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General Court decision on Madeira Free Zone scheme

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On September 21, 2022, the General Court of the European Union (General Court or the Court) gave its [decision](#) in the case T-95/21 regarding the Madeira Free Zone State aid scheme.

The Court ruled that the Commission was correct to conclude that the Madeira Free Zone State aid scheme (Regime III) – the objective of which was to contribute to the economic development of the outermost region of Madeira through tax incentives, was not implemented in line with approved conditions. Consequently, the General Court dismissed the appeal brought by Portugal against the Commission's decision.

Background

The Madeira Free Zone State aid scheme – providing corporate income tax reductions and other tax benefits for companies established in the region, was initially approved by the European Commission (EC) in 1987 as compatible regional aid. The scheme was subject to several successive amendments and approvals by the European Commission. The final successor of the scheme – i.e. Regime III, was authorized by the Commission through two decisions which covered the period January 1, 2007 – December 31, 2014. The approvals explicitly linked the amount of aid granted to jobs created / maintained in the region and to activities carried out locally.

Following concerns triggered during its standard monitoring of the implementation of State aid decisions, on July 6, 2019 the Commission opened an [in-depth investigation](#) into the regime. On December 4, 2020, the European Commission [concluded](#) that the Madeira Free Zone State aid scheme (Regime III) was not implemented in line with approved conditions. In particular the Commission argued that the tax benefits were granted with respect to income that was not derived

from activities carried out in the Autonomous Region of Madeira ('RAM ') and to companies that did not create or maintain jobs in the region. As a result, the Commission concluded that the aid scheme under dispute was in breach of EU State aid rules (the Decision). The EC required Portugal to recover aid granted to companies that did not meet the approved conditions. Portugal decided to appeal the European Commission's Decision – see E-news [Issue 131](#).

The General Court decision

The General Court first rejected Portugal's plea that the scheme under dispute did not constitute 'State aid' under EU law. In this context, the Court recalled the conditions that are required to be fulfilled cumulatively for a national measure to be classified as prohibited State aid:

- i) there must be an intervention by a Member State or by means of state resources;
- ii) the intervention must be liable to affect trade between Member States;
- iii) it must grant a selective advantage to its beneficiary;
- iv) it must distort or threaten to distort competition.

The Court noted that, contrary to Portugal's views, the Commission is not required to establish that the scheme under dispute effectively impacted trade between Member States and effectively distorted competition. Instead, based on settled case-law, the Commission only has to examine whether that aid is likely to affect trade and distort competition. In the Court's view, granting tax benefits to companies operating in the Free Zone could in principle distort competition (by means of reducing the operational costs otherwise borne by companies not benefiting from the scheme). Moreover, since companies registered in the Free Zone carry out activities opened to international competition, the scheme is liable to impact trade between Member States.

The Court continued by analyzing the criteria related to the existence of a selective advantage, as established by settled case-law:

- i) identifying the reference system of ordinary or 'normal' taxation;
- ii) determining if the relevant measure entails a derogation from the reference system;
and
- iii) assessing if the derogation is justified by the nature or general scheme of the reference system.

The Court noted that the scheme under dispute provided tax benefits to companies that carry out activities exhaustively listed in an annex and that certain type of activities are specifically excluded. As such, irrespective of the reference system selected (i.e. the corporate income tax framework in the Free Zone area or the RAM), the regime provided a favorable treatment for companies that were in a comparable factual and legal situation. The Court considered that the selectivity criteria was met as the disputed regime represented a derogation from the reference framework and its objective.

The General Court continued by rejecting Portugal's plea that Regime III should have been classified as 'existing aid' and therefore subject to a different review procedure. In its arguments, the plaintiff noted that the Free Zone was created before Portugal's EU accession and any subsequent amendments were minor and only made in order to comply with successive versions of the Commission's guidelines on regional State aid. In this context the Court noted that, under EU State aid law, any change to an existing scheme which goes beyond purely formal or administrative amendments qualifies as 'new aid'. Contrary to Portugal's view, the Court held that Regime III introduced substantial changes, by amending constituent elements of the initial scheme (i.e.

activities in scope, additional criteria introduced, updated thresholds). Consequently, in the Court's view, Regime III represented 'new aid' for the purpose of EU law.

The Court also rejected several other arguments put forward by the plaintiff, including an alleged breach of the principles of legal certainty and the protection of legitimate expectations. The Court noted that recovery was the logical consequence of finding that a State aid measure was unlawful, and that the Commission was generally required to order the recovery of the aid. Moreover, a Member State which granted aid in breach of EU law can not rely on the principle of legitimate expectations of the beneficiaries to avoid the recovery of the unlawful State aid.

The Court concluded by rejecting Portugal's plea regarding the impossibility of recovering the unlawful aid. Portugal had argued that it would not be in the position to determine the amount of aid recoverable per beneficiary and that, in certain cases, recovering the aid could lead to insolvency cases. The General Court however held that Member States can no justify their failure to comply with their EU law obligations on the grounds that they encountered administrative or practical difficulties when implementing the recovery Decision. Moreover, based on settled case-law, the fact that the recovery of unlawful State Aid could lead to bankruptcy of the beneficiaries can not affect the compulsory nature of the recovery.

EU Tax Centre comment

In terms of next steps, Portugal has now the option to appeal the decision before the CJEU.

Even before the decision of the General Court on Portugal's plea was known, the Portuguese tax authorities (as the executor of the recovery Decision on behalf of the European Commission) had already started the internal procedures necessary to comply with the Decision by notifying most of the beneficiaries affected.

Based on a statement made by the Portuguese Secretary of State for Tax Affairs, it is estimated that the number of beneficiaries covered by the recovery Decision is around 300, representing a total to be recovered of approximately EUR 833 million plus interest. Beneficiaries notified by the recovery Decision are granted a period of only 25 days to exercise their right of preliminary hearing against the proposed methodology for recovering the aid. The exercise of this right by the affected taxpayers can only focus on matters of fact, given that the Portuguese tax authorities acts concerning this matter cannot be challenged, insofar as they merely implement the Decision of the European Commission. Notwithstanding, beneficiaries affected may still challenge the Decision by appealing before the CJEU.

Should you have any queries, please do not hesitate to contact [KPMG's EU Tax Centre](#), or, as appropriate, your local KPMG tax advisor or KPMG in Portugal ([Pedro Alves](#) or [Rui Silva](#)).



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