Cases T-211/04 and T-215/04

Government of Gibraltar and United Kingdom of Great Britain and Northern Ireland

v

Commission of the European Communities

(State aid – Aid scheme notified by the United Kingdom regarding the Government of Gibraltar's reform of corporate tax – Decision declaring the aid scheme incompatible with the common market – Regional selectivity – Material selectivity)

Summary of the Judgment

1. *State aid – Concept – Selective nature of the measure – Tax measure adopted by an infra-State body*

(Art. 87(1) EC)

2. *State aid – Concept – Selective nature of the measure – Derogation from the common or 'normal' tax regime*

(Art. 87(1) EC)

1. Article 87(1) EC requires assessment of whether, under a particular legal regime, a national measure is such as to favour 'certain undertakings or the production of certain goods' in comparison with others which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation. Such an analysis is also required in respect of a measure adopted not by the national legislature but by an infra-State authority, since a measure adopted by a regional or local authority and not the central authorities can constitute aid if the conditions laid down by Article 87(1) EC are satisfied. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with 'normal' taxation. The 'normal' tax rate is the rate in force in the geographical area constituting the reference framework.

Therefore, in order to assess the selectivity of a measure adopted by an infra-State body and designed to determine, in part only of the territory of a Member State, a reduced tax rate in relation to that applying in the rest of that Member State, it must be examined, first, whether that measure has been devised by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government, secondly, whether it has been devised without the central government being able to intervene directly as regards its content, and, third, whether the financial consequences of that infra-State body introducing the measure are offset by aid or subsidies from other regions or from the central government of the Member State concerned.

(see paras 78-80, 86)

2. Article 87(1) EC requires it to be determined whether, under a given legal regime, a national measure is likely to favour 'certain undertakings or the production of certain goods' over others which, having regard to the objective pursued by that regime, are in a comparable factual and legal situation. In order for the Commission to classify a tax measure as selective, it must begin by

identifying and examining the common or ‘normal’ regime under the tax system applicable in the geographical area constituting the relevant reference framework. It is in relation to this common or ‘normal’ tax regime that the Commission must, secondly, assess and determine whether any advantage granted by the tax measure at issue may be selective by demonstrating that the measure derogates from that common regime inasmuch as the measure differentiates between economic operators who, in light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation.

If, in the course of those first two stages, the Commission has demonstrated the existence of derogations from the common or ‘normal’ tax regime resulting in a differentiation between undertakings, such a differentiation is none the less not selective when it arises from the nature or general scheme of the system of charges of which it forms part. In that situation, the Commission must determine, in a third stage, whether the State measure in question is not selective in nature even though it gives an advantage to the undertakings which are able to benefit from it. In that regard, given that the differentiations provided for vis-à-vis the common or ‘normal’ tax regime constitute derogations and are prima facie selective, it is for the Member State to show that those differentiations are justified by the nature and general scheme of its tax system in that they derive directly from the basic or guiding principles of that system. In that context, a distinction must be made between, on the one hand, the objectives attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives.

If the Commission has failed to carry out the first two stages of the review of a measure’s selectivity, it cannot embark upon the third and final stage of its assessment, as otherwise it will go beyond the limits of that review. Such an approach would be liable, first, to enable the Commission to assume the role of the Member State with regard to determination of that State’s tax system and of the common or ‘normal’ regime under it, including in relation to the objectives, the tax system’s inherent mechanisms for achieving those objectives and its bases of taxation, and second, thus to make it impossible for the Member State to justify the differentiations in question on the basis of the nature and of the general scheme of the tax system notified, since the Commission would not first either have identified the common or ‘normal’ regime under that system or have established that those differentiations constitute derogations from that regime.

(see paras 141, 143-145)

JUDGMENT OF THE COURT OF FIRST INSTANCE (Third Chamber, Extended Composition)

18 December 2008 (*)

(State aid – Aid scheme notified by the United Kingdom regarding the Government of Gibraltar’s reform of corporate tax – Decision declaring the aid scheme incompatible with the common market – Regional selectivity – Material selectivity)

In Cases T?211/04 and T?215/04,

Government of Gibraltar, represented by M. Llamas, barrister, by J. Temple Lang, solicitor, and initially by A. Petersen and K. Nordlander and subsequently by K. Karl, lawyers,

applicant in Case T?211/04,

supported by

United Kingdom of Great Britain and Northern Ireland, represented initially by M. Bethell, acting as Agent, D. Anderson QC and H. Davies, barrister, and subsequently by E. Jenkinson and E. O’Neill, acting as Agents,

intervener,

United Kingdom of Great Britain and Northern Ireland, represented initially by M. Bethell and E. Jenkinson, acting as Agents, D. Anderson QC and H. Davies, barrister, and subsequently by E. Jenkinson, E. O’Neill and S. Behzadi?Spencer, acting as Agents,

applicant in Case T?215/04,

v

Commission of the European Communities, represented by N. Khan and V. Di Bucci, acting as Agents,

defendant,

supported by

Kingdom of Spain, represented by N. Díaz Abad, abogado del Estado,

intervener,

APPLICATIONS for annulment of Commission Decision 2005/261/EC of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform (OJ 2005 L 85, p. 1),

THE COURT OF FIRST INSTANCE OF THE EUROPEAN COMMUNITIES (Third Chamber, Extended Composition),

composed of M. Jaeger, President, V. Tiili, J. Azizi, E. Cremona (Rapporteur) and O. Czúcz, Judges,

Registrar: C. Kantza, Administrator,

having regard to the written procedure and further to the hearing on 14 March 2007,

gives the following

Judgment

Legal context

I – *Community rules*

1 Article 87(1) EC provides:

‘Save as otherwise provided in this Treaty, 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.'

2 Commission Notice 98/C 384/03 on the application of the State aid rules to measures relating to direct business taxation (OJ 1998 C 384, p. 3; 'the notice relating to State aid in the field of direct business taxation') explains in paragraph 2 that the notice is intended to provide clarification on the question whether a tax measure can be qualified as aid under Article 87(1) EC.

3 Paragraph 16 of the notice states:

'The main criterion in applying Article [87](1) [EC] to a tax measure is … that the measure provides in favour of certain undertakings in the Member State an exception to the application of the tax system. The common system applicable should thus first be determined. It must then be examined whether the exception to the system or differentiations within that system are justified "by the nature or general scheme" of the tax system, that is to say, whether they derive directly from the basic or guiding principles of the tax system in the Member State concerned. If this is not the case, then State aid is involved.'

4 Article 299(4) EC states that the provisions of the Treaty are to apply to the European territories for whose external relations a Member State is responsible.

II – *Status of Gibraltar*

5 Gibraltar has been a Crown colony (or British Overseas Territory) since 1713 and the United Kingdom of Great Britain and Northern Ireland is responsible for its external relations. Gibraltar is not part of the United Kingdom.

6 At the material time, the instruments establishing Gibraltar's system of governance were the Gibraltar Constitution Order 1969 ('the 1969 Constitution') and the accompanying despatch of 23 May 1969.

7 Executive power is exercised in Gibraltar both by a Governor who is appointed by, and the representative of, the Queen and, in respect of defined domestic matters, by Gibraltar's Council of Ministers. The latter consists of the Chief Minister and other ministers, appointed by the Governor from among the elected members of the House of Assembly.

8 Legislative power is divided between the House of Assembly and the Governor. The House of Assembly consists of the Speaker, the Attorney-General, the Financial and Development Secretary and 15 elected members. Elections to the House of Assembly are in principle held every four years.

9 Gibraltar has its own courts. However, appeals against decisions of Gibraltar's highest court may be brought before the Judicial Committee of the Privy Council of the United Kingdom.

10 Since the territory of Gibraltar is a European territory, within the meaning of Article 299(4) EC, for whose external relations the United Kingdom is responsible, the provisions of the Treaty apply to it. While, by virtue of Article 28 of the Act concerning the conditions of accession of the Kingdom of Denmark, Ireland and the United Kingdom of Great Britain and Northern Ireland to the European Communities, which is annexed to the Treaty relating to their accession (OJ, English Special Edition of 27 March 1972, p. 5), acts of the Community institutions on, inter alia, the 'harmonisation of legislation of Member States concerning turnover taxes … shall not apply to Gibraltar' unless the Council provides otherwise, Community rules on competition, including those

relating to aid granted by the Member States, do apply to Gibraltar.

Facts

I – *Background to the Government of Gibraltar's reform of corporate tax*

11 On 11 July 2001, the Commission decided to initiate the formal investigation procedure under Article 88(2) EC in respect of two corporate tax measures applied in Gibraltar, respectively concerning 'exempt companies' (OJ 2002 C 26, p. 13) and 'qualifying companies' (OJ 2002 C 26, p. 9).

12 Exempt companies were not actually present in Gibraltar while qualifying companies had a bricks and mortar presence there and were active in various sectors.

13 In order to qualify for exempt company status, a company had to meet a number of conditions. Those conditions included the prohibition of carrying on or transacting any trade or business in Gibraltar, other than with other exempt companies and with qualifying companies. No Gibraltarian or resident of Gibraltar could hold or be interested in any of the shares in an exempt company other than as a shareholder in a public company. Subject to some limited exceptions, an exempt company was exempted from payment of income tax in Gibraltar and was liable only to taxation at a fixed sum of GBP 225 per annum.

14 The conditions for the grant of qualifying company status were, essentially, identical to those necessary for exempt company status. Qualifying companies paid tax at a rate negotiated with the Gibraltar tax authorities of between 2% and 10% of profits.

15 By judgment of 30 April 2002 in Joined Cases T-195/01 and T-207/01 *Government of Gibraltar* v *Commission* [2002] ECR II-2309, the Court of First Instance, on the one hand, annulled the decision to initiate the formal investigation procedure relating to exempt companies and, on the other, dismissed the application for annulment of the decision to initiate that procedure that related to qualifying companies.

16 On 27 April 2002, without prejudice to whether or not the tax regimes relating to exempt companies and to qualifying companies constituted State aid, the Government of Gibraltar announced its intention to repeal all its corporate tax laws and introduce an entirely new corporate tax regime for all companies in Gibraltar. This reform of corporate tax by the Government of Gibraltar forms the subject-matter of the present dispute.

II – *Government of Gibraltar's reform of corporate tax*

17 By letter of 12 August 2002, the United Kingdom notified the Commission, pursuant to Article 88(3) EC, of the Government of Gibraltar's reform of corporate tax.

18 This reform comprises a system of taxation applicable to all companies established in Gibraltar and a top-up (or penalty) tax applicable solely to companies in the financial services sector and to utilities, which include undertakings operating in the telecommunications, electricity and water sectors.

19 The tax reform will be implemented through:

– the Companies (Payroll Tax) Ordinance;

– the Companies (Annual Registration Fee) Ordinance;

– the Rates Ordinance; and

– the Companies (Taxation of Designated Activities) Ordinance.

20 The legislation relating to the tax reform will be implemented by the Government of Gibraltar after it has been passed by the House of Assembly. As part of the reform, the exempt company legislation and the qualifying company legislation will be repealed with immediate effect.

A – *System of taxation introduced by the tax reform*

21 The system of taxation that is introduced by the reform and will be applicable to all companies established in Gibraltar consists of a payroll tax, a business property occupation tax and a registration fee:

– payroll tax: all Gibraltar companies will be liable to a payroll tax in the amount of GBP 3 000 per employee each year; every ‘employer’ in Gibraltar will be required to pay payroll tax in respect of the total number of its full-time and part-time ‘employees’ who are ‘employed in Gibraltar’; the legislation relating to the tax reform will define the abovementioned terms;

– business property occupation tax (‘BPOT’): all companies occupying property in Gibraltar for business purposes will have to pay a tax on the occupation of that property at a rate equivalent to a percentage of their liability to the general rates charged on property in Gibraltar;

– registration fee: all Gibraltar companies will have to pay an annual registration fee, of GBP 150 per annum in the case of companies not intended to generate income and of GBP 300 per annum in the case of companies intended to generate income.

22 Liability to payroll tax together with BPOT will be capped at 15% of profits. The effect of this cap is that companies will pay payroll tax and BPOT only if they make a profit, and in an amount not exceeding 15% of profits.

B – *Top-up (or penalty) tax*

23 Certain activities, namely financial services and activities of utilities, will be subject to a top-up (or penalty) tax on profits generated by them. The top-up tax will apply only to profits that can be allocated to those activities.

24 Thus, financial services companies will be charged, in addition to payroll tax and BPOT, a top-up (or penalty) tax on profits from financial services activities at a rate of between 4% and 6% of profits (calculated in accordance with internationally accepted accounting standards); such companies will have their tax liability (payroll tax, BPOT and top-up tax) capped, in aggregate, at 15% of profits.

25 Utility companies will be charged, in addition to payroll tax and BPOT, a top-up (or penalty) tax on profits from their activities at the rate of 35% of profits (calculated in accordance with internationally accepted accounting standards). Such companies will be permitted to deduct payroll tax and BPOT from their liability to top-up tax. Although utility companies will also have their annual liability to payroll tax and BPOT capped, in aggregate, at 15% of profits, the operation of the utilities top-up tax will ensure that these companies always pay a tax equal to 35% of profits.

III – *Administrative procedure and contested decision*

26 By letter of 16 October 2002, the Commission informed the United Kingdom authorities of its

decision to initiate the procedure laid down in Article 88(2) EC in respect of the tax reform and invited interested parties to submit comments (OJ 2002 C 300, p. 2). The United Kingdom submitted its comments by letter of 13 December 2002.

27 The Commission received comments from the Confederación Española de Organizaciones Empresariales (Spanish Confederation of Business Organisations), the Ålands Landskapsstyrelse (Åland Executive, Finland), the Kingdom of Spain and the Government of Gibraltar. The Commission forwarded them to the United Kingdom, which informed the Commission of its comments by letter of 13 February 2003.

28 On 30 March 2004 the Commission adopted Decision 2005/261/EC on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform (OJ 2005 L 85, p. 1; 'the contested decision').

29 The operative part of the contested decision reads as follows:

'Article 1

The proposals notified by the United Kingdom for the reform of the system of corporate taxation in Gibraltar constitute a scheme of State aid that is incompatible with the common market.

Those proposals may accordingly not be implemented.

Article 2

This Decision is addressed to the United Kingdom of Great Britain and Northern Ireland.'

30 In support of its conclusion regarding the selective nature of the tax reform, the Commission states, in essence, in recitals 98 to 152 of the contested decision, that the reform is both regionally and materially selective. It is regionally selective since it provides for a system of corporate taxation under which companies in Gibraltar are taxed, in general, at a lower rate than those in the United Kingdom (recital 127 of the contested decision). The Commission finds that the following aspects of the tax reform are materially selective: first, the requirement that a company must make a profit before it becomes liable to payroll tax and BPOT, since that requirement favours companies which make no profit (recitals 128 to 133 of the contested decision); second, the cap limiting liability to payroll tax and BPOT to 15% of profits, since that cap favours companies which, for the tax year in question, have profits that are low in relation to their number of employees and occupation of business property (recitals 134 to 141 of the contested decision); and, third, the payroll tax and BPOT, since those two taxes inherently favour companies which have no real physical presence in Gibraltar and which as a consequence do not incur corporate tax (recitals 142 to 144 and 150 of the contested decision). The Commission concludes that 'the notified measures therefore entail both a regional and a material selectivity and the latter follows both from a number of specific features of the proposed system and from the analysis of that system as a whole' (recital 152 of the contested decision).

Procedure and forms of order sought

31 By applications lodged at the Registry of the Court of First Instance on 9 June 2004, the Government of Gibraltar (the applicant in Case T-211/04) and the United Kingdom (the applicant in Case T-215/04) brought the present actions for annulment of the contested decision.

32 By document lodged at the Court Registry on 4 October 2004, the United Kingdom applied for leave to intervene in support of the form of order sought by the applicant in Case T?211/04.

33 By documents lodged at the Court Registry on 7 October 2004, the Kingdom of Spain applied for leave to intervene in support of the forms of order sought by the Commission in Cases T?211/04 and T?215/04.

34 By documents lodged at the Court Registry on 1 December 2004, the applicant in Case T-211/04 requested, in accordance with Article 116(2) of the Rules of Procedure of the Court of First Instance, that Annex A 2 to the application be accorded confidential treatment vis-à-vis the interveners. It withdrew this request by document lodged at the Court Registry on 26 April 2005.

35 By orders of the President of the Third Chamber of the Court of First Instance of 14 December 2004 and 15 February 2005, the applications for leave to intervene in Cases T?211/04 and T?215/04 were granted.

36 By document lodged at the Court Registry on 8 March 2005, the United Kingdom requested that Cases T-211/04 and T-215/04 be joined for the purposes of the oral procedure and of judgment under Article 50 of the Rules of Procedure. The parties concerned submitted their observations on this request within the prescribed time-limit.

37 By documents lodged at the Court Registry on 16 March 2005 and 15 April 2005 respectively, the applicants in Cases T-211/04 and T-215/04 requested that priority treatment be given to those cases under Article 55(2) of the Rules of Procedure.

38 The Kingdom of Spain lodged its statement in intervention in Case T-215/04 on 29 April 2005 and in Case T-211/04 on 20 June 2005. The principal parties in those cases submitted their observations on the statements within the prescribed time-limit. The United Kingdom did not lodge a statement in intervention in Case T-211/04.

39 By decisions of 12 May 2005 and 13 December 2006, the Court decided, on the basis of Article 55(2) of the Rules of Procedure, to grant the requests for priority treatment in Cases T-211/04 and T-215/04.

40 On 6 June 2005 the Court decided to assign Cases T-211/04 and T-215/04 to the Third Chamber, Extended Composition.

41 By order of 18 December 2006, Cases T-211/04 and T-215/04 were joined for the purposes of the oral procedure.

42 Upon hearing the report of the Judge-Rapporteur, the Court of First Instance (Third Chamber, Extended Composition) decided to open the oral procedure and, by way of a measure of organisation of procedure as provided for in Article 64 of the Rules of Procedure, requested the parties in Cases T-211/04 and T-215/04 to submit their written observations on the consequences to be inferred from the Court of Justice’s judgment in Case C-88/03 *Portugal* v *Commission* [2006] ECR I-7115 (‘the judgment on the tax regime in the Azores’) with respect to the present cases. The parties complied with that request within the prescribed period.

43 The parties presented oral argument and replied to the questions put by the Court at the hearing which took place on 14 March 2007.

44 The Court considers that the two cases should be joined for the purposes of judgment, the parties having indicated their agreement to this at the hearing.

45 The applicant in Case T?211/04 claims that the Court should:

– annul the contested decision;

– order the Commission and the Kingdom of Spain to pay the costs.

46 The applicant in Case T?215/04 claims that the Court should:

– annul the contested decision;

– order the Commission to pay the costs.

47 In Cases T-211/04 and T-215/04, the Commission contends that the Court should:

– dismiss the action;

– order the applicant to pay the costs.

48 In Cases T-211/04 and T-215/04, the Kingdom of Spain contends that the Court should:

– dismiss the action;

– order the applicant to pay the costs.

Law

49 The applicants essentially put forward three pleas in law. The first relates to errors of law and assessment regarding application of the criterion of regional selectivity, the second to errors of law and assessment regarding application of the criterion of material selectivity, and the third to breach of essential procedural requirements in the context of examination of the tax reform's third aspect classified as materially selective, namely the inherent nature of the payroll tax and BPOT. The final plea subdivides into two parts, the first concerning breach of the right to a fair hearing and the second concerning breach of the duty to state reasons.

I – *The first plea: errors of law and assessment regarding application of the criterion of regional selectivity*

A – *Arguments of the parties*

50 The applicants submit that in the present instance the Commission misapplied the criterion of regional selectivity in considering the territory of the United Kingdom and its corporate tax regime to be the appropriate reference framework for assessing Gibraltar's tax reform. They essentially rely on four points in support of their view.

51 First, they submit that the criterion of regional selectivity cannot apply here in the manner in which the Commission applied it, because Gibraltar is not part of the United Kingdom under national law, international law or Community law. The case-law, the notice relating to State aid in the field of direct business taxation and the reasoning upon which the Commission relies in the contested decision all concern tax measures applicable to a territorial entity that forms part of a Member State. Gibraltar cannot be equated to such an entity.

52 Second, the applicants submit that, even if Gibraltar were to be regarded as forming part of the United Kingdom for the purpose of applying the Community State aid rules, the United Kingdom could not constitute the appropriate reference framework, because the two entities lack a common tax system. Gibraltar's tax reform does not constitute a 'derogation', an 'exception' or a 'reduction' vis-à-vis the United Kingdom corporate tax regime; the latter is not the 'normal' tax

system which would apply in Gibraltar in the absence of the tax reform at issue. Consequently, the criterion of regional selectivity cannot be applied.

53 In this connection, the applicants contend first of all that the United Kingdom authorities play no role in the definition of the political and economic environment in Gibraltar. On the political plane, Gibraltar's authorities include its own executive, legislature and judiciary, distinct from those of the United Kingdom. On the economic plane, Gibraltar receives no subsidy or financing of any kind from the United Kingdom. It raises all its revenue from its own taxation. It adopts the economic policies which it considers to be best suited to the territory with no reference to the United Kingdom's economic policies. It mints and prints its own currency, determines its own money supply and decides its borrowing and expenditure by itself. The contested decision contains errors of fact relating to the relevance to Gibraltar of the exercise of central power in the United Kingdom.

54 They applicants contend, next, that Gibraltar and the United Kingdom constitute two entirely separate and distinct fiscal territories. The Government of Gibraltar and the House of Assembly devise the tax regime applicable in Gibraltar taking account only of the specific circumstances and characteristics of its economy, without being in any way influenced or restricted by the tax laws or policies adopted in the United Kingdom. The tax laws of the United Kingdom have never been applied in Gibraltar and would not apply there even in the absence of Gibraltar's tax laws. There is therefore no norm to which Gibraltar taxes can be compared, or from which they could deviate. The contested decision contains errors of fact so far as concerns the description of Gibraltar as a place in which tax powers are decentralised but a central reference system remains (recital 121 of the contested decision), the description of the tax reform as a reduction of the amount of tax levied at national level (recital 109 of the contested decision) and the Commission's assertion that 'the tax system currently applied in Gibraltar largely follows the model of the United Kingdom, with the exception of the advantages granted to the offshore economy' (recital 112 of the contested decision).

55 According to the Government of Gibraltar, the criterion of selectivity assumes that the tax measure at issue may be compared with a normal tax rate otherwise applicable to the activity in the region in question. This necessarily means that the standard of comparison is a tax or other measure in the same tax jurisdiction. However, in the present case, Gibraltar and the United Kingdom are two separate tax jurisdictions; even in the absence of a specific corporate tax regime in Gibraltar, the United Kingdom tax regime would not apply there. This is not because the United Kingdom chose to transfer or to give up its tax powers to Gibraltar, as the Commission stated in recital 114 of the contested decision. The United Kingdom cannot choose to apply its tax laws to its colonial territories and it never exercised tax powers over Gibraltar.

56 The applicants contend, finally, that, contrary to the view adopted by the Commission in the contested decision, the political and fiscal autonomy enjoyed by an infra-State body does constitute a relevant criterion for assessing whether a tax measure adopted by the body is selective, inasmuch as that political and fiscal autonomy enables the infra-State body in question to be considered an appropriate reference framework.

57 Third, in their written observations on the consequences to be inferred from the judgment on the tax regime in the Azores, the applicants, while maintaining that the criterion of regional selectivity could not apply in the present instance because Gibraltar does not form part of the United Kingdom and the two entities lack a common tax system, submit in the alternative that the reference framework in the present instance is the territory of Gibraltar when the approach for defining that framework as set out in paragraphs 67 and 68 of the judgment on the tax regime in the Azores is applied.

58 Fourth, the applicants submit that, even if the tax reform proved to be regionally selective, it would be justified by its nature or its general scheme.

59 The Commission contends that the relevant question in this instance is not whether or not Gibraltar forms part of the United Kingdom for the purposes of applying domestic law or international law, but whether it forms part of the United Kingdom for the purposes of applying Community law, which establishes its own system of law. According to the Commission, that is the case.

60 It further contends that Gibraltar's economic separation from the United Kingdom has no bearing on the matter. Such a consideration has never been taken into account in State aid decisions because, even where there is a genuine economic separation between the central authorities and the autonomous region, the rules on regional State aid operate simply on the basis of the existence of an advantage for some undertakings by reference to their establishment or activity in a part of a Member State.

61 The Commission disputes in any event the applicants' claim that Gibraltar enjoys economic and fiscal independence from the United Kingdom and gives examples of financial support provided to Gibraltar by the United Kingdom.

62 The Commission also contends, contrary to the applicants' case, that the United Kingdom central authorities play a fundamental role in the definition of the political and economic environment in Gibraltar because, in particular, the United Kingdom is responsible for the application of Community law in Gibraltar and Gibraltar's monetary stability is wholly derived from the United Kingdom (its currency is nothing but the pound sterling under another name). Similarly, the Commission asserts that the concept of 'defined domestic matters', which according to the applicants covers taxation, has little meaning in the context of Community law for two principal reasons: (i) the 1969 Constitution provides that central authority (in the form of the Governor) may intervene, notably to secure the implementation in Gibraltar of international obligations, and (ii) unlike the United Kingdom, Gibraltar does not participate in the adoption of Community acts which affect its 'defined domestic matters' and must be implemented in its territory.

63 So far as concerns the applicants' arguments relating to Gibraltar and the United Kingdom not having a common tax system, the Commission essentially submits that, once it is established that Gibraltar forms part of the United Kingdom for the purposes of applying the Community State aid rules, the appropriate reference framework can only be that constituted by the United Kingdom tax regime.

64 The Commission notes that Article 87 EC refers to aid 'granted by a Member State' which affects trade between Member States. It submits that the relevant question is not whether the United Kingdom and Gibraltar are part of the same tax jurisdiction but whether a tax scheme applicable in Gibraltar is capable of being aid granted by a Member State. The Commission considers that the answer to the question must be in the affirmative since the Community State aid rules apply in full to Gibraltar, as the Government of Gibraltar itself accepts. The Member State

which proposes to grant aid in Gibraltar can only be the United Kingdom and therefore the question whether the scheme is regionally selective can only be assessed by reference to the United Kingdom, as the Member State responsible for compliance with Community law in Gibraltar.

65 The Commission also maintains that the absence of a common (or normal) tax system which would apply in Gibraltar if the Gibraltar tax scheme did not apply does not preclude application of the criterion of regional selectivity. This absence of a common tax system results from a choice made by the United Kingdom. The latter chose to establish a particular constitutional relationship with Gibraltar and also chose, by means of the act by which it acceded to the Community, to make Gibraltar subject to the State aid rules. The United Kingdom also retains sufficient powers over Gibraltar to be able to ensure that Gibraltar adopts a regime of corporate taxation that is compatible with the Treaty. It follows that the reference framework must be none other than that provided by the United Kingdom.

66 The Commission contests, moreover, the relevance of the degree of fiscal autonomy of the infra-State body for the purposes of applying the concept of State aid. It submits that that argument is also posited on acceptance of the premiss that Gibraltar is part of the United Kingdom. Given such a premiss, the claim that the application of the State aid rules depends on the degree of autonomy enjoyed by the region in question must be unfounded (save in the case of symmetrical delegation of taxing powers referred to in recital 115 of the contested decision).

67 In its written observations on the consequences to be inferred from the judgment on the tax regime in the Azores, the Commission states that in that judgment the Court of Justice accepts its view that the criterion for identifying the reference framework for assessing regional selectivity is the body that plays a fundamental role in the definition of the political and economic environment in which undertakings operate, but rejects its proposition that this can only be the Member State.

68 In the Commission’s submission, the question whether here the reference framework may be Gibraltar depends on the conditions laid down in the judgment on the tax regime in the Azores, not on Gibraltar’s constitutional status in domestic law.

69 The Commission contends that the requirement, referred to in paragraph 66 of the judgment on the tax regime in the Azores, that the region ‘occupies a fundamental role in the definition of the political and economic environment in which the undertakings present on the territory within its competence operate’ implies a fourth condition for the purposes of determining the appropriate reference framework, preliminary to and separate from the three tests listed in paragraph 67 of that judgment.

70 This fourth condition requires the region in question to enjoy a degree of autonomy over the political and economic environment in which undertakings established in its territory operate that is comparable to the influence exercised by the central government of a Member State whose constitution does not provide for regional autonomy. The Commission explains that the rationale behind this requirement, in the light of the Treaty rules on State aid, is that in order to establish whether certain undertakings benefit from a given advantage it is necessary to compare their situation with that of other undertakings operating in the same political and economic environment.

71 The Commission submits that the Government of Gibraltar does not play a fundamental role in the definition of the political and economic environment in which undertakings established in Gibraltar operate and that consequently the territory of Gibraltar cannot constitute the appropriate reference framework. Once this preliminary condition is not met, consideration of the three tests set out in paragraph 67 of the judgment on the tax regime in the Azores is otiose.

72 In the alternative, the Commission examines those three tests and maintains that Gibraltar does not satisfy two of them, namely the test relating to the ability of the United Kingdom Government to intervene directly in the field of tax measures adopted by the Gibraltar authorities and the test relating to the existence of subsidies offsetting the financial consequences for Gibraltar of its tax regime. Consequently, the territory of Gibraltar does not constitute the appropriate reference framework.

73 The Kingdom of Spain stresses that its intervention in support of the Commission cannot be interpreted, explicitly or implicitly, as indicating support for the reasoning in the contested decision concerning regional selectivity. In its view, the case of Gibraltar should be distinguished from those of the tax regime of the autonomous territories of the Basque Country and Navarre because of the existence of a tax harmonisation framework in those territories.

74 At the same time, it considers that it would not be possible for an entirely different tax regime from that of the United Kingdom to be applied in Gibraltar without the imposition of limits or coordinating rules of any kind, since that would imply that, in the matter of State aid, the territory of Gibraltar would be treated as another Member State, an outcome which the Kingdom of Spain sees as substantially changing the international status of that territory.

75 In its written observations on the consequences to be inferred from the judgment on the tax regime in the Azores, the Kingdom of Spain contends that a fourth condition must be added to the three conditions already set out by the Court of Justice in that judgment, for the purpose of determining whether the infra-State body constitutes the appropriate reference framework for assessing the tax measures adopted by that body. Under this fourth condition, the tax measure in question would not be selective if it were circumscribed by a number of harmonisation criteria which are similar to those that apply, by virtue of Community law, to tax measures adopted by the Member State to which the infra-State body belongs and which aim to protect the free movement of persons, capital, goods and services and to prevent distortion of the single market.

B – *Findings of the Court*

76 The rules of Community law relating to aid granted by the Member States apply to Gibraltar (*Government of Gibraltar* v *Commission*, cited in paragraph 15 above, paragraph 12). Article 87(1) EC is therefore the starting point for the Court’s analysis.

77 That provision prohibits State aid which ‘[favours] certain undertakings or the production of certain goods’, that is to say aid which is selective (Case C-66/02 *Italy* v *Commission* [2005] ECR I?10901, paragraph 94).

78 As regards appraisal of the condition of selectivity, it is clear from settled case-law that Article 87(1) EC requires assessment of whether, under a particular legal regime, a national measure is such as to favour ‘certain undertakings or the production of certain goods’ in comparison with others which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation (Case C-143/99 *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke* [2001] ECR I-8365, paragraph 41; Case C-308/01 *GIL Insurance and Others* [2004] ECR I-4777, paragraph 68; and Case C-172/03 *Heiser* [2005] ECR I-1627, paragraph 40).

79 Such an analysis is also required in respect of a measure adopted not by the national legislature but by an infra-State authority, since a measure adopted by a regional or local authority and not the central authorities can constitute aid if the conditions laid down by Article 87(1) EC are satisfied (Case 248/84 *Germany* v *Commission* [1987] ECR 4013, paragraph 17).

80 It is clear from the foregoing that in order to determine whether the measure at issue is selective it is appropriate to examine whether, within the context of a particular legal regime, that measure constitutes an advantage for certain undertakings in comparison with others which are in a comparable legal and factual situation. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with 'normal' taxation. The 'normal' tax rate is the rate in force in the geographical area constituting the reference framework (judgment on the tax regime in the Azores, paragraph 56).

81 In the present instance, it must be examined whether the territory of the United Kingdom constitutes the appropriate reference framework for assessing the tax reform with regard to regional selectivity. A negative answer to this question would necessarily mean that the territory of Gibraltar constitutes the appropriate reference framework for assessing the tax reform and would invalidate any conclusion that the reform is regionally selective.

82 It is apparent in particular from recitals 104 and 125 of the contested decision that the Commission relied on two factors in concluding that the territory of the United Kingdom constituted the appropriate reference framework for determining whether the tax reform was regionally selective: first, it considered, in essence, that the reference framework could only be the territory of the Member State concerned because of the general scheme of the Treaty and of the State aid rules in particular, and that the extent of the infra-State body's autonomy in relation to central government was not relevant for the purposes of determining that framework; second, it based its conclusion on the role played by the United Kingdom authorities in defining the political and economic environment in which undertakings operate in Gibraltar.

1. The relevance of the extent of the infra-State body's autonomy in relation to the central government of the Member State concerned for the purposes of determining the appropriate reference framework

83 So far as concerns the first factor upon which the Commission based its conclusion determining the territory of the United Kingdom to be the appropriate reference framework in this instance (see paragraph 82 above), it is clear that, as the Commission has acknowledged in its written observations on the consequences to be inferred from the judgment on the tax regime in the Azores, the Court of Justice rejected its analysis in paragraphs 57 and 58 of that judgment in the following terms:

'57 … the reference framework need not necessarily be defined [in terms of] the limits of [the territory of] the Member State concerned, so that a measure conferring an advantage in only one part of the national territory is not selective on that ground alone for the purposes of Article 87(1) EC.

58 It is possible that an infra-State body enjoys a legal and factual status which makes it sufficiently autonomous in relation to the central government of a Member State, with the result that, by the measures it adopts, it is that body and not the central government which plays a fundamental role in the definition of the political and economic environment in which undertakings operate. In such a case it is the area in which the infra-State body responsible for the measure exercises its powers, and not the country as a whole, that constitutes the relevant context for the

assessment of whether a measure adopted by such a body favours certain undertakings in comparison with others in a comparable legal and factual situation, having regard to the objective pursued by the measure or the legal system concerned.'

84 It is sufficient, therefore, to examine the merits of the second factor supporting the Commission's conclusion defining the United Kingdom as the reference framework, namely the role played by the United Kingdom authorities in defining the political and economic environment in which undertakings operate in Gibraltar (see paragraph 82 above).

2. The United Kingdom's role in the definition of the political and economic environment in Gibraltar as a criterion for determining the reference framework in this instance

a) The judgment on the tax regime in the Azores

85 In the judgment on the tax regime in the Azores, the Court of Justice, referring in paragraph 65 to the situation in which a regional or local authority adopts, in the exercise of powers sufficiently autonomous in relation to the central power, a tax rate lower than the national rate and which is applicable only to undertakings present in the territory within its competence, found in particular as follows:

'66 In [that] situation, the legal framework appropriate to determine the selectivity of a tax measure may be limited to the geographical area concerned where the infra-State body, in particular on account of its status and powers, occupies a fundamental role in the definition of the political and economic environment in which the undertakings present on the territory within its competence operate.

67 As the Advocate General pointed out in paragraph 54 of his Opinion, in order that a decision taken in such circumstances can be regarded as having been adopted in the exercise of sufficiently autonomous powers, that decision must, first of all, have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government. Next, it must have been adopted without the central government being able to directly intervene as regards its content. Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government.

68 It follows that political and fiscal independence of central government which is sufficient as regards the application of Community rules on State aid presupposes, as the United Kingdom Government submitted, that the infra-State body not only has powers in the territory within its competence to adopt measures reducing the tax rate, regardless of any considerations related to the conduct of the central State, but that in addition it assumes the political and financial consequences of such a measure.'

86 In the present instance, it should accordingly be examined whether the tax reform satisfies the three conditions set out in paragraph 67 of the judgment on the tax regime in the Azores. Thus, it must be examined (i) whether the tax reform has been devised by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government of the United Kingdom, (ii) whether the tax reform has been devised without the central government of the United Kingdom being able to intervene directly as regards its content and (iii) whether the financial consequences for Gibraltar of introducing the tax reform are offset by aid or subsidies from other regions or from the central government of the United Kingdom.

87 The Court cannot uphold the Commission's argument that paragraph 66 of the judgment on

the tax regime in the Azores contains a fourth condition preliminary to and separate from the three conditions listed in paragraph 67, namely the condition that the infra-State body must occupy a fundamental role in the definition of the political and economic environment in which the undertakings present on the territory within its competence operate. There is no support for that argument in the judgment on the tax regime in the Azores or in the Opinion of Advocate General Geelhoed in the same case (points 54 and 55).

88 Nor can the Court uphold the argument put forward by the Kingdom of Spain regarding the existence of a fourth condition, in addition to the three conditions set out by the Court of Justice in the judgment on the tax regime in the Azores, relating to the tax measure at issue being circumscribed by harmonisation criteria which are imposed by Community law on tax measures adopted by the Member State to which the infra-State body in question belongs. Besides its vagueness so far as concerns identification of the harmonisation criteria referred to and their content, this argument is not supported by the judgment on the tax regime in the Azores and must therefore also be rejected.

b) Application of the first and second conditions set out in the judgment on the tax regime in the Azores

89 With regard to the first condition set out in the judgment on the tax regime in the Azores, it need merely be stated that, as the principal parties acknowledge, the competent Gibraltar authorities which have devised the tax reform have, from a constitutional point of view, a political and administrative status separate from that of the central government of the United Kingdom and that, accordingly, the first condition is met.

90 In the case of the second condition set out in the judgment on the tax regime in the Azores, it must be examined in this instance whether the tax reform has been devised without the central government of the United Kingdom being able to intervene directly as regards its content.

91 The Commission submits that this condition is not met here because, by virtue of sections 33 and 34 of the 1969 Constitution, the United Kingdom does have the power to intervene directly, through the Governor, notably in matters relating to ‘financial and economic stability’, which, it submits, must include matters of taxation.

92 The Commission counters the applicants’ contention that the United Kingdom’s residual power to legislate in Gibraltar has never been exercised in matters of taxation by stating that the second condition set out in the judgment on the tax regime in the Azores poses the question whether the Member State’s central authorities can intervene and not whether as a matter of practice they do.

93 It must be stated first that, as is apparent from the case-files and from *Government of Gibraltar* v *Commission*, cited in paragraph 15 above, paragraph 53, company taxation falls within the category of defined domestic matters. It is not in dispute that executive competence in relation to those matters rests with Gibraltar’s Council of Ministers. The latter has the power to draft, and to submit to Gibraltar’s legislature for adoption, tax measures applicable in the territory of Gibraltar.

94 Second, under section 32 of the 1969 Constitution, Gibraltar’s legislature has the power, subject to certain provisos, to make laws ‘for the peace, order and good government of Gibraltar’. It is not disputed that this power encompasses the adoption of tax measures. Under section 33(1) of the 1969 Constitution, legislative power is exercised, in principle, by means of bills passed by the House of Assembly and assented to by the Queen or by the Governor on behalf of the Queen. It is not in dispute that members of the House of Assembly are democratically elected by, and solely represent, the people of Gibraltar. Section 33(2) of the 1969 Constitution provides also that

the Governor may withhold his assent to bills or reserve certain bills for a decision on their assent by the Queen. Furthermore, section 34(2) of the 1969 Constitution provides that the Governor may, with respect to matters constituting defined domestic matters and in the interests of maintaining the financial and economic stability of Gibraltar, introduce bills, under certain conditions, into the House of Assembly and, under certain conditions, adopt such bills by assenting thereto.

95 Third, it is clear from the case-files that the United Kingdom retains a residual power of last resort to legislate for Gibraltar but that this power has been exercised only exceptionally and never in matters of taxation. No United Kingdom law in respect of fiscal matters applies, or has ever applied, to Gibraltar.

96 Finally, the Commission does not dispute that, in the present instance, Gibraltar's tax reform has been devised by the Gibraltar authorities without the intervention of the United Kingdom authorities.

97 It must be held that the powers granted to the Governor by sections 33 and 34 of the 1969 Constitution, which moreover have never been exercised in matters of taxation, do not demonstrate that the 'central government' of the United Kingdom is able to intervene 'directly' as regards the content of the tax reform, within the meaning of the second condition set out in the judgment on the tax regime in the Azores. Despite the fact that the Governor is appointed by the Queen – acting in her capacity as the Queen of Gibraltar – and he is her representative in Gibraltar (section 18 of the 1969 Constitution), the case-files do not show that the Governor of Gibraltar can be equated with the central government of the United Kingdom and that his ability to intervene in the legislative process in Gibraltar can be classified as 'direct intervention' of the 'central government' of the United Kingdom within the meaning of paragraph 67 of the judgment on the tax regime in the Azores.

98 Moreover, the residual power which the United Kingdom retains to legislate for Gibraltar and the various powers granted to the Governor under the 1969 Constitution that entitle him to participate in the legislative process must be interpreted in the light of the status of Gibraltar as a colony or 'non-self-governing territory' under Article 73, in Chapter XI, of the Charter of the United Nations, for whose external relations the United Kingdom, as the 'administering power' for the purposes of that provision, is responsible. The obligations of the United Kingdom in its capacity as the administering power for Gibraltar are made clear in Article 73 of the Charter, the relevant part of which provides:

'Members of the United Nations which have or assume responsibilities for the administration of territories whose peoples have not yet attained a full measure of self-government recognise the principle that the interests of the inhabitants of these territories are paramount, and accept as a sacred trust the obligation to promote to the utmost, within the system of international peace and security established by the present Charter, the well-being of the inhabitants of these territories, and, to this end:

(a) to ensure, with due respect for the culture of the peoples concerned, their political, economic, social, and educational advancement, their just treatment, and their protection against abuses;

(b) to develop self-government, to take due account of the political aspirations of the peoples, and to assist them in the progressive development of their free political institutions, according to the particular circumstances of each territory and its peoples and their varying stages of advancement;

…’

99 In the light of the foregoing, the United Kingdom’s residual power to legislate for Gibraltar and the various powers granted to the Governor must be interpreted as means enabling the United Kingdom to assume its responsibilities towards the population of Gibraltar and to perform its obligations under international law, and not as granting an ability to intervene directly as regards the content of a tax measure adopted by the Gibraltar authorities, in particular since those residual powers have never been exercised in matters of taxation.

100 Accordingly, the second condition set out in the judgment on the tax regime in the Azores is met in the present instance.

c) Application of the third condition set out in the judgment on the tax regime in the Azores

101 With regard to the third condition set out in the judgment on the tax regime in the Azores, it must be examined in this instance whether any financial consequences for Gibraltar of introducing the tax reform are offset by aid or subsidies from other regions or from the central government of the United Kingdom.

102 The Commission submits that this condition implies that no assistance is even potentially available to the infra-State body to offset the effect of the body’s decisions about its tax measures. It contests, therefore, that this condition requires the existence of a link between, on the one hand, any measure by the region reducing taxation and, on the other, any subsidy that might be forthcoming from central government or another region. According to the Commission, that interpretation is inconsistent with the claimed fourth condition that the infra-State body must play a fundamental role in the definition of the political and economic environment in which the undertakings present on its territory operate; in order to determine whether this condition is met all sources of financing from central government must be considered, given that money is fungible and that a payment that relieves one head of public expenditure by Gibraltar allows it to apply more money elsewhere or to levy lower taxes. In the light of its interpretation, the Commission disputes that the third condition is met in the present instance, on account of the financial assistance allegedly granted by the United Kingdom to Gibraltar.

103 In this regard, the Commission relies in particular on the financing by the United Kingdom of the Gibraltar Social Insurance Fund in order for Gibraltar to be able to pay the pensions of Spanish nationals currently resident in Spain who worked in Gibraltar before the Spanish authorities decided to close the border between Spain and Gibraltar in 1969. It also relies on development aid granted by the United Kingdom to Gibraltar on various occasions since the United Kingdom’s accession to the Community, the financing by the United Kingdom of a scheme for providing venture capital to small and medium-sized enterprises (SMEs) established in the United Kingdom and Gibraltar, and the subsidising of the operation of Gibraltar’s airport by the United Kingdom’s Ministry of Defence.

104 That reasoning cannot be upheld.

105 It should be remembered first of all that the argument that a fourth condition is contained in paragraph 66 of the judgment on the tax regime in the Azores is not well founded (see paragraph 87 above). The Commission is therefore wrong in relying thereon in order to substantiate its reasoning.

106 In addition, the Court of Justice’s use of the verb ‘offset’ in paragraph 67 of the judgment on the tax regime in the Azores implies that a causal link must exist between the tax measure at issue

adopted by the infra-State body and the financial support from other regions or the central government of the Member State concerned. The interpretation proposed by the Commission would make the third condition set out in the judgment on the tax regime in the Azores a dead letter, since it would be very difficult to conceive of an infra-State body which does not receive any financial support, in whatever form, from central government.

107 It is clear that the United Kingdom’s financial assistance to Gibraltar upon which the Commission relies is linked to specific circumstances and has no causal link with the tax reform.

108 First, as is apparent from the case-files, the financing by the United Kingdom since 1985 of the Gibraltar Social Insurance Fund concerns payment of the pensions of Spanish nationals who worked in Gibraltar before the Spanish authorities closed the border between Spain and Gibraltar from 1969 to 1985.

109 Second, as is apparent from the document relied upon by the Commission in support of its contention, the development aid granted by the United Kingdom to Gibraltar concerned the period between 1978 and 1986 and related to projects to develop the infrastructure on Gibraltar, education projects and housing projects.

110 Third, as is apparent from the Commission decision of 4 February 2003 relating to the Small and Medium Enterprise Venture Capital and Loan Fund (Aid N 620/2002; OJ 2003 C 110, p. 14), the financing by the United Kingdom of a scheme for providing venture capital to SMEs established in the United Kingdom and Gibraltar, which was notified by the United Kingdom on 11 September 2002, benefits those SMEs and the investors concerned.

111 Finally, so far as the subsidising of the operation of Gibraltar’s airport is concerned, the applicants contended at the hearing, without being challenged by the Commission, that this airport was constructed by the British military during the Second World War and was still a British military airport also made available for civilian use.

112 Having regard to the foregoing, and in the absence of evidence to the contrary adduced by the Commission, it must be found that none of the abovementioned financing serves to offset any financial consequences that the tax reform would entail for Gibraltar, for the purposes of the third condition set out in the judgment on the tax regime in the Azores.

113 Since therefore there is nothing that can cast doubt on the applicants’ assertions that Gibraltar does not receive any financial support from the United Kingdom that offsets the financial consequences of the tax reform, it must be held that the third condition set out in the judgment on the tax regime in the Azores is met in the present instance.

114 As the three conditions set out in the judgment on the tax regime in the Azores are met, it is to be concluded that the role played by the United Kingdom in the definition of the political and economic environment in which undertakings operate in Gibraltar is not sufficient for the view to be taken that the territory of the United Kingdom constitutes the appropriate reference framework in the present instance. Thus, the second factor supporting the Commission’s conclusion defining the reference framework as being the territory of the United Kingdom (see paragraph 84 above) is not well founded either.

115 Accordingly, it must be concluded that the reference framework corresponds exclusively to the geographical limits of the territory of Gibraltar, without there being any need to examine the applicants’ arguments relating to Gibraltar not forming part of the United Kingdom and to Gibraltar and the United Kingdom lacking a common tax system. This definition of the reference framework means that no comparison can be made between the tax regime applicable to companies

established in Gibraltar and that applicable to companies established in the United Kingdom for the purpose of establishing a selective advantage favouring the former.

116 It follows from all of the foregoing that the Commission's conclusion in the contested decision relating to the tax reform's regional selectivity is vitiated by an error of law and of assessment.

117 The first plea must consequently be upheld.

II – *The second plea: errors of law and assessment regarding application of the criterion of material selectivity*

A – *Arguments of the parties*

118 The applicants challenge the legality of the Commission's conclusions in the contested decision relating to the material selectivity of three aspects of the tax system introduced by the reform, namely: (i) the requirement that a company must make a profit before it becomes liable to payroll tax and BPOT (recitals 128 to 133 of the contested decision); (ii) the cap limiting liability to payroll tax and BPOT to 15% of profits (recitals 134 to 141 of the contested decision); and (iii) the inherent nature of the payroll tax and BPOT (recitals 142 to 144 and 150 of the contested decision).

119 The Government of Gibraltar considers that the three aspects at issue referred to above are of general application within Gibraltar and do not favour specific undertakings or the production of specific goods. In the submission of the Government of Gibraltar, the reform constitutes a tax scheme in its own right, founded on the criteria of employment and property occupation, and is not a derogation from any profit-based tax scheme. The Commission failed to identify a reference point in relation to which the reform grants a selective advantage. It confused and misrepresented both elements of the reform, that is to say, the payroll tax and BPOT on the one hand and the 15% cap on the other, by treating one element as if it were the general rule and the other as if it were an exemption from this general rule (and vice versa) and by not treating them as two elements of equal importance for the operation of the tax scheme proposed by Gibraltar. The United Kingdom submits, to like effect, that under the tax system introduced by the reform the operative event for liability to tax is the profitable employment of an employee or the profitable use of property.

120 As regards the requirement that a company must make a profit before it becomes liable to payroll tax and BPOT, the applicants dispute that this condition is materially selective, maintaining that companies which do not make a profit are not exempted from any tax burden which would apply normally. The requirement of profit does not constitute an exemption or derogation from a common system of taxation, and so cannot be said to be selective.

121 The applicants also criticise the Commission for not having identified the beneficiaries of the tax measure at issue in accordance with the requirements of Article 87(1) EC. In the present instance, the companies benefiting from the requirement that a profit be made, namely those which do not achieve a profit in a given year, can be identified only on the basis of their temporary circumstances or current performance, which creates a variable group of companies likely to change significantly from year to year. The case-law requires a sufficiently definable and predictable group of undertakings to be favoured by a general taxation measure such as the requirement that a profit be made in order for that measure to fall within the scope of Article 87(1) EC.

122 The applicants contend in the alternative that the requirement that a company must make a profit is justified by the nature and general scheme of the tax reform and accordingly escapes

classification as State aid. More specifically, the tax reform is based on the principle that tax should be paid out of income rather than capital. The taxation of companies which do not make a profit would result in taxation of their capital, contrary to the basic principle of the tax reform.

123 As regards the cap limiting liability to payroll tax and BPOT to 15% of profits, the applicants contend that the cap is not selective because it favours neither certain defined categories of undertakings nor the production of certain categories of goods. The cap is generally applicable, to all Gibraltar companies. Again, it is not possible to determine in advance which if any companies will benefit from the cap. The cap forms part of the common regime of taxation in the same way as the employment of employees and the occupation of business property, and does not constitute a derogation from that regime.

124 In the alternative, the applicants contend that the cap of 15% of profits is justified by the nature and general scheme of the system. They regard the cap as a regressive factor in the system introduced by the tax reform and submit that the Commission should not classify the tax exemption covering the amount of tax exceeding the cap as State aid. The Government of Gibraltar also justifies the introduction of the cap on the basis of the need to avoid an overtaxing of companies which could trigger layoffs and instability in times of cyclical market fluctuations or depression.

125 As regards, finally, the payroll tax and BPOT, the applicants submit that, in criticising the Government of Gibraltar's choice of the bases of taxation, namely employment and property occupation, the Commission in reality challenges the very nature of the general tax regime devised by it, thus trespassing upon the prerogatives of the Member States regarding the devising of the tax policies that suit them best. The fact that companies which have no employees and occupy no business property in Gibraltar will not be liable to tax does not constitute a derogation from any 'normal' tax rate; that situation results simply from the nature of the general tax regime in Gibraltar.

126 In the applicants' submission, it appears from the contested decision that according to the Commission the only method of corporate taxation that can properly be regarded as general is a system based on the taxation of company profits. The Commission seems to be seeking to establish from a Community perspective a 'normal' tax regime, namely one of profit-based taxation, in order to conclude that any departure from it could be considered to constitute State aid. This approach on the part of the Commission would render the powers of the Member States in tax matters illusory and is both wrong in law and insufficiently reasoned.

127 In the alternative, the applicants contend that the use of employment and of the occupation of business property as bases of taxation is justified by the nature and general scheme of the tax system which the Government of Gibraltar wishes to introduce. In this connection, the United Kingdom emphasises the need for Gibraltar to introduce a tax that is simple and easy for a tax authority with a limited number of staff to collect, while the Government of Gibraltar stresses the particular characteristics of the Gibraltar economy, namely scarce labour resources, significant dependence on workers commuting daily from Spain and a territory of limited area.

128 The Commission submits as a preliminary point that the potentially wide application of the criterion of material selectivity as adopted in the contested decision is justified in the light of the case-law, which shows that measures ostensibly available to all economic operators in a given territory are nevertheless selective in nature when they in fact favour certain of those operators or a specific category of them. The Commission also contests, in light of the case-law, the assertion that it is necessary to identify the beneficiaries of the tax reform in a precise and predictable manner.

129 As regards the selective nature of the requirement that a company must make a profit and of

the cap of 15% of profits, the Commission contests the applicants' argument that it elevated the significance of one element of the tax reform above that of the other. It considers, on the contrary, that the reform creates a hybrid system in the sense that the profit made by a company is a vital element in applying what is ostensibly a payroll tax and a business property occupation tax.

130 The Commission observes that, for certain companies, each element of that system works to remove liability to tax which would otherwise arise by virtue of the other element. More specifically, a company might be highly profitable, but if it took the form of what is presently classified as an 'exempt company' it would need neither premises nor employees and would accordingly be almost untaxed. Conversely, a company might have employees and occupy premises, but if it made no profits the tax reform would likewise leave it untaxed.

131 The hybrid character of the tax reform renders its nature and general scheme indiscernible. While, according to the applicants, labour and land are two factors of production in short supply in Gibraltar, this should lead to the conclusion that those scarce resources should be taxed without exemptions or thresholds so as to ensure that they are allocated to their most efficient use. Under that alleged logic of the tax reform, the requirement that a company must make a profit before it becomes liable to any tax and the condition imposing a cap of 15% of profits are not comprehensible and, therefore, the selective nature of those two aspects of the tax reform cannot be justified by the nature and general scheme of that reform.

132 The Commission also contests that the cap of 15% of profits can be justified as a technical adjustment intended to ensure that the payroll tax and BPOT are regressive.

133 The Commission further contests both the alleged need for tax to be paid out of income rather than capital and the alleged need for the level of taxation not to exceed the taxpayer's willingness to pay.

134 So far as concerns the first of those justifications, the Commission expresses its inability to understand why the Government of Gibraltar chose the approach of payroll tax and BPOT subject to the cap of 15% of profits. The nature of those taxes is that they are limited in their reach, and their ability to provide a source of tax revenue from Gibraltar companies is further limited by the 15% rule.

135 So far as concerns the second of those justifications, the Commission maintains that the constraints imposed on raising tax revenue that are due to the limits on taxpayers' willingness to pay taxes are accommodated by the level at which such taxes are set. If GBP 3 000 per year per employee is considered the appropriate level for a tax on the scarce resource of labour in Gibraltar, nothing in the notification of the tax reform explains why an inefficient employer of labour should be advantaged by, in effect, the waiver of payroll tax in favour of a 15% profits tax.

136 As regards the inherently selective nature of the payroll tax and BPOT, the Commission observes that the argument that it is seeking to attack the very nature of the tax scheme which the Government of Gibraltar wishes to establish simply begs the fundamental question in issue, which is whether the reform is indeed a general tax scheme. It recalls that, according to the contested decision, the tax reform is materially selective by its nature, because it uses payroll tax and BPOT as a basis for corporate taxation in an economy such as Gibraltar's, where there is a large offshore sector of companies without employees or property.

137 It is not correct that such companies are identifiable only due to temporary circumstances or the vicissitudes of the trade cycle. The Commission maintains that, although the status of exempt company is to be abolished as a result of the reform, the reform leaves in place the same features that presently make the setting up of an exempt company attractive. According to the Commission,

there is nothing temporary about the circumstances of companies whose nature is such that they operate with no physical presence or employees.

138 The Commission further submits that the advantages of the regime are effectively not open to all undertakings on an equal access basis and contests the justification derived from the nature and general scheme of the system. It explains that this alleged justification could not be examined in the contested decision, given the finding in that decision that no general scheme could be discerned due to the hybrid nature of the tax reform. It considers that the fact that the reform results in the setting of different tax rates for different types of undertakings is inimical to the possibility that the reform could be justified by reason of its nature and general scheme. The Commission also contests the other arguments advanced by the applicants in support of such justification and concludes that there is nothing in the nature and general scheme of the tax reform that justifies the selective exclusion from corporate tax of such a large proportion of Gibraltar's registered companies.

139 The Kingdom of Spain supports the Commission's position that the reform proposed by Gibraltar is materially selective. It considers, in essence, that it is selective for the various features of the tax reform not to apply in the same way to all sectors of economic activity, with the result that some sectors, which it is possible to determine a priori, are liable to lower overall rates of tax than others.

140 The Kingdom of Spain also asserts that the requirement that a company must make a profit is an element alien to the nature of the payroll tax and BPOT, which prompts the conclusion that this requirement seeks to introduce an element of material selectivity into the tax system proposed by Gibraltar. It also contests the justification of the alleged selectivity of the tax reform on the basis of the nature and general scheme of the system.

B – *Findings of the Court*

141 It should be remembered, with regard to the condition relating to the selective nature of the advantage granted by a disputed tax measure, that Article 87(1) EC requires assessment of whether, under a particular legal regime, a national measure is such as to favour 'certain undertakings or the production of certain goods' in comparison with others which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation (see the case-law cited in paragraph 78 above).

142 Judicial review of the Commission's determinations in this regard is, in principle, a comprehensive review, given that aid as defined in the Treaty, of which the condition regarding selectivity is a constituent, is a legal concept which must be interpreted on the basis of objective factors (see, to this effect, Case C-83/98 P *France* v *Ladbroke Racing and Commission* [2000] ECR I?3271, paragraph 25; Case T-296/97 *Alitalia* v *Commission* [2000] ECR II?3871, paragraph 95; and Case T-98/00 *Linde* v *Commission* [2002] ECR II?3961, paragraph 40).

143 As the Commission itself states in paragraph 16 of the notice relating to State aid in the field of direct business taxation, in order for it to classify a tax measure as selective, it must begin by identifying and examining the common or 'normal' regime under the tax system applicable in the geographical area constituting the relevant reference framework. It is in relation to this common or 'normal' tax regime that the Commission must, secondly, assess and determine whether any advantage granted by the tax measure at issue may be selective by demonstrating that the measure derogates from that common regime inasmuch as the measure differentiates between economic operators who, in light of the objective assigned to the tax system of the Member State concerned, are in a comparable factual and legal situation (see, to this effect, *Italy* v *Commission*, cited in paragraph 77 above, paragraph 100; Joined Cases C-182/03 and C-217/03 *Belgium and Forum 187*

v *Commission* [2006] ECR I?5479, paragraph 120; the judgment on the tax regime in the Azores, paragraph 56; and the Opinion of Advocate General Darmon in Joined Cases C-72/91 and C-73/91 *Sloman Neptun* [1993] ECR I?887, points 50 to 72).

144 If the Commission, in the course of the first two stages of its assessment as referred to in paragraph 143 above, has demonstrated the existence of derogations from the common or 'normal' tax regime resulting in a differentiation between undertakings, it is clear from settled case-law that such a differentiation is none the less not selective when it arises from the nature or general scheme of the system of charges of which it forms part. In that situation, the Commission must determine, in a third stage, whether the State measure in question is not selective in nature even though it gives an advantage to the undertakings which are able to benefit from it (see, to this effect, *Adria?Wien Pipeline and Wietersdorfer & Peggauer Zementwerke*, cited in paragraph 78 above, paragraph 42; Case C-409/00 *Spain* v *Commission* [2003] ECR I?1487, paragraph 52; and the judgment on the tax regime in the Azores, paragraph 52). In that regard, given that the differentiations provided for vis-à-vis the common or 'normal' tax regime constitute derogations and are prima facie selective, it is for the Member State to show that those differentiations are justified by the nature and general scheme of its tax system in that they derive directly from the basic or guiding principles of that system. In that context, a distinction must be made between, on the one hand, the objectives attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives (see, to this effect, the judgment on the tax regime in the Azores, paragraph 81).

145 It should be added that, if the Commission has failed to carry out the first two stages of the review of a measure's selectivity (see paragraph 143 above), it cannot embark upon the third and final stage of its assessment, as otherwise it will go beyond the limits of that review. Such an approach would be liable, first, to enable the Commission to assume the role of the Member State with regard to determination of that State's tax system and of the common or 'normal' regime under it, including in relation to the objectives, the tax system's inherent mechanisms for achieving those objectives and its bases of taxation, and second, thus to make it impossible for the Member State to justify the differentiations in question on the basis of the nature and of the general scheme of the tax system notified, since the Commission would not first either have identified the common or 'normal' regime under that system or have established that those differentiations constitute derogations from that regime.

146 With regard to determination of the tax system at issue, it must be stated that, as Community law currently stands, direct taxation falls within the competence of the Member States. Thus it is solely the latter, and infra-State bodies which have sufficient autonomy – as defined in the judgment on the tax regime in the Azores – in relation to central government, that have competence to devise systems of corporate taxation which they consider the best suited to the needs of their economies (see, to this effect, Case C?204/90 *Bachmann* [1992] ECR I?249, paragraph 23; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I?11673, paragraph 50; and Case T-67/94 *Ladbroke Racing* v *Commission* [1998] ECR II?1, paragraph 54; see also the Opinion of Advocate General Poiares Maduro in Case C-446/03 *Marks & Spencer* [2005] ECR I?10837, points 23 and 24). Furthermore, as is essentially indicated by paragraph 13 of the notice relating to State aid in the field of direct business taxation, application of the Community rules on State aid is without prejudice to the power of the Member States to decide on their economic policy and, therefore, on the tax system – and the common or 'normal' regime under it – which they consider the most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production and economic sectors.

147 It must be determined now whether in the present instance the Commission adhered to

those principles when it assessed whether the measure at issue is selective.

1. Relevant recitals of the contested decision

148 It is to be recalled that in the contested decision the Commission concluded that three aspects of the tax system introduced by the reform confer selective advantages on the companies benefiting therefrom and may therefore constitute State aid, namely (i) the requirement that a company must make a profit before it becomes liable to payroll tax and BPOT, (ii) the cap limiting liability to payroll tax and BPOT to 15% of profits and (iii) the inherent nature of the payroll tax and BPOT.

149 First, as regards the requirement that a company must make a profit, the Commission stated in recital 128 of the contested decision that this condition 'acts as an exemption for unprofitable companies and constitutes an advantage which relieves such companies of the liability for payroll tax and [BPOT] which would normally be borne by their budgets'.

150 The Commission added that this exemption from payroll tax and BPOT is selective as it applies only to those companies that make no profit (recital 129 of the contested decision).

151 In recital 131 of the contested decision the Commission gave the following explanation in response to the United Kingdom's argument that, even if the exemption for unprofitable companies were selective, it would be justified by the nature or general scheme of the system:

'While exemption of non-profitable companies is an intrinsic feature of a system based on taxation of profits, this is not the case when the tax is levied on the number of employees or on the business use of property. Such systems have been conceived in a way that establishes an entirely different basis for corporate entities to be taxed. For example, it is in the internal logic of a payroll tax system that each and every employee should result in a corresponding payroll tax liability for the enterprise that employs them ... Even if a payroll tax were introduced as a proxy for a profit tax (this is not an argument put forward by the United Kingdom), it would still be within the logic of a payroll tax system for unprofitable companies to be liable to the tax. The use of payroll as a proxy for profitability removes the need to ascertain profits or overcomes difficulties in doing so. This is not the situation in Gibraltar, where under the reform, measurement of company profits is a feature of the rules for both the payroll tax and the top-up tax.'

152 In addition, the Commission maintained as follows, in paragraph 132 of the contested decision, in response to the United Kingdom's assertion that the tax system introduced by the reform is based on the profitable use of labour and as such coherent:

'This suggests the existence of a hybrid system, where two different tax bases are used according to the situation of the companies. Under these circumstances, it becomes impossible to detect the nature and general scheme of the system and to apply this justification. In particular, it cannot be considered that any given feature of such a system forms part of the general scheme, since this would amount to accepting an automatic justification for such a system.'

153 Second, as regards the cap limiting liability to payroll tax and BPOT to 15% of profits, the Commission stated that a consequence of establishing the cap 'is that profitable companies whose tax liability would otherwise exceed this threshold are relieved of tax they would have to pay in excess of this threshold'. According to the Commission, 'this tax reduction constitutes an advantage to those companies that benefit from it by relieving them of a charge that would normally be borne by their budgets' (recital 134 of the contested decision).

154 The Commission then stated that this 15% cap is selective as only a limited number of

companies will enjoy a reduction in their tax liability through its application. According to the Commission, ‘the beneficiaries will be labour intensive companies, that is those which, for the tax year in question, have low profits in relation to their number of employees and occupation of business property’ and ‘the application of a pure payroll and business property tax system might imply a very high level of taxation for such companies’ (recital 135 of the contested decision).

155 In recital 137 of the contested decision, the Commission rejected in the following terms the United Kingdom’s argument that, even if the 15% cap were selective, it would be justified by the nature or general scheme of the system of which it is part:

‘There is nothing intrinsic in a system of taxation of the profitable use of labour and property which requires a limit on the proportion of profits which a company must pay as a result of its use of those taxable factors. The inherent logic of such a system is that the more people a company employs and the more property it occupies, the greater the tax liability.’

156 Recital 137 cited above must be read together with recital 136 in which the Commission stated, in particular, (i) that ‘whilst conventional systems of corporation tax limit the proportion of profits paid in taxes through the setting of the rates of tax (banded systems include a top or maximum tax rate), the equivalent technical measure in a payroll tax system is the rate of tax per employee, in the Gibraltar case, set at a uniform rate of GBP 3 000’, (ii) that ‘the introduction in a payroll and property tax system of a cap linked to a different criterion, namely the level of profits, cannot be compared with the application of variable rates in a progressive system of profit taxation, which is justified by the nature and general scheme of the system’, and (iii) that ‘the [15%] cap is not directly linked to the labour or business property costs but rather to the profitability of companies’ and that ‘the latter is an element external to a payroll and business property tax’.

157 Third, the Commission concluded that the payroll tax and BPOT grant a selective advantage, on the basis of the following considerations.

158 First of all, in recital 143 of the contested decision the Commission stated essentially that a payroll tax and a business property occupation tax can be considered to be selective when they are applied in the absence of a general system of taxation of company profits and operate in an economy, such as that of Gibraltar, characterised by the existence of a large offshore sector without any physical presence, which would escape any taxation under the payroll and property tax system. Even though the tax system formed by the two abovementioned taxes formally applies without discrimination to all enterprises, de facto it benefits the current exempt companies and constitutes a specific advantage in favour of these undertakings with no real presence in Gibraltar, which as a consequence do not incur corporate tax.

159 Then, in recital 144 of the contested decision the Commission added, in particular, that ‘such a system, targeting only the number of employees or the commercial use of real estate in a context where a large number of companies have no employees and no real estate, does not enjoy the same general character as the taxation of companies’ profits, which [aims] at taxing the result of the economic activity as a whole’ and that ‘it may therefore be considered as selective at least in circumstances such as those in the present case’.

160 Finally, in recital 150 of the contested decision the Commission stated that the tax reform preserves the favourable tax treatment of companies having the legal form of an exempt company within the meaning of the tax legislation preceding the reform. On the basis of the premiss that as a general rule those companies do not have a physical presence in Gibraltar, the Commission found that exempt companies outside the financial services sector will continue to be taxed at an effective rate of zero, while exempt companies in the financial services sector will experience the imposition of tax of 5% of profits, a rate which results from the application of the top-up tax to them

(see paragraph 24 above); in contrast, the rest of the Gibraltar economy will be subject to an upper limit of either 15% or 35% of profits.

161 Fourth and last, it should be noted that in recital 147 of the contested decision the Commission relied on the following table:

‘Table 1: Data on Gibraltar companies

		Tax rate	
	Number	Current	Post-reform
All companies (breakdown by sector)	29 000		
Financial services	179	0-35%	5-15% (3)
Utilities	23	35%	35%
Other	28 798	0-35%	0-15%
All companies (breakdown by income)	29 000		
With income	10 400		

0-35%

0-15% (1)

No income

18 600

Companies with income (breakdown by status)

10 400

Non-exempt

1 400

0-35%

0-15% (1)

Exempt

9 000

0%

0-5% (2) (3)

Non-exempt with income (breakdown by profit)

1 400

Make profit

[900]

0-35%

0-15% (1)

No profit

500

Non-exempt with income (breakdown by status)

1 400

Qualifying

140

2-10% (4)

0-15%

Non-qualifying

1 260

35% (5)

0-15%

Utilities

23

35%

35%

Exempt with income (breakdown by sector)

9 000

Financial services

70

0%

5% (2) (3)

Non-financial services

8 930

0%

0% (2)

Notes:

(1) Assuming that the financial services top-up tax would be set at 5%.

(2) Ignoring utilities, which would be taxed at 35%.

(3) Assuming that exempt companies have no physical presence in Gibraltar and would therefore have no liability for payroll or business property occupation tax.

(4) The majority of qualifying companies. A few have tax rates outside this range.

(5) Assuming they are taxed at the full, standard corporation tax rate.'

162 The Commission deduced the following from this in recital 148 of the contested decision:

'Table 1 shows how certain clearly defined sectors in the Gibraltar economy would be affected on implementation of the reform in terms of taxation. Although the Commission acknowledges that under the reform, the formal distinction between the offshore and onshore economy will be abolished, the comparison of taxation serves to illustrate the inherently selective nature of the tax system proposed. Different kinds of companies will be subject to different taxation rates, which is a further element confirming that the proposed system grants selective advantages to those sectors that benefit from lower rates.'

2. Grant of a selective advantage by the disputed aspects of the reform

163 With regard to determination of the tax system and the common or 'normal' regime under that system in the present instance, it is apparent from the case-files and recitals 5, 6, 10, 12 and 13 of the contested decision that Gibraltar decided to abolish, by means of the tax reform, taxation of company profits, with the exception of the top-up tax charged on utility and financial service companies, and to replace such taxation with the two taxes at issue, namely the payroll tax and BPOT. At the same time, it decided to cap liability to those two taxes at 15% of profits. According to the Government of Gibraltar's statements in the course of the administrative procedure, the two taxes at issue thus constitute the new 'general' company tax regime introduced by the tax reform.

164 During the administrative procedure and in its written pleadings before the Court, the Government of Gibraltar maintained that the choice of employment and the occupation of property for business purposes as bases of taxation was considered essential in the light of the characteristics of Gibraltar's economy, namely limited labour resources, significant dependence on workers commuting daily from Spain, the many small companies and the need to introduce simple taxes given the operational limits of the Gibraltar authorities. The Commission has moreover not disputed the scarcity of the two factors of production at which the taxes at issue are directed, namely labour and land.

165 The Government of Gibraltar also maintained during the administrative procedure and before the Court that the reason underlying the cap limiting liability to payroll tax and BPOT to 15% of profits is the wish to base taxation on the principle of ability to pay and to avoid an overtaxing of companies which could trigger layoffs, serious instability in a small economy such as Gibraltar's and subsequent losses of tax revenue.

166 It is not in dispute that the cap of 15% of profits implicitly introduces a precondition for liability to the abovementioned taxes, namely that a company must make a profit before it can be liable to tax. The Government of Gibraltar contended during the administrative procedure and before the Court that profitability is a sine qua non for any tax liability but does not constitute the basis of taxation. It also contended during the administrative procedure and before the Court that the reason for introducing this threshold is the wish to base the taxation on the principle of

companies' ability to pay and the wish to avoid its transformation into a tax on companies' capital.

167 Furthermore, in its written pleadings before the Court, the Government of Gibraltar described the tax reform as being based on two pillars, land and labour as the bases of taxation, with a limit on tax liability at 15% of profits, and it submitted that if either pillar of the reform were removed, Gibraltar's proposed tax scheme would collapse.

168 In conclusion, the Government of Gibraltar submits, in essence, that the abovementioned elements of the tax reform, namely the payroll tax, BPOT, the cap of 15% of profits and the requirement, derived by implication from the introduction of the cap of 15% of profits, that a company must make a profit before it can be liable to payroll tax and BPOT, together constitute a tax system in its own right which should be treated as being the common or 'normal' tax regime introduced by the tax reform in the territory of Gibraltar. It contends that under that regime there is no 'normal' rate of taxation, and there is no 'principal' tax and 'secondary' or 'derogating' tax. A company's tax burden in a given year is determined on the basis of the following two interacting elements: the number of staff employed and the area occupied by the company, on the one hand, and the profits made by it, on the other.

169 The United Kingdom essentially supports the Government of Gibraltar's position relating to the common or 'normal' tax regime introduced by the reform, submitting in particular that under that regime the operative event for liability to tax is the profitable employment of an employee or the profitable use of property (see paragraph 119 above).

170 In the light of these explanations provided by the Government of Gibraltar and the United Kingdom, from the administrative procedure onwards, the Commission could not forgo performance of its duty, as described in paragraph 143 above, to begin by identifying the common or 'normal' regime under the notified tax system and, if necessary, to challenge the Gibraltar authorities' description of that regime. In the absence of identification and examination of the common or 'normal' regime, the Commission cannot establish to the requisite legal standard that certain of the elements of the notified tax system constitute derogations, and are therefore prima facie selective, vis-à-vis the common or 'normal' regime. In those circumstances it is likewise impossible for the Commission to assess correctly whether any differentiations between undertakings resulting from the application of a tax measure derogating from the common or 'normal' tax regime are capable of being justified by the nature or the general scheme of the tax system of the Member State concerned, since the Commission has neither identified nor examined the common regime first.

171 It does not appear from any ground of the contested decision that the Commission conducted the essential preliminary examination, referred to in paragraph 170 above, consisting in determining whether the various aspects of the tax system introduced by the reform that are at issue are capable of forming a common or 'normal' tax regime in its own right.

172 On the contrary, as regards the requirement that a company must make a profit and the 15% cap, the Commission simply found immediately that these two aspects of the reform constitute derogations, and are therefore prima facie selective, vis-à-vis the payroll tax and BPOT (recitals 128, 129, 134 and 135 of the contested decision) which were thus, implicitly but necessarily, considered by it to form the common or 'normal' regime introduced by the reform.

173 Furthermore, as regards the payroll tax and BPOT, it is apparent from the contested decision (see paragraphs 157 to 160 above) that the Commission did not follow any stage of the analysis relating to the determination of selectivity, failing, first, to identify and examine the common or 'normal' tax regime from which those two taxes might derogate, second, to demonstrate that they constitute derogations and, third, to assess any justification for the alleged

derogations on the basis of the nature or general scheme of the tax system introduced by the reform.

174 It was only in response to the United Kingdom's arguments relating to the possible justification of the alleged differentiations between undertakings resulting from the application of the abovementioned aspects of the tax reform – that is to say in the context of the third and final stage of the analysis relating to the determination of selectivity (see paragraph 144 above) – that the Commission, first, stated in recitals 131, 136 and 137 of the contested decision that the requirement that a company must make a profit and the 15% cap are, essentially, elements alien to the inherent logic of a tax system founded on the payroll tax and BPOT, and second, in recital 132 of the contested decision, evoked in a succinct and vague manner the 'existence of a hybrid system' of which it would be 'impossible to detect the nature and general scheme' and stated that 'it cannot be considered that any given feature of such a system forms part of the general scheme, since this would amount to accepting an automatic justification for such a system'. It is clear from the considerations set out in paragraphs 145 and 146 above that, in the light of the competence of States in tax matters, in so doing the Commission went beyond the limits of its review.

175 Moreover, apart from the Commission's failure, as found above, to observe the analytical framework relating to the determination of selectivity, neither the considerations set out in the contested decision, as referred to in paragraph 174 above, nor the arguments put forward by the Commission and the Kingdom of Spain in the course of the present proceedings are sufficient to call into question the validity of the definition of the common or 'normal' regime under the notified tax system.

176 First, the Commission's assertions that it would be within the logic of a tax system founded on the payroll tax or BPOT for unprofitable companies to be liable to tax (recital 131 of the contested decision) or for the tax burden of taxable companies to increase linearly with the labour employed and the area occupied, with any limitation on that burden on the basis of profits made being regarded as a derogation (recitals 136 and 137 of the contested decision), are not in themselves capable of calling into question the validity of that definition.

177 In this connection, the Commission has not rebutted to the requisite legal standard the Government of Gibraltar's argument that the requirement that a company must make a profit is inherent in the logic of a system of taxation based on staff numbers and the use of occupied land since it corresponds to a fundamental objective of that system, namely that of not taxing companies that are not profitable. Thus, the Commission has not demonstrated that this failure to charge tax cannot be regarded as forming an integral part of the common or 'normal' regime under that notified tax system.

178 Nor, for analogous reasons, has the Commission established that the Gibraltar authorities are not justified in devising in their territory, in the exercise of their powers in tax matters, a common or 'normal' tax regime which includes the general application of a cap limiting liability to tax to 15% of profits in order to prevent companies from paying an excessive proportion of their profits in tax. The mere assertion by the Commission that, in a tax system such as that proposed by the Gibraltar authorities, the more people a company employs and the more property it occupies, the greater the tax liability will have to be (recital 137 of the contested decision) is not sufficient to call into question the validity of the choice made by those authorities as to the elements constituting the common or 'normal' regime under that tax system.

179 Second, the classification by the Commission, in recital 132 of the contested decision and in its written pleadings, of the tax system introduced by the reform as 'hybrid' constitutes merely a way of describing that system, which is composed of various constituents. This classification does not demonstrate, in itself, that such a system cannot constitute a common or 'normal' tax regime

applicable in the territory of Gibraltar inasmuch as, first, that system is founded, essentially, on two objectives -– namely that of taxing the use of two factors of production scarce in Gibraltar and that of respecting companies' ability to pay – which have been determined by the Gibraltar authorities in the exercise of their powers in tax matters and, second, as Community law currently stands, there is no harmonised standard relating to what constitutes the 'common' or 'normal' regime under a national tax system.

180 In this context, the Commission and the Kingdom of Spain cannot validly submit, in a purely hypothetical way, that in certain situations the two objectives assigned to the tax system, and the common or 'normal' regime under it, introduced by the reform (see paragraph 179 above) are mutually incompatible, such as in the case of a company which makes large profits but which, because it does not have a physical presence in Gibraltar, will not be liable to payroll tax and BPOT or in the case of a company which is a major employer in Gibraltar but which likewise will not be liable to those two taxes because it does not make a profit. These hypothetical situations are not sufficient to demonstrate that the tax system and the common or 'normal' regime under it that are referred to above cannot meet two different objectives, as determined by the Gibraltar authorities.

181 This assessment is not called into question by the Commission's vague assertion that it cannot be considered that any given feature of a system forms part of the general scheme since this would amount to accepting an automatic justification for such a system (recital 132 of the contested decision). Suffice it to state that an approach of this kind does not observe the different stages of analysis, as set out in paragraphs 143 and 144 above, and accordingly goes beyond the limits of the review to be conducted by the Commission given the competence of States in tax matters (see paragraphs 145 and 146 above).

182 Third, in its written pleadings the Commission has wondered why Gibraltar chose the approach of introducing a payroll tax and BPOT subject to the cap of 15% of profits, given the limited reach of the resulting taxation. In this connection, it stated in recital 144 of the contested decision that the tax system constituted by the two abovementioned taxes 'does not enjoy the same general character as the taxation of companies' profits, which [aims] at taxing the result of the economic activity as a whole'. In addition, it has alleged that the Government of Gibraltar has provided no explanation as to why the 15% cap reflects companies' ability to pay and has wondered why this cap was adopted notwithstanding the wish of the Government of Gibraltar to tax the use of its scarce resources. Finally, it has suggested that taxed companies' ability to pay could be respected by adjusting the level of the payroll tax from year to year in the light of the state of the local economy.

183 However, the Commission has not succeeded, by means of these vague and general questions and hypotheses, in casting doubt on the validity of the Gibraltar authorities' description of the common or 'normal' regime under the notified tax system and of its constituents.

184 It is thus clear from paragraphs 170 to 183 above that, having failed to observe the analytical framework relating to the determination of selectivity, the Commission did not set out considerations in the contested decision sufficient to call into question the definition, as put forward by the Gibraltar authorities, of the common or 'normal' regime under the tax system. It also follows therefrom that, in not observing that analytical framework, the Commission went beyond the limits of its review, in the light of the extent of the competence of the Gibraltar authorities regarding the determination of its tax system and of the common or 'normal' regime under that system. It is clear from the reasoning as set out, in particular, in recitals 131, 132, 136, 137 and 144 of the contested decision that, in not using as the starting point for its analysis regarding material selectivity the regime which the applicants classified in this instance as the common or 'normal' tax regime and

by failing to identify that regime and to examine its validity, the Commission, instead of conducting the review referred to in paragraphs 143 and 144 above, imposed its own logic as to the content and operation of the tax system notified.

185 In light of the foregoing considerations, it is to be concluded that none of the three aspects of the tax system as notified that are at issue can be considered to confer a selective advantage for the purposes of Article 87(1) EC, since the Commission has not demonstrated to the requisite legal standard that they constitute derogations from the common or 'normal' tax regime introduced by the reform in Gibraltar giving rise to differentiations between undertakings as regards the tax burden.

186 Finally, it should be stated that the comparison of the alleged effects of the tax system introduced by the reform with the effects of the tax system preceding it, as drawn by the Commission in Table 1 and recital 150 of the contested decision, cannot be accepted in this instance for the purposes of applying Article 87(1) EC. It is irrelevant that the situation of the presumed beneficiary of the measure at issue is better or worse in comparison with the situation under the law as it previously stood or, on the other hand, has not altered over time (*Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke*, cited in paragraph 78 above, paragraph 41). What matters is whether the tax system at issue, viewed independently from its predecessor, favours certain undertakings within the meaning of Article 87(1) EC (see, to this effect, Case 57/86 *Greece* v *Commission* [1988] ECR 2855, paragraph 10).

187 It follows from all of the foregoing that the Commission has not established the existence of selective advantages stemming from the three aspects of the tax reform that are at issue. Therefore, by classifying those aspects as State aid, the Commission made an error of law in the application of Article 87(1) EC.

188 The second plea must consequently be upheld.

189 Since the first and second pleas must be upheld, the contested decision should be annulled in its entirety, without any need to consider the plea alleging the breach of essential procedural requirements.

Costs

190 Under Article 87(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the applicants have applied for costs and the Commission has been unsuccessful, the latter must be ordered to pay the costs.

191 Under the first subparagraph of Article 87(4) of the Rules of Procedure, Member States which have intervened in proceedings are to bear their own costs. The United Kingdom of Great Britain and Northern Ireland, as intervener in Case T?211/04, and the Kingdom of Spain, as intervener in Cases T-211/04 and T?215/04, shall accordingly bear their own costs.

THE COURT OF FIRST INSTANCE (Third Chamber, Extended Composition)

hereby:

1. **Joins Cases T?211/04 and T?215/04 for the purposes of judgment;**

2. **Annuls Commission Decision 2005/261/EC of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform;**

3. **Orders the Commission to pay the costs of the Government of Gibraltar and those of the United Kingdom of Great Britain and Northern Ireland in Case T-215/04, and to bear its own costs;**

4. **Orders the United Kingdom of Great Britain and Northern Ireland to bear its own costs as intervener in Case T-211/04;**

5. **Orders the Kingdom of Spain to bear its own costs as intervener in Cases T-211/04 and T-215/04.**

Jaeger

Tiili

Azizi

Cremona

Czúcz

Delivered in open court in Luxembourg on 18 December 2008.

Table of contents

I – The first plea: errors of law and assessment regarding application of the criterion of regional selectivity

A – Arguments of the parties

B – Findings of the Court

1. The relevance of the extent of the infra-State body’s autonomy in relation to the central government of the Member State concerned for the purposes of determining the appropriate reference framework

2. The United Kingdom’s role in the definition of the political and economic environment in Gibraltar as a criterion for determining the reference framework in this instance

a) The judgment on the tax regime in the Azores

b) Application of the first and second conditions set out in the judgment on the tax regime in the Azores

c) Application of the third condition set out in the judgment on the tax regime in the Azores

II – The second plea: errors of law and assessment regarding application of the criterion of material selectivity

A – Arguments of the parties

B – Findings of the Court

1. Relevant recitals of the contested decision

2. Grant of a selective advantage by the disputed aspects of the reform

Costs

* Language of the case: English.