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STATE AID AND TAXATION IN SPAIN

Carlos Benítez[1] and Diego del Cuadro[2]

1. Introduction: Legislation of the Provincial Parliaments in the Basque Country

The Commission's Decision of May 10th, 1993,[3] which declared that some legislation from the Parliaments of the three Basque Provinces of Alava, Guipuzcoa and Vizcaya[4] was contrary to the European Community Treaty ("ECT") gave rise to great controversy in Spain, not only because of its contents, which were criticised on technical grounds but also and mainly because of the manner in which it was used by the Spanish Supreme Court in a judgment dated February 7th 1998.

Before analysing this Decision and the above-mentioned judgment from the Supreme Court it is appropriate to make a brief reference to the interplay of the State and the Autonomic tax systems in Spain.

Since the establishment of the existing Constitution, in 1978, Spain has been established as a single State comprised of various territorial entities known as Autonomous Communities. The distribution of governing powers between the State

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1 Carlos Benítez, Head of Tax Department, Gomez-Acebo & Pombo, Castellana, 164-28046 Madrid, Spain. Tel (+34 91) 582 91 00 Fax: (+34 91) 582 91 14.

2 Diego del Cuadro, Attorney, Gomez-Acebo & Pombo, Castellana, 164-28046, Madrid, Spain. Tel (+34 91) 582 91 00 Fax: (+34 91) 582 91 14.

3 Commission's Decision 93/337/EEC 10th May 1993; OJ L134 3rd June1993 p 25, regarding tax incentives in the Basque Country.

4 Law 28/1988 of Alava, Law 8/1988 of Vizcaya and Law 6/1988 of Guipuzcoa, as well as Decrees 205/1988 and 227/1988 from the Basque Government.

and the Autonomous Communities is established in the Constitution[5] and in the respective Autonomic Statutes.

The Autonomous Communities of the Basque Country and Navarra differ from the rest as being "Foral Territories", an expression going back to the Middle Ages, making reference to their separate legislation ("fueros") which the King was bound to respect. The difference is outlined in the 1st Additional Provision to the Constitution, according to which "The Constitution protects and respects the historical rights of the Foral Territories", although as pointed out in the subsequent paragraph "The general updating of said Foral Regime will be carried out, should it be the case, within the Constitutional framework and the Statutes of Autonomy".

The updating of the Foral legislation foreseen in the Constitution has led to the restoration of the "Economic Agreement" with the Basque Country, as well as to the modification and improvement of the previously existing "Agreement System" with Navarra. In both cases, the Foral Territories have the authority to establish and collect their own taxes, in line with the legislation applicable in the rest of the nation, despite their obligation to transfer part of the proceeds to the State in order to finance their share of the State budgetary costs.

2. The Regulation in Question

Once the EC Commission became aware of the existence of certain Basque legislation that did not comply with the EC Treaty, it declared their provisions incompatible with European Community Laws.

The legislation in question was Law 28/1988 of Alava, Law 8/1988 of Vizcaya and Law 6/1988 of Guipuzcoa, as well as Decree 205/1988 concerning investments of special technological interest, and Decree 227/1988 regarding the farming and fishing sectors, which, in short, contemplated the following:

- A 95% tax reduction of the Transfer tax and Stamp Duties affecting investments made in the Autonomic Community.

- A Corporation Tax credit amounting to 20% of investments made in the territories, which could be increased up to 50% for investments creating employment or having special technological interest, as well as free tax depreciation of the related assets not being bound by the maximum rates otherwise permissible.

5 Articles 148 and 149.

- Similar tax deductions in the Personal Income Tax affecting individual entrepreneurs and professionals.

The scope of the application of these tax benefits was determined by the Economic Agreement in effect in 1988, to be implemented by the Basque authorities, which specifically prevented the Basque Provinces from applying their legislation to individuals and entities not residing in the Basque country. Therefore the aforementioned tax incentives could not apply to residents of other EEC countries.

According to the Economic Agreement the Basque tax system must adhere to the following main principles:

(a) Solidarity with the other Autonomous Communities in accordance with the terms established in the Constitution and the Autonomic Protocol.

(b) The general tax structure must be equivalent to that of the State.

(c) The foral tax systems must abide by the Treaties and Conventions signed by the Spanish State.

(d) Tax provisions promoting investments which discriminate depending upon the location where goods are manufactured should not be adopted.

(e) Tax legislation should not reduce business competition, nor distort the assignment of resources and the free movement of capital and labour.

(f) Legislation implementing the Economic Agreement should not impose a tax burden lower than that existing in the rest of Spain.

3. The Decision of the Commission Dated 10th May 1993

As mentioned above, as soon as the Commission became aware of the existence of some Basque legislation which could be incompatible with EC Law, it initiated the procedure set forth in Article 93 of the ECT[6], asking the Spanish State and the other Member States, as well as any other interested third party, to file their observations.

After considering the observations, the Commission issued its decision on the 10th

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6 Article 93 of the Treaty contains the procedure to be followed by the Commission on detecting that a member of the State has adopted internal measures that could be conceived as "State Aid".

May 1993, declaring that the legislation in question was incompatible with EC legislation and giving seven months to the Spanish Government to eliminate the distortions that these laws could cause to competition.

The Commission's Decision was based on the provisions of Articles 92 and 52 ECT.

3.1 Article 92 ECT

Article 92 of the Treaty establishes that "any aid granted by a member-state, or through State resources in any form whatsoever, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between member-states, be incompatible with the common market." Together with this general principal of incompatibility of state aids with the Common Market, Article 92 establishes a series of exemptions that complete the regulation and are compatible with the Common Market as long as they meet certain requirements.

By simply reading Article 92 of the Treaty it is evident that the aid concept has been constructed on a deliberately wide scale. This is also manifested in various official statements. For example, the *Steenklenmijnen* judgment[7] stated that the idea of aid is more general than the idea of government grant, as it does not only include positive aid but also interventions that in different ways lighten the levies that normally form part of the budgetary planning of a company and, without being grants in the strict sense of the word, are of the same nature and cause the same effects.

It is clear that the expression "in any form whatsoever" contained in Article 92, includes tax benefits, widely used by Member States to mask state aids.[8]

The Commission[9] considers that state aids comprise government grants, tax exemptions and reductions, parafiscal reductions, interest allowances, loan guarantees in highly favourable conditions, assignment of real estate and land free of charge or in highly favourable conditions, the supply of goods or services under favourable conditions, subsidies, or any other measures to the same effect.

In the case in question, the Commission considered that the tax benefits contained in

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7 Court of Justice judgment of the 23.2.1961 in Case 30/59 *Steenklenmijnen v Haute Autorité* [1961] ECR1.

8 See Case C-187/92 (Ayuntamiento de Valencia) C-387/92 [1994] ECR I-877.

9 14th Report concerning the Politics of Competition.

the Basque legislation constituted state aid as they only applied to those entities operating exclusively in the Basque Country and to those individuals residing habitually in the relevant province who carry out activities exclusively in the Basque Country.[10]

According to the Commission, the questioned legislation led to a distortion of competition as it strengthened the financial condition available to, and the opportunities of those companies benefiting from the aids to the detriment of their competitors, who were not entitled to them.

The Commission also pointed out that the system distorted competition and could affect exchanges between Member States insofar as the beneficiaries may export part of their products to another Member State. Likewise, even if the beneficiaries did not export, Spanish producers may benefit as there are fewer possibilities for companies established in other Member States to sell their goods in the Spanish market.[11]

3.2 Article 52 of the ECT

Article 52 defines the right to establishment as including the right to take up and pursue activities as self-employed persons as well as the setting-up and management of undertakings and more specifically companies or firms (as defined in the second paragraph of Article 58),[12] under the conditions determined by the country of establishment for its own nationals. (This right is subject to the provisions of the Chapter relating to capital concerning free movement of capital.)

The Commission in a peculiar combination of legal concepts, very much criticised in Spain, considered that the fiscal system created by the Basque regulations apart from qualifying as a state aid, also violated the freedom of establishment.

Following the Commission's reasoning, as the aid only applies to entities operating exclusively in the Basque Country and individuals residing therein, the system is contrary to the provisions in article 52 of the ECT. This is due to the fact that a

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10 Point III of the Decision of the 10th May 1993.

11 The Decision also points out that the fact that the beneficiary companies are not known before-hand, does not exclude the application of article 92, as these companies are identifiable afterwards.

12 Paragraph 2 of Article 58 establishes that "Companies or firms" means companies or firms including co-operative societies and other legal persons governed by public or private law, save for those which are non-profit-making.

company of another Member State wishing to establish a branch office, or agency or establishment in the Basque Country, but also maintaining activities in the said Member State, could not benefit from these aids. Similarly, a Spanish company established in the Basque Country could not expand its activities to another Member State as it would lose the beneficial fiscal treatment.

Criticisms of the Commission's Decision

Several authorities have criticised the Commission's Decision for its association of Articles 92 and 52 of the ECT. The Commission considers that there are two different infringements to be considered, namely that the State Aid granted is (i) contrary to the free functioning of the Common Market as it may distort competition by benefiting certain undertakings or the production of certain goods (Article 92.1) and (ii) violates the freedom of establishment of companies by inducing them to establish themselves in the Basque Country.

The question raised is that, whilst the Commission has the capacity, by virtue of Article 93, to declare the existence of a state aid, it is unclear whether it is also the competent authority to declare the existence or violation of the freedom of establishment.

In fact, within the ambit of the right to establishment, the right to achieve legislative harmonisation is given exclusively to the Council, and in the case of an infringement of it the mechanism of intervention to be followed is the one contemplated in Article 169 ECT, according to which, should the Commission decide that a Member State has not complied with one of its obligations regarding the EC Treaty (e.g. the right to establishment) it will issue a ruling on the subject after offering the State the possibility to file its own comments. If the State does not adhere to the ruling the Commission may appeal to the Court of Justice.

This means that the ECT contains two different procedures, namely the one established in Article 93, in the case of state aid contrary to the Common Market, and Article 169 as a general course of action against the breach of obligations by the State, in order to guarantee the freedom of establishment within its territory.

In our view, however, the Commission's Decision followed the appropriate course of action because, although the right violated was the right of establishment this was done by way of state aid. Furthermore, had the procedure of Article 169 been followed, then the rights of the Kingdom of Spain would have been violated as the course prescribed to determine the existence of state aid would have been deliberately avoided.

If the means used to limit the right of establishment is state aid, it seems logical that the appropriate procedure is initially followed to determine the existence of an illicit aid (Article 93), and once this has been established, to analyse the consequences (limitation of the right of establishment). Procedurally, it would be illogical, as well as uneconomical, to wait until the procedure set forth in Article 93 is finalised to initiate the procedure under Article 169.

Finally, it must be noted that, although the offenders were the corresponding autonomic legislative bodies, according to Article 93 of the Constitution and 169 of the ECT, the State is solely responsible for all breaches of Community legislation, even though such responsibility does not prevent the State from claiming against the body which is actually responsible.

4. Reactions to the Commission's Decision

The reaction of the Spanish state to the ruling contained in Decision 93/337/EEC, according to which "Spain must modify, by December 31st, 1993 its fiscal system ....(analysed).. in order to eliminate the distortions regarding Article 52" was very disappointing and informal. The State did not modify the fiscal system but, on the contrary, issued a controversial provision; the 8th Additional Provision to Law 42/1994 in the legislation accompanying the 1995 Budget[13] according to which:

> "Residents in the European Union, not residing in Spain, who are subject to the State tax legislation, and because of these circumstances, cannot take advantage of the tax legislation prevailing in the Autonomous Community or the Historical Territory of the Basque Country or Navarra where they operate shall be entitled, within the framework of Community legislation, to be reimbursed by the State Tax Administration the amounts effectively paid in excess in comparison with the situation in which they could have taken advantage of the legislation of said Autonomic Communities or Historical Territories, under the terms to be established by the implementing regulations hereof".

In providing for reimbursement from the Spanish State, the discrimination against EC residents outside the Spanish Territory, operating in a Foral territory, was eliminated, but the issue of possible discrimination against Spanish residents in other Spanish Communities remained unaffected. The solution, the above-quoted provision could also be appealed to the Constitutional Tribunal on the grounds of violating the

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13 It may be observed that the State's reaction was delayed beyond the final date set by the Commission. On the other hand, this is quite normal.

principle of fair allocation of resources contained in Article 31.2 of the Spanish Constitution, as the State revenue is required to compensate non-residents who, as a matter of fact, operate as any other Spanish resident could do. Furthermore, the amount of the compensation to be paid by the State was to be determined, in the end, by the tax provisions in Autonomic legislation.

In these circumstances, many appeals were filed with the High Court of Justice in the Basque Country and also with the Supreme Court, who resolved the matter in its judgment of February 7th, 1998.

5. The Supreme Court Judgment of February 7th, 1998

By this judgment, the Supreme Court declared the nullity of the tax incentives regarding investment established by the Vizcaya Regional Parliamentary Law number 8/1988, of July 1st.

As a precedent, the judgment, which questions the legal grounds supporting the Basque tax legislation, may have wide repercussions insofar as identical legislation was passed by the Parliaments of the historic territories of Alava (Regional Parliamentary Law 28/1988, of July 18th) and Guipuzcoa (Regional Parliamentary Law 6/1998, of July 14th)

The judgment was based on the Commission's Decision 93/337/EEC which declared the legislation in question to be contrary to the principle of freedom of establishment, and to the prohibition by the Economic Agreement of "effective global pressure" which is lower in the Basque Country than that of the common territory. In short, the line of argument of the Supreme Court is as follows[14]

1. The legality of the challenged provision was questioned by the Commission, who reached the conclusion that it breached the principle of freedom of establishment.

2. The Regional legislation discriminates in favour of those Community residents not residing in Spain, making it obvious that the "effective global pressure" on those operating throughout Spain was not identical.[15]

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14 Study of the judgment of February 7th 1998 made in "Jursprudencia Tributaria Atanzadi", no. 21 1998.

15 This phrase is explained at p 25 below.

3. By extrapolating the reasoning of the Commission's Decision the Supreme Court concludes that those Spanish persons operating in Spain but not exclusively, in the Basque Country, are at a competitive disadvantage as against other EC residents, given that they, unlike other EC residents, cannot obtain a refund of the excess tax paid.

4. The Regional Parliamentary Law is null and void due to infringement of Article 4.11 and 4.12 of the "Economic Agreement", which acknowledges the prohibition of privileges and the unity of the market.

This judgment is being criticised from all angles, for many reasons.

In the first place, the Court has moved away from its previous standpoint regarding what is called "effective global pressure". Article 4(e) of the "Economic Agreement" established that its application could not result in an effective fiscal global pressure lower than that existing in the Common territory. The Supreme Court had previously worked out this concept and in its judgment dated July 19th, 1991[16] established the criteria to determine the existence of lesser global fiscal pressure:

> "... the fiscal pressure to be considered is that which affects a complete fiscal year and the taxes as a whole..."
>
> "the rules of the "Economic Agreement" refer to "effective pressure" and "global", indicating that the fiscal pressure to be taken into account is that produced by the overall tax system, not just by one or several taxes, and in [the case in question] only five were examined, therefore although various tax collection data were submitted they only referred to partial fiscal pressure and not global fiscal pressure".
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> "The only interpretation possible is to compare the group of taxes mentioned during one or several fiscal years so that the comparison will consequently show if there exists greater or lesser fiscal pressure. This is the interpretation that the court understands must be given to the Rules of the Economic Agreement".

As can be clearly seen, the terms of the February 1998 judgment which defines effective global pressure by reference to one tax, cannot be easily reconciled with the previous doctrine which defines it by reference to the overall tax system. If the terms of the judgment are to prevail then the whole fiscal system of the Basque Country may be in danger, as a lower pressure in just one tax would entail the infringement

16 RJ 1991, 6227.

of Article 4 of the Economic Agreement.

It must be noted that the new standpoint could be found unconstitutional as it may fail to recognise the historic rights of the Foral Territories contained in the 1st Additional Provision to the Constitution. Furthermore, the discrimination pointed out by the Court, deviating from previous judgments, may be considered as superficial as it fails to evaluate the aggregate effect of the various taxes comprising the autonomic tax system.

Although the Court relies upon discrimination as between Spanish residents in declaring the legislation void,[17] Spanish law does not prohibit tax differences caused by residence in different Autonomic Communities or Provinces. On the contrary, the existence of autonomous territorial entities with law-making capacity will inevitably lead to different treatment of taxpayers residing in different communities.[18] Furthermore, it does not seem logical to declare the nullity of the legislation in question because of its possible discriminatory effects on residents in Spain residing outside the Basque Country, as these (contrary to those residing in other EC States) will not receive any reimbursement at all for the excess tax paid.
In the words of the Supreme Court:

> "...the Spanish companies operating in the Basque Country, but established outside the Basque Country, that are also residents of the European Community, will not receive reimbursement of the recognised differences in taxes which will be reimbursed, and will be at a competitive disadvantage."

It would have been more logical for the Court instead of referring to the Foral legislation to point out the discrimination introduced by the State's 8th Additional Provision[19] which does not make any distinction between residents of another Member State and residents of the Spanish Territory outside the Basque Country. The Supreme Court, however, did not deem it convenient to refer the case to the Constitutional Court where the State's 8th Additional Provision could have been considered and instead, it resolved to declare the nullity of the regional legislation of reference.

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17 See point 3 on page 25 above.

18 The Constitutional Court judgment of January 21st, 1986 RTC 1986.8 also sustains this position.

19 See para 4 on page 23 above.

6. Conclusion

The judgment from the Spanish Supreme Court dated February 7th, 1998 has shaken the grounds on which the equilibrium between the fiscal systems of the Autonomic Communities and the Spanish State is based.

Most probably, the consequences of this judgment will not go by unnoticed, considering the vast number of similar appeals which are pending court resolution. For various reasons, including political ones, it is unlikely that the Supreme Court will keep on declaring the nullity of the Basque tax legislation, even though it is widely felt that it is often more beneficial than that applicable in the rest of the State of Spain.