Portuguese authorities), the advantage each company would gain from this reduction in IRC would not exceed EUR 7 050 per year. This amount would be even lower in the case of small firms subject to personal income tax (IRS), which would allow the level of such advantages to be considered to be proportional to the additional costs they are intended to offset.
- (38) In so far as the reductions in income and corporation tax are applicable to firms that operate outside the financial sector and bearing in mind the Portuguese authorities' undertaking to notify the Commission in good time of any application of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores beyond 31 December 2006 (the date corresponding to the expiry of the regional aid map), in order to allow the Portuguese authorities to prove and the Commission to determine the real impact of these tax reductions on regional development, with a view to re-assessing their relevance to the situation of the region, the Commission is therefore able to consider such aid to be granted in compliance with the conditions laid down in point 4.16.2 of the guidelines on national regional aid. As a result, in so far as the aforesaid tax reductions will apply to firms that operate outside the financial sector, the Commission is also able to consider the abovementioned aid to be compatible with the common market under the derogation in Article 87(3)(a) of the Treaty.
- (39) On the other hand, as regards the application of income and corporation tax reductions for firms that operate in the financial sector, the Commission finds that they are not justified by their contribution to regional development and that their level is not proportional to the handicaps they are intended to alleviate. Therefore, in so far as it is still not in possession of quantified data enabling it to measure objectively the level of the additional costs facing financial firms liable for tax in the Azores, the Commission is not able to consider such tax reductions to be compatible with the relevant provisions of the guidelines on national regional aid. As a result, in so far as the aforesaid tax reductions apply to firms which operate in the financial sector, the Commission is not able to consider the abovementioned aid to be compatible with the common market under the derogation set down in Article 87(3)(a) of the Treaty.
- (40) Similarly, in so far as the income tax reductions apply to firms which operate in the financial sector, the Commission is not able to consider such aid to be compatible with any other derogation laid down in the Treaty. On the one hand, bearing in mind its characteristics as operating aid, it cannot be considered to be intended to contribute to the development of certain economic activities or certain economic areas without affecting trading conditions to an extent contrary to the common interest (Article 87(3)(c)). On the other, it is not aid of a social character granted to individual consumers (Article 87(2)(a)), it is not intended to make good the damage caused by natural disasters or other exceptional occurrences (Article 87(2)(b)), it is not granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany (Article 87(2)(c)), it is not intended to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State (Article 87(3)(b)), it is not intended to promote culture or heritage conservation (Article 87(3)(d)), and it does not relate to other categories of aid specified by the Council (Article 87(3)(e)).

- (41) Under the circumstances, the Commission finds that only the exclusion of firms that operate in the financial sector from the scope of the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores in so far as income and corporation tax reductions are concerned, in accordance with the willingness expressed in this regard by the Portuguese authorities during the formal investigation procedure, will allow it to consider the above-mentioned aid to be compatible with the common market under the derogation laid down in Article 87(3)(a) of the Treaty. For this purpose all firms that carry on economic activities covered by section J of the statistical classification of economic activities in the European Community (NACE Rev. 1.1) ⁽¹⁵⁾ should be considered to be firms that operate in the financial sector, i.e. financial intermediation (code 65), insurance (code 66) and activities auxiliary to financial intermediation and insurance (code 67).
- (42) Although the Portuguese authorities have declared that activities of the 'intra-group services' type (activities the economic basis of which is to provide services to firms belonging to the same group, as coordination, financial or distribution centres) currently do not exist in the Portuguese legal system, for reasons of transparency and legal certainty the Commission finds that where such activities can in practice be carried on as services provided principally to firms (section K, code 74 of NACE Rev. 1.1), they should also be excluded by law from benefiting from such aid. In fact, since their effects on the decision to locate firms belonging to a group and their external effects on the local economy are small, the Commission considers that such activities do not contribute sufficiently to regional development and therefore cannot be declared compatible under Article 87(3)(a), or by virtue of other derogations laid down by the Treaty, for the same reasons indicated in relation to the financial sector.
- (43) Lastly, the Commission would refer to Article 14 of Council Regulation (EC) No 659/1999 of 22 March 1999, which lays down detailed rules for implementing Article 88 of the EC Treaty ⁽¹⁶⁾ and provides that all unlawful aid may be recovered from the recipient. The aid scheme which is the subject of the present Decision is not covered by any existing category of aid referred to in Article 1(b) of Regulation (EC) No 659/1999, without prejudice to the possibility that some aid paid under this scheme may constitute existing aid by virtue of the specific situation of the recipient. Bearing in mind that the aforesaid aid was put into effect unlawfully and that no principle of Community law exists which is opposed to recovery, the tax benefits which firms that operate in the financial sector have already enjoyed and those that derive from activities of the 'intra-group services' type (and for the years 1999, 2000 and 2001) should be recovered by the Portuguese authorities.
- (44) This Decision relates to the scheme as it stands and should be implemented immediately, recovering unlawful aid declared incompatible. The Commission would remind Portugal that a negative decision on an aid scheme does not prejudice the possibility that certain advantages granted under the scheme might be considered, either totally or in part, as not being aid or as aid compatible with the common market, on its own merits (for example, on the grounds that the individual benefit is covered by the *de minimis* rules or that it is granted within the framework of a future decision or by dint of exemption regulations).

VI. CONCLUSION

- (45) The Commission finds that Portugal has unlawfully implemented the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, contrary to Article 88(3) of the Treaty. However, based on the above assessment and after examining the scheme in the light of the guidelines on national regional aid, the Commission considers that it meets the conditions for being considered compatible with the common market, under the derogations of Article 87(3)(a) of the Treaty and Article 61(3)(a) of the EEA Agreement, with the exception of aid awarded to firms that carry on financial activities or activities of the 'intra-group services' type (coordination, financial or distribution centres),

⁽¹⁵⁾ Commission Regulation (EC) No 29/2002 of 19 December 2001 amending Council Regulation (EEC) No 3037/90 on the statistical classification of economic activities in the European Community (OJ L 6, 10.1.2002, p. 3).

⁽¹⁶⁾ OJ L 83, 27.3.1999, p. 1.

HAS ADOPTED THIS DECISION:

Article 1

The part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax, implemented on the basis of Articles 4 and 5 of Regional Legislative Decree No 2/99/A of 20 January 1999, is compatible with the common market, subject to the provisions of Article 2.

Article 2

The part of the aid scheme referred to in Article 1 is incompatible with the common market in so far as it applies to firms that carry on financial activities covered by section J (codes 65, 66 and 67) of the statistical classification of economic activities in the European Community (NACE Rev. 1.1), and to firms that carry on activities covered by section K, code 74, of that classification, the economic basis of which is to provide services to other firms belonging to the same group, as coordination, financial or distribution centres.

Article 3

1. Portugal shall take all necessary measures to recover from the firms that carry on the activities referred to in Article 2 the aid made available under the part of the aid scheme referred to in Article 1.
2. Recovery shall be effected without delay and in accordance with the procedures of national law, provided that they allow the immediate and effective implementation of the Decision. The aid to be recovered shall include interest from the date on which it was placed at the disposal of the beneficiaries until the date of its recovery. Interest shall be calculated on the basis of the reference rate used for calculating the grant equivalent of regional aid.

Article 4

Portugal shall inform the Commission, within two months following notification of this Decision, of the measures taken to comply with it.

Article 5

This Decision is addressed to the Portuguese Republic.

Done at Brussels, 11 December 2002.

For the Commission
Mario MONTI
Member of the Commission
