

II

(Acts whose publication is not obligatory)

COMMISSION

COMMISSION DECISION

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

(notified under document number C(2004) 929)

(Only the English text is authentic)

(Text with EEA relevance)

(2005/261/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

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

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

Having called on interested parties to submit their comments pursuant to the provisions cited above ⁽¹⁾, and having regard to their comments

Whereas:

- (2) On 16 October 2002, the Commission decided to initiate the procedure laid down in Article 88(2) of the EC Treaty in respect of the reform (C(2002) 3734). This decision was notified to the United Kingdom on 18 October 2002 (SG(2002) D/232221). After an extension of the deadline, the United Kingdom replied by letter dated 16 December 2002 (A/39214).
- (3) The Commission Decision to initiate the formal investigation procedure was published in the *Official Journal of the European Communities*, inviting interested parties to submit their observations ⁽²⁾. Comments were submitted by the Spanish Confederation of Business Organisations (Confederación Española de Organizaciones Empresariales) on 30 December 2002 (A/39469), by the Åland Executive, Finland (Ålands Landskapsstyrelse) on 2 January 2003 (A/30002), by the Spanish Government on 2 and 3 January 2003 (A/30003 and A/30018), and by the Government of Gibraltar on 3 January 2003 (A/30011). These comments were forwarded to the United Kingdom, who replied by letter dated 13 February 2003 (A/31313).

I. PROCEDURE

- (1) By letter dated 12 August 2002, registered on 19 August (SG(2002) A/8328), the United Kingdom notified to the Commission, pursuant to Article 88(3) of the EC Treaty, the Government of Gibraltar corporation tax reform (hereinafter the reform).

⁽¹⁾ OJ C 300, 4.12.2002, p. 2.

II. DETAILED DESCRIPTION OF THE MEASURE

- (4) The description that follows takes account of the modifications to the reform proposals made by the Government of Gibraltar in response to the opening of the formal State aid investigation procedure. These modifications were set out in the United Kingdom's letter of 16 December 2002. They are summarised in paragraphs 27 to 30 below.

⁽²⁾ See footnote 1.

Objective of the reform

- (5) The stated aim of the reform is to adopt a new general corporate tax scheme that does not involve any element of State aid, to provide legal certainty for companies active in Gibraltar and to ensure sufficient revenue for the Gibraltar Government from company taxation. The reform is also intended to deliver compliance with the EU Code of Conduct for Business Taxation⁽³⁾ (hereinafter the Code of Conduct) and with the OECD Report on Harmful Tax Competition⁽⁴⁾. According to the Government of Gibraltar, an essential element of the reform is the general abolition of taxation on company profits, with the exception of top-up taxes on utilities and financial services activities. The reform proposals are based on the complete elimination of all discrimination between resident and non-resident, or domestic and non-domestic economic activity, i.e. the elimination of so-called ring-fencing provisions. The exempt and qualifying companies legislation will be abolished. Thus the formal distinction between the so-called offshore and onshore economy will be removed.
- (6) The general tax system to be introduced under the Reform will be a payroll tax, a business property occupation tax and a registration fee, applicable to all Gibraltar companies. The Gibraltar Government estimates that its current very limited but essential income from corporate taxes of GBP 13,7 million (about EUR 20 million), representing 9,25 % of total Government revenue, will be largely maintained under the new system based on these three general taxes applicable to all Gibraltar companies. This compares with personal income tax of GBP 53,6 million (about EUR 77 million) representing 36,3 % of revenue. Income from top-up taxes on financial services and utilities activities will be limited, but will likely make up any shortfall in corporate tax revenue under the general system.

Implementation

- (7) The reform will be implemented through:
- the Companies (Payroll Tax) Ordinance,
 - the Companies (Annual Registration Fee) Ordinance,
 - the Rates Ordinance,
 - the Companies (Taxation of Designated Activities) Ordinance.
- (8) The legislation will be implemented by the Gibraltar Government after it is passed by Gibraltar's Parliament (the House of Assembly). As part of the reform, the Companies Taxation and Concessions Ordinance (the

exempt company legislation) and the Income Tax (Qualifying Companies) Regulations (the qualifying company legislation) will be repealed with immediate effect. The income tax ordinance will be amended to repeal or duly amend all provisions which charge companies to income tax.

- (9) The rules will be administered by the Gibraltar Commissioner for Income Tax. All companies in Gibraltar will be required to file public accounts with the Companies Registry in accordance with the 4th and 7th EC Company Law Directives. All companies in Gibraltar with a tax liability will be required to file tax accounts with the Commissioner and stringent measures will also be introduced in order to ensure compliance with such obligations. For the first time in Gibraltar, a tribunal to deal specifically with company taxation matters (to be called the Companies Taxation of Designated Activities Tribunal) will be set up whose purpose will be to exercise such powers relating to appeals and other matters arising from the operation of the new legislation. Such powers will include the power to require a company to make available for inspection by the Tribunal all such books, accounts, employment records or other documents which, in the opinion of the Tribunal, contain or may contain information relating to the subject matter of the proceedings.

Payroll tax and business property occupation tax

- (10) Profits-based taxation will be replaced by a general payroll tax pursuant to which all Gibraltar companies will be liable in the amount of GBP 3 000 per employee each year. Every 'employer' in Gibraltar will be required to pay payroll tax for the total number of its full-time and part-time 'employees' who are 'employed in Gibraltar'. The central terms used will be defined as follows:
- *Employer* is any company incorporated or registered under any law in force in Gibraltar paying emoluments on its own account or making payments to any person in respect of service or services provided by an individual who is deemed to be an employee.
 - *Employee* is any individual to whom emoluments are paid or are payable including directors other than directors who exercise no function other than that of a director and part-time and casual labour.
 - *Employed in Gibraltar* means any employee employed in Gibraltar who works in or from Gibraltar or is based in Gibraltar.

⁽³⁾ OJ C 2, 6.1.1998, p. 1.

⁽⁴⁾ Approved by the OECD Council on 9.4.1998.

- (11) The Gibraltar Government will introduce detailed anti-avoidance rules intended to eliminate all possibility for abuse. This will include introducing the concept of 'deemed employee' and rules targeted at employees who may be carrying out an activity outside Gibraltar. The combined effect of the meaning of the terms 'employees' and 'employed in Gibraltar' will be to cover, essentially, all employees physically present in Gibraltar. According to the United Kingdom, of a total of 14 000 employees in Gibraltar, 10 100 are employed by the private sector.
- (12) All companies occupying property in Gibraltar for business purposes will pay a business property occupation tax at a rate equivalent to a percentage of their liability to the general rates charged on property in Gibraltar (currently expected to be a rate of 100 %).
- (13) Liability to payroll tax together with business property occupation tax will be capped at 15 % of profits. Thus, companies will only pay the payroll tax and the business property occupation tax if they make profit, but in an amount not exceeding 15 % of profits.
- (14) The vast majority of companies in Gibraltar will be subject to the payroll tax and to the business property occupation tax only. According to the Gibraltar Government, it is not possible to estimate the number of companies in Gibraltar that will accrue an estimated payroll tax and business property occupation tax liability of in excess of 15 % of profits and, as a result of the cap, pay tax at a rate corresponding to 15 % of profits as this will vary year-on-year and will depend on the individual circumstances of each company.

Registration fee

- (15) The Gibraltar Government will replace the fees currently paid by companies in Gibraltar (of an amount of approximately GBP 40 per annum) with a registration fee applicable to all Gibraltar companies of GBP 150 per annum for companies not intended to generate income and of GBP 300 per annum for companies intended to generate income.

Taxation of designated activities (top-up or penalty taxes)

- (16) Certain designated activities, namely financial services and utilities, will be subject to an additional top-up or penalty tax on profits generated by such activities. The respective top-up taxes will apply only to profits that can be allocated to such designated activities. The United Kingdom estimates that of approximately 29 000

companies in Gibraltar, 179 will be liable to the top-up tax on financial services activities, whilst 23 will be liable to the top-up tax on utilities activities.

- (17) The definition of 'financial services' company includes, *inter alia*:
- credit institution,
 - moneylender,
 - investment firm, dealer, broker, adviser or manager,
 - life assurance and collective investment scheme intermediary,
 - collective investment scheme operator or trustee,
 - insurance broker, agent or manager,
 - professional trustee,
 - company manager,
 - bureau de change,
 - auditor.

The definition of financial services also includes companies that advise or provide services in respect of finance, law, tax or accounting.

- (18) The definition of 'utilities' activities encompasses the provision of services, equipment or premises for:
- telecommunications (voice telephony, fax communications, data communications and transmissions, callback and call through services),
 - electricity (generation, distribution and supply),
 - water (production, import/export, supply of either potable or salt water),
 - sewage (provision, operation, management, maintenance, repair, replacement, modification, renovation, replacement, renewal of sewers and disposal/treatment of sewage),
 - petroleum (collection, production, import/export, treatment improvement, pumping, storage, distribution and supply of fuel oil).

- (19) Financial services companies will, in addition to the payroll and property taxes, be charged a top-up tax on profits from financial services activities at the rate of 8 % of profit (calculated in accordance with internationally accepted accounting standards). Financial services companies will have their annual liability to payroll tax, business property occupation tax and top-up tax capped, in aggregate, at 15 % of profit.

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

(21) Liability to the top-up taxes will be determined on the basis of the relevant activities. The same rules will apply to financial services and to utilities activities. Accordingly, for 'hybrid' companies:

- a company engaged in a utilities activity and in a general activity will have the profits it derives from its utilities activity taxed at 35 %,
- a company engaged in a financial services activity and in a general activity will have the profits it derives from its financial services activity taxed at 8 %,
- a company engaged in a utilities activity and in a financial services activity will have the profits it derives from its utilities activity taxed at 35 % and the profits from its financial services activity taxed at 8 %.

(22) The same distinction will be made in respect of unearned profits, notably, any profits made by a hybrid company from any rents, royalties, premiums, any other profits arising from real property in Gibraltar, dividends, interests or discounts. Such unearned profits will be taxed at the 8 % or 35 % top-up rate to the proportion which the profits and gains from the financial services or utilities activities bears to the whole of the trading profits or gains made by the company.

Other features of the reform

(23) Under the Rates Ordinance, certain premises are exempt. These exempt premises include courts of justice, churches, cemeteries, public gardens, uninhabitable military defences, civil defence premises, lighthouses and the Gibraltar Museum. Such premises will consequently be exempt from the additional rate, the business property occupation tax. The Gibraltar authorities may also reduce or remit the payment of any general rate where this 'is in the interests of the development of Gibraltar'.

(24) Both the Companies (Payroll Tax) Ordinance and the Companies (Taxation of Designated Activities) Ordinance

lay down rules for the calculation of profits or gains. These rules are necessary for the application of the cap of 15 % of profits on the liability for Payroll tax and for the purposes of determining the liability to the top-up tax on financial services and activities. Profits are computed in accordance with Accounting Standards in the United Kingdom as modified for use in Gibraltar by the Gibraltar Society of Chartered and Certified Accountancy Bodies.

(25) For the purposes of determining profits, capital gains and capital losses are excluded.

(26) For the purposes of determining profits, the following capital allowances, *inter alia*, are deductible:

- in respect of entertainment centres, mills, factories and other premises, 4 % per annum;
- in respect of plant and machinery, up to GBP 30 000 for the first year in which the expenditure is made (up to GBP 50 000 for computer equipment), and 33 1/3 % of the remainder in subsequent years.

Modifications to the reforms originally notified

(27) In response to the opening of the formal State aid investigation procedure, the following changes have been made by the Government of Gibraltar to the tax reform proposals.

(28) The provisions which would cap, at GBP 500 000, the combined liability to payroll tax, business property occupation tax and, where applicable, the 8 % top-up tax on financial services activities, have been removed. The removal of the quantum cap will be accompanied by a lowering of the top-up tax for financial services companies from 8 % of profits to a single but as yet undetermined rate in the range of 4 to 6 %.

(29) The provision which would exempt certain premises of the Upper Rock of Gibraltar from rates (and consequently from business property occupation tax) has been removed.

(30) The provisions which would exempt the following classes of income for the purposes of determining profits have been removed:

- any interest received by any chargeable company in respect of any loan made by it to any person for the purpose of financing investment in development projects designed to promote the economic and social development of Gibraltar, where the terms and conditions of such loan have been approved for this purpose, in writing, by the Gibraltar authorities;

- the interest payable on any loan charged on the Consolidated Fund (i.e. Gibraltar Government finances) from the date and to the extent specified by an approval granted by the Gibraltar authorities.

III. GROUNDS FOR INITIATING THE PROCEDURE

(31) In its evaluation of the information submitted by the United Kingdom in the notification, the Commission considered that a number of features of the reform proposals would be liable to confer an advantage on Gibraltar companies. In particular:

- the entire system would grant an advantage to Gibraltar companies compared with UK companies (regional selectivity),
- the requirement to make a profit before incurring any payroll and property tax liability would confer an advantage on unprofitable companies;
- the 15 % cap on liability to payroll and property taxes would confer an advantage on those companies to which it applies,
- the GBP 500 000 cap on liability to payroll and property taxes would confer an advantage on those companies to which it applies,
- some technical features of the reform would be liable to give rise to State aid (certain exemptions from rates/property tax and exemptions for certain specified interest income for the purposes of determining profits).

(32) The Commission also considered that these advantages would be granted via State resources, would affect trade between Member States and would be selective. The Commission also considered that none of the exceptions on the general prohibition on State aid provided for in Articles 87(2) and 87(3) of the EC Treaty applied. On these grounds the Commission had doubts as to the compatibility of the measure with the common market and therefore decided to initiate the formal investigation procedure.

IV. COMMENTS FROM THE UNITED KINGDOM

(33) The observations of the United Kingdom can be summarised as follows.

(34) The Commission's objections to the reform proposals as set out in the decision to open the formal State aid

investigation procedure fall under six headings, all based on specificity:

- the fact that companies are liable to taxes only if they make profits would confer an advantage on unprofitable companies compared with profitable ones,
- the operation of the 15 % profits-based cap would benefit those undertakings to which it applies by reducing their liability to payroll tax, business property occupation tax, and financial services top-up tax, if applicable,
- the operation of the GBP 500 000 quantum cap would benefit those undertakings to which it applies by reducing their liability to payroll tax, business property occupation tax, and financial services top-up tax, if applicable,
- the exemption for certain properties on the Upper Rock confers a tax advantage on undertakings occupying such premises,
- the two provisions exempting interest on certain loans from the calculation of profits for purposes of the corporate tax rules confer an advantage on certain companies,
- several features of the proposed tax scheme result in a lower tax burden for companies in Gibraltar when compared with companies in the United Kingdom and therefore constitute an advantage for the former (regional specificity).

(35) Neither the United Kingdom nor the Government of Gibraltar shares the Commission's doubts as to the possible State aid character of certain elements of the reforms. However, without prejudice to whether the original reform proposals contain any element of state aid, the Government of Gibraltar will:

- drop the GBP 500 000 cap from the planned new tax system,
- remove the provision to exempt from rates (and hence from business property occupation tax) certain properties on the Upper Rock of Gibraltar,
- remove the provision to exempt certain interest income for the purposes of determining profits.

(36) The three remaining objections do not give rise to State aid.

Not taxing unprofitable companies is not State aid

(37) No selectivity arises from the absence of liability for tax where no profits are made. It is true that neither the payroll tax nor the business property occupation tax is payable if the taxpayer company has no profit. Profit is a *sine qua non* of liability. But it is not the tax base. It is a condition precedent for liability to the tax in question. This is natural, since a tax on a company which makes no profit becomes a tax on the capital of the company. Contrary to what the Commission claims, the 'operative event' under the payroll tax and the business property tax is not profit. The 'operative events' are the profitable employment of an employee and the profitable use of property. It is not the case that payroll or occupation of business premises are secondary factors. The logic of the proposed scheme is dual — employment and occupation constitute the tax base, while profitability constitutes a lower quantitative threshold to liability. Both the tax base and the quantitative limitation are of a general nature, applicable in the same way to all companies regardless of their size or the sector in which they are active.

(38) Even if the quantitative limitation were selective, it follows from the nature and logic of the planned corporate tax scheme that companies are only taxed if they make money from which to pay the taxes. The Commission has itself conceded in point 25 of the Commission notice on the application of the State aid rules to measures relating to direct business taxation⁽⁵⁾ (hereinafter the Notice) that such selectivity is justified by the nature of the tax system. This is as valid for a tax system which is based on the profitable use of labour and property as it is for a 'pure' profit-based system in which companies that make no profit are not taxed. A parallel cannot be drawn with social security contributions as they serve a different purpose unrelated to whether a company is profitable.

Limiting tax to 15 % of profits is not State aid

(39) The proposed limitation is not selective. In order to constitute State aid, a tax measure must be selective in favouring certain companies and/or sectors over others. The application of the 15 % cap will depend on the relationship between profit and the number of employees in a given year. This will potentially benefit all companies, whether large or small and in all sectors of the economy, which in a given year reach that level of profit in relation to payroll. A specific group of companies to which the limits on tax liability will apply cannot be

defined and in any case the group will change year-on-year. The rules are generally applicable and available to all Gibraltar companies. The Commission itself explains in point 14 of the Notice that the fact that some firms or some sectors benefit more than others from a tax measure does not necessarily mean that the measure is caught by the State aid rules.

(40) The Government of Gibraltar has devised a general tax scheme based both on the simple factors of property and payroll, and of the existence of profitability. At the same time, it has decided that it wishes to apply the tax in a regressive way. In effect, there are two bands of tax, based on overall profit. Where the tax bill is below 15 % of overall profits, the full tax is paid. Where the tax bill exceeds 15 % of overall profits, a zero rate is applied as regards the surplus. Such a decision is also fully in line with the freedom of the Government of Gibraltar to devise its tax regime without engaging the State aid rules.

(41) The Government of Gibraltar wishes to limit the maximum tax bill of companies under the new system. If there are different tax rates in different 'bands' (when the tax base is different in size) one tax rate is always lower than another, and therefore in some sense confers an advantage on the taxpayers who are lucky enough, or who are able to arrange their affairs, to pay the lower of the rates. But this does not create a State aid.

(42) Even if the 15 % cap confers a specific advantage on the companies to which it applies, such a limit would still be justified by the nature or general scheme of the system of which it is a part. All direct taxes in Gibraltar must find the optimal balance between maximising tax revenue and limiting the maximum liability of individual taxpayers so that it does not exceed their ability to pay. It may therefore be necessary to make the direct taxes regressive at some level. Some limit of this kind is essential because of the specific circumstances of the Gibraltar economy, such as its limited geography and labour. The economy of Gibraltar is small and more vulnerable than most to shocks created by the natural and fair tax competition between jurisdictions. Companies may not be able to afford to leave a large Member State as easily as they can move out of a tiny economy like Gibraltar. Without the tax base being subject to quantitative limitations the principal objective inherent in any tax system — which is to ensure the necessary revenue to meet public expenditure — might be endangered by market fluctuations.

⁽⁵⁾ OJ C 384, 10.12.1998, p. 3.

(43) Labour in Gibraltar is a scarce taxable asset. However, a tax on labour cannot follow the same progressive principle and logic as a tax on profit. A tax on labour must at the same time take into consideration both the ability of a company to create taxable income and the need to ensure the necessary stability in the workforce. Given the cyclical nature of the economy and corporate profitability, a labour tax that does not contain a regressive element could trigger mass layoffs and instability in times of cyclical market fluctuations or depression. As a very small economy, random variations resulting from overall economic fluctuations can have a much larger proportional effect in Gibraltar than in a larger economy. The internal logic of the proposed payroll tax system therefore justifies capping payroll tax liability in relation to profits.

(44) In contrast, utilities would have a corporate tax liability of 35 % of profits. This is justified by the nature and logic of the system, as labour stability is ensured because utilities are closely linked to the territory served and, as a direct result of the small size of the Gibraltar market, occupy a natural monopoly or semi-monopoly position making them highly profitable. The same need for a regressive element in the tax applied to utilities does not therefore arise.

Regional specificity

(45) There is no legal authority for the suggestion that where there are two separate genuinely autonomous tax jurisdictions in one Member State, the rates of tax in the two jurisdictions can be compared, and the lower rate of tax regarded as a State aid merely because it is lower than the other tax rate. This would mean that there would be a State aid every time an autonomous regional tax authority, which is responsible for managing public spending in the region, chooses on the basis of democratically expressed public preferences to cut spending and reduce taxes. The issue has been discussed by the Advocate General⁽⁶⁾ but has never been addressed by the Court as the cases concerned were withdrawn. In one of a series of more recent cases concerning the Basque provinces, the Court of First Instance stated that the contested decision had no effect on the competence of Álava to adopt general tax measures applicable to the whole of the region⁽⁷⁾.

(46) Such regional variations between autonomous jurisdictions are not State aid within the meaning of Article 87 EC. A State aid measure is only present if State resources are used through a tax foregone. This assessment presupposes that there is a rate of tax for a certain activity that applies across the Member State, which is

not the case where taxation is subject to territorial autonomy, as opposed to being set in a uniform way and then varied according to location. Similarly, the analysis of a selective advantage relies on the assumption that there is a level of tax that would otherwise apply to a certain activity in the relevant territory.

(47) The State aid criteria assume that the supposed aid may be compared with a standard or normal tax rate. A supposed State aid measure can only be present if it is in some sense an exception to or an exemption from a standard which would otherwise be applicable to the company receiving it. A tax rate to which the recipient of the supposed aid measure would not be subject — not even if the currently applicable rate allegedly constituting aid was abolished — cannot be a valid standard of comparison for the purposes of deciding whether ‘aid’ is present or not. The only possible standard of comparison for the purpose of assessing selectivity is the tax situation which would otherwise apply in the same tax jurisdiction. Where such a regime is devised locally, as in Gibraltar, this is not meaningful.

(48) The Commission’s position would appear to make it impossible for any tax jurisdiction which did not cover the whole Member State to adopt any tax rate except the one applicable in the other tax jurisdiction in the State. It could not adopt a lower rate, because that would automatically constitute State aid, merely by comparison. But nor could the tax jurisdiction adopt a higher tax rate, because the tax rate in the rest of the State would automatically become State aid. This would make almost every exercise of fiscal autonomy into a measure creating State aid, either in the jurisdiction in question or, still more absurdly, elsewhere in the Member State. Differentiations in direct business taxation frequently exist within Member States as a consequence of the various layers of territorial subdivision even at the lowest municipality levels. In this context, a parallel can be drawn with the WTO Agreement on Subsidies and Countervailing Duties where it is clearly stated that ‘the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy’ for purposes of the rules prohibiting the grant of such subsidies (Article 2.2).

(49) If the United Kingdom and Spain were to enter into an agreement to establish joint sovereignty over Gibraltar, the Commission’s position on regional specificity would have the nonsensical effect that the prevailing tax rate in Gibraltar would have to equal both the prevailing tax rate in the United Kingdom and the prevailing tax rate in Spain. Otherwise State aid would be present in the jurisdiction applying the lower rate.

⁽⁶⁾ Opinion in Joined Cases C-400/97, C-401/97 and C-402/97, [2000] ECR I-1073.

⁽⁷⁾ Joined Cases T-92/00 and T-103/00, [2002] ECR II-1385, p. 27.

- (50) The Commission appears to suggest that if there are taxes in two separate tax jurisdictions in the same State, even if the formal percentage tax rate is the same, the fact that different exemptions apply or different allowances are given would mean that the companies getting the allowance or exemption would be in receipt of aid if, all other things being equal, they would have paid a higher rate of tax in the other jurisdiction. However, the Commission's theory is inappropriate to the facts of the Gibraltar case. Comparisons between the tax base or tax structure of a company profits tax can sometimes be made with a company profits tax in another jurisdiction. But it is simply impossible to make useful or meaningful comparisons between tax systems that are completely different because the tax base is not the same.
- (51) If maintained, the Commission's reasoning on regional specificity would not respect the fundamental principle of subsidiarity in EU law and could constitute a misuse of its powers. If the Member State concerned can function with two or more autonomous tax jurisdictions competing for corporate tax revenue within its territory without suffering significant distortive effects on competition, it does not under the subsidiarity principle of the EC Treaty become a Community task to intervene in the constitutional arrangements of the Member State. The Commission seems in fact to be seeking to use the State aid rules to pursue tax uniformity within EU Member States.
- (52) The Commission may suggest that a State cannot plead its own national law, even constitutional law, to avoid its obligations under Community law. But this principle is irrelevant to the issue of selectivity. The question of selectivity arises because it is suggested that a given tax provision is more favourable than a more general tax rule which would otherwise apply. This cannot alter the fundamental right of a Member State to organise its tax system so that autonomous tax regions can raise in an independent and non-discriminatory way the necessary revenues to fund public tasks. There can be no State aid on the basis of regional specificity in circumstances where, as in Gibraltar, there is a genuinely autonomous tax jurisdiction which determines its tax system independently, and in which taxes imposed by the other tax jurisdictions in the State are not payable.
- (53) The Commission's position would seriously interfere with the possibilities for Member States to decentralise their powers and thereby establish the necessary fiscal autonomy in the regions to cover the expenditures incurred in the exercise of such decentralised powers. It would make it impossible for any region or tax jurisdiction to increase or reduce its taxes without creating a State aid, either in its own region (if tax was reduced) or elsewhere (if tax was increased). It would be absurd to suggest that the State aid rules should be interpreted in such a way as to make it impossible for a Member State to decentralise taxing powers effectively when it amended its constitution.
- (54) The Commission states that in the absence of a specific company taxation regime in Gibraltar, companies in Gibraltar would be subject to the standard United Kingdom tax regime. This represents a serious misunderstanding of the constitutional position of Gibraltar. The standard United Kingdom tax regime applies in the United Kingdom. It does not apply in other tax jurisdictions. It is not a normal or residual regime which applies in the absence of special provisions. The fact that the United Kingdom is responsible for the foreign relations of Gibraltar does not mean that any provisions of United Kingdom law would ever apply automatically in Gibraltar.
- (55) Gibraltar is an overseas territory of the United Kingdom. It forms part of Her Majesty the Queen's Dominions but is not part of the United Kingdom. Gibraltar is not a region of the United Kingdom in any sense. It has its own constitutional order including its own institutions distinct from those of the United Kingdom. Gibraltar also adopts its own legislation. In respect of defined domestic matters, Gibraltar is autonomous and self-governing. Gibraltar is an economically self-sufficient autonomous tax jurisdiction. It receives no financial assistance from the United Kingdom and United Kingdom tax laws do not apply to Gibraltar. The Gibraltar Government is required to generate sufficient revenue through taxation to finance its expenditure autonomously, and is competent to propose to the Gibraltar legislature and to enforce within Gibraltar corporate taxation laws. The Gibraltar and United Kingdom economies are two entirely distinct and separate economies. Accordingly, Gibraltar is, in every relevant way, totally distinct from the United Kingdom, notably in constitutional, political, legislative, economic, fiscal, revenue-raising and geographical terms.
- (56) In the same way as Gibraltar is not part of the United Kingdom, and indeed for that reason, Gibraltar is not part of the United Kingdom for Community law purposes. Community law applies to Gibraltar by virtue of Article 299(4) of the EC Treaty and not Article 299(1). The following points illustrate Gibraltar's special, separate status and the fact that Gibraltar cannot be considered to be a region of the United Kingdom for State aid purposes:
- the extent of Gibraltar's Community membership is different to that of the United Kingdom's. In particular, Gibraltar does not form part of the only fiscal territory which has been defined at Community level (i.e. the Community VAT territory),

- European Community law is given effect in Gibraltar by virtue of the European Communities Ordinance 1972 — primary legislation passed by Gibraltar's Parliament, and not by virtue of the European Communities Act 1972 which gives effect to Community law within the United Kingdom,
- the Gibraltar legislature implements EC directives within Gibraltar independently of the United Kingdom's own implementation,
- whenever Community law requires the setting up of competent authorities, Gibraltar sets up its own competent authorities, distinct from those set up for the same purpose in the United Kingdom, and
- until the European Court of Human Rights' judgment in the *Matthews* case, Gibraltar was excluded from participation in elections to the European Parliament even though that exclusion was operated by Annex II to the 1976 Act on Direct Elections which was termed as follows: 'The United Kingdom will apply the provisions of this Act only in respect of the United Kingdom.'

General comments

- (57) The Commission appears to fear that Gibraltar's proposed new corporate tax system might perpetuate harmful tax competition. Both the United Kingdom and the Gibraltar Governments believe that the proposed tax reform is compatible with the Code of Conduct on business taxation and the OECD report on harmful tax competition. Harmful tax measures typically involve lack of transparency, lack of exchange of information, and a more favourable tax treatment of non-resident companies compared with resident ones. With the proposed reform Gibraltar will eliminate all such harmful aspects of the current exempt and qualifying companies taxation. Even if Gibraltar were to be considered a favourable tax territory, this concern cannot be addressed through the application of the State aid rules when no State aid is involved.

V. COMMENTS FROM INTERESTED PARTIES

- (58) Observations were received from the Government of Gibraltar, Spain, the Spanish Confederation of Business Organisations and the Åland Executive.

The Government of Gibraltar

- (59) The Government of Gibraltar is aware of, and fully endorses, the arguments put forward by the United

Kingdom⁽⁸⁾. The additional points made by the Government of Gibraltar in its separate observations can be summarised as follows.

- (60) The Gibraltar Government has no power to tax United Kingdom companies. Similarly, the United Kingdom Government has no power to tax Gibraltar companies. Gibraltar's tax laws are enforced exclusively by the Gibraltar authorities.
- (61) The objective of the reform is to implement a corporate tax regime which complies both with the State aid rules and with the Code of Conduct. The reform is also part of the wider aim to secure compliance with international standards for financial regulation and supervision and to obtain good standing in the international financial community. Gibraltar had previously been found to be a 'tax haven' by the International Monetary Fund (IMF), the Financial Action Task Force (FATF) and the OECD. The IMF and FATF Reports on Gibraltar⁽⁹⁾ confirm Gibraltar's compliance with the main international standards on financial regulation and supervision. The Gibraltar Government's commitment to the OECD⁽¹⁰⁾ delivers compliance with the requirements for exchange of information and transparency. Gibraltar's tax reform, as amended, delivers de facto compliance with the EU Code of Conduct. The reform also delivers compliance with the State aid rules. Clearance under State aid rules remains the last obstacle in the way of ensuring that Gibraltar, as required by the international community including the European Union, has now addressed all the perceived evils of a tax haven.
- (62) Two Gibraltar measures, the exempt and qualifying company regimes, were among eleven measures into which the Commission opened formal State aid investigations on 11 July 2001. All 11 were among the large number of fiscal measures identified as harmful by the Code of Conduct Group⁽¹¹⁾. They were singled out under the Commission's powers to enforce State aid rules, sometimes by applying new interpretations of the selectivity criterion, essential to the notion of State aid. The mere fact that a tax regime is listed as harmful under the Code of Conduct does not, however, necessarily mean that it involves State aid (point 30 of the Notice). By proceeding in this way, the Commission has embarked on a strategy which could easily lead to the unwanted consequence for competition policy that tax measures which constitute a significant distortion of competition to the detriment of the effective functioning of the single market are left intact for political reasons

⁽⁸⁾ See paragraphs 33 to 57.

⁽⁹⁾ Published, respectively, in October 2001 and on 22 November 2002.

⁽¹⁰⁾ Public commitment made on 27 February 2002.

⁽¹¹⁾ Report of Code of Conduct Group (Business Taxation) to the Ecofin Council on 4 December 2001 (14467/01 — FISC 249, 27.11.2001).

— the Commission refrains from using appropriate tax harmonisation measures — while less harmful tax systems are being persistently challenged by the Commission in a way that does not respect equality of treatment. In order to achieve a common level of business taxation across the European Union, if that is the objective, the Commission must resort to tax harmonisation measures. Otherwise an abuse of powers may be involved. Point 15 of the Notice confirms that differences between tax systems as such are not regulated by the State aid rules, but should rather be addressed under Articles 95 to 97 EC.

(63) The new system will address the concerns regarding possible harmful tax competition. First, the reform abolishes any distinction between resident and non-resident companies (so-called ring-fencing) which has been at the heart of the Code of Conduct exercise, the OECD Report on Harmful Tax Competition, and the selectivity aspect of the exempt and qualifying companies legislation. The reform applies in a uniform way to all companies registered in Gibraltar. Second, it delivers transparency of the system because all companies will be required to file tax accounts. Finally, financial services companies in Gibraltar will not be exempted from taxation, but will be subject to an extra top-up tax on profits attributable to such activities.

(64) The 15 % profits-based cap and non-taxation of companies making no profit are of general application and do not constitute material selectivity. The simple fact that one company may benefit from a general rule in a given year as compared to another company in the same tax jurisdiction cannot be sufficient to constitute a State aid under the rules of the EC Treaty. This result is clearly not contemplated by the points 13 and 14 of the Notice.

(65) Regional selectivity could arise if there was a tax, applicable throughout the whole State, but regional parliaments or authorities had power to reduce the rate of that tax (or to give exemptions from it) in their regions. Selectivity issues therefore can arise if the taxing powers of the region said to be giving aid are in some sense secondary or supplementary powers to modify a standard or residual regime. This may perhaps be the position in some other Member States, but it is not the position in Gibraltar. The situation is entirely different if the tax jurisdiction said to be giving aid is, and has been at all relevant times, a genuinely autonomous tax jurisdiction which determines its tax system independently under its own budgetary responsibility, and in which taxes imposed by the other tax jurisdictions in the State are not payable.

(66) Without prejudice to whether generally applicable deviations from a national norm adopted by a fully auton-

omous region (in contrast to a region acting by ad hoc delegation of powers) without any link to the central budget would constitute State aid or not, the Gibraltar tax reform is also in that respect fundamentally different. Not only is there a genuine, *sui generis*, autonomy in the territory, but this autonomy is used to devise independently a wholly different and separate system which is not based, in any way, on the United Kingdom scheme or norms. It is thus completely inappropriate and irrelevant to compare the Gibraltar tax rules to the rules which would apply had the same tax subject been based in the United Kingdom.

(67) The Court of First Instance (CFI) has recently reviewed the Commission's decisions to open formal procedures in cases concerning fiscal measures adopted pursuant to some degree of regional autonomy granted to the Basque Provinces under the Spanish constitution. However the Basque Provinces applied their fiscal powers to deviate from the national tax system by granting tax relief from otherwise applicable rules. In its preliminary conclusions that the tax measures in question were selective and could constitute illegal State aid, the Commission did not rely on the fact that they applied only to part of the Spanish territory. The CFI specifically noted in one case⁽¹²⁾ that the Commission's decision to open procedures 'has no effect on the competence of the Territorio Histórico de Álava to adopt general tax measures applicable to the whole of the region concerned'.

(68) The reform is not regional in scope for the purposes of the State aid rules because the fiscal measures in question, which constitute the entire and exclusive corporate tax system, would apply in the same way throughout the relevant tax jurisdiction.

The Åland Executive

(69) The comments of the Åland Executive can be summarised as follows.

(70) In deciding that the reform is likely to constitute State aid, the Commission states that the possible existence of regional selectivity is taken into account in order to reach its conclusions. The Commission cites previous decisions, including the decision to open the formal State aid investigation procedure on captive insurance companies in the Åland Islands. This invitation to submit comments refers to the possible existence of regional specificity. But the reference was dropped from the Commission's final decision. Therefore the Åland case cannot serve as an example of regional specificity or selectivity. The account of previous Commission practice should refer only to the Commission's final decision.

⁽¹²⁾ See footnote 7.

(71) If a self-governing region has sole power to legislate in matters relating to direct corporate taxation, and that region introduces a tax measure, the measure has to be assessed and authorised in accordance with the same principles that would apply if it were taken by a Member State. The self-governing region is to be regarded as a separate jurisdiction in those areas where legislative power lies with its legislature exclusively. This means that the compatibility of a tax measure with the rules on State aid is to be judged in the same way whether it is taken by a Member State or by a self-governing region. Any other conclusion would make it impossible for a region under self-government to exercise its legislative power in a way that differed from the rest of the Member State. Accordingly, a tax measure that is plainly a general one within a self-governing region is not to be regarded as selective, and does not constitute State aid for purposes of Article 87(1) of the EC Treaty, in so far as the region has exclusive power in tax matters, irrespective of whether the tax charged in the area is different from that in the Member State to which the region belongs. Any other interpretation would jeopardise the region's authority in tax matters.

Spain

(72) Spain essentially endorses the Commission's preliminary analysis of the reform set out in the invitation to comment⁽¹³⁾. The additional comments made by Spain can be summarised as follows.

(73) Gibraltar's tax system is an extremely important issue for Spain, given the geographical contiguity of the two territories and the serious detriment it is causing to Spanish public finances. The unfair competition from Gibraltar can be described as harmful since both under the present system and under the proposed new arrangements the tax burden on businesses and investments is much lower there than in Spain. The reform would continue to be harmful to the Spanish tax system since it would maintain a level of taxation substantially lower in Gibraltar than in Spain, where the standard rate of corporation tax is 35 %, and would differ greatly from the tax system in the United Kingdom, creating a risk that businesses would relocate to Gibraltar in order to benefit from more favourable tax arrangements. It is likely that most firms in Gibraltar would pay less than the maximum liability of 15 %, at least 15 to 20 percentage points lower than in either Spain or the United Kingdom.

(74) For the 28 800 companies not liable to the top-up taxes on utilities and financial services activities, the proposed

tax system is not in fact an overall corporation tax on business profits but a combination of various individual taxes subject to ceilings which render the tax liability either extremely small or non-existent (the reform is referred to as 'zero rate tax' in Gibraltar). Most of these companies can be regarded as letterbox or asset management companies and provided that they generated profits they would be liable to GBP 3 000 per employee per year. Since most of them will have only one employee (an accountant or auditor), usually part-time, they would pay only a maximum of GBP 3 000 per year in tax if they do not occupy property, which is usually the case.

(75) The introduction of the registration fee would discriminate in tax terms in favour of companies that do not generate profits (GBP 150), such as letterbox or asset management companies, in comparison with active companies (GBP 300). This would be a clear example of maintenance of the status quo in favour of that type of company.

(76) The financial services sector accounts for 30 % of gross domestic product. The tax on the profits of financial services firms would not constitute a genuine corporation tax since those firms' combined liability by way of payroll tax, business property occupation tax and top-up tax would not exceed 15 % of their profits or GBP 500 000.

(77) Offshore companies would remain outside the scope of two of the new taxes: around 8 000 companies without any physical presence in Gibraltar would thus be exempt. The reform leaves intact the tax situation of businesses with no staff or premises in Gibraltar.

(78) Gibraltar is a region which, far from being dependent on aid or incentives designed to boost economic development, enjoys enviable financial health.

(79) As far as the selective nature of any aid is concerned, the top-up tax on profits would be levied only on companies providing certain financial services and utilities. Such specificity cannot derive from or be justified by the nature or general scheme of the system⁽¹⁴⁾. Companies in sectors where capital is extremely mobile, which employ very few staff, would basically incur only the payroll tax, and as such their liability would be capped. This would confer an advantage exclusively on such firms, whose costs would be reduced and whose profitability would be increased in relation to their competitors.

⁽¹³⁾ See footnote 1.

⁽¹⁴⁾ This exception was recognised by the Court in Case 173/73 [1974] ECR 709.

(80) The Advocate General of the European Court of Justice maintained ⁽¹⁵⁾ that all measures which involve a competitive advantage, including a financial advantage, 'limited to companies which invest in a particular area of the Member State are attributable to the State in question and cannot therefore, by definition, in the scheme of the fiscal system of the State, be understood as measures of a general nature'. He also took the view that 'the fact that the measures at issue were adopted by regional authorities with exclusive competence under national law' was 'merely a matter of form', and 'not sufficient to justify the preferential treatment reserved to companies which fall within the scope' of regional laws.

(81) Although the stated aim of the planned reform is to adopt a new corporation tax scheme that does not involve any element of State aid, it cannot be exempted from the scope of Article 87 on the grounds that it is a tax measure or pursues company-law objectives. The main effects of the reform would be immediately to distort competitive conditions in the area and to encourage businesses to relocate. The scheme would significantly benefit businesses located in Gibraltar since the effective rate of taxation in that territory would be much lower (or even non-existent) in comparison with the rate applied in the United Kingdom. By establishing a clear reduction in the tax burden for the businesses concerned, such regional selectivity would distort competition and affect trade between Member States.

(82) The technical mechanism of the payroll tax can be regarded as harmful within the meaning of point B of the Code of Conduct, in addition to the fact that the Gibraltar tax regime as it stands creates a tax burden that is significantly lower than that generally imposed in the United Kingdom. The reform would act as a disincentive to substantial economic presence in Gibraltar and would thus be caught by the criterion for regarding tax measures as harmful set out in point B.3 of the Code of Conduct. The United Kingdom has not so far honoured the promises it made under the auspices of the OECD with a view to removing Gibraltar from the list of non-cooperating tax havens.

(83) Gibraltar's economic approach is also harmful to Gibraltar itself, since it has given rise to an economy that lacks sound foundations and is unsustainable in the medium or long term. It has also deprived the neighbouring region, Campo de Gibraltar, of potential development opportunities. Campo de Gibraltar is currently one of Spain's least developed regions. Gibraltar's relative prosperity is due to a large extent to the underdevelopment of the surrounding region.

(84) This tax system is not only discriminatory and unfair but it also encourages tax evasion and money laundering.

Tax evasion stimulated by the possibility of money laundering in Gibraltar is causing serious harm to Spain's public finances, and such money laundering is facilitating the activities of organised criminal gangs. The above-mentioned IMF report stresses that there are no mandatory rules on combating money laundering in Gibraltar.

The Spanish Confederation of Business Organisations

(85) The Spanish Confederation of Business Organisations endorses the Commission's preliminary analysis of the reform set out in the invitation to comment and argues that the reform could seriously harm the interests of Spanish businesses. Its additional comments can be summarised as follows.

(86) The tax burden would be much lower than that incurred by businesses in metropolitan United Kingdom and in Spain: total tax liability in Gibraltar would be capped at 15 %, whereas the rate of taxation in the United Kingdom and in Spain is at least 30 % and can be even higher. Under the new scheme many firms in Gibraltar would pay hardly any tax at all. The costs which beneficiary firms would have to bear would be lower than their competitors. The much lower level of tax in Gibraltar is highly discriminatory and undermines the competitiveness both of Spanish businesses in the area and UK businesses.

(87) The vast majority of businesses established in Gibraltar are very small (usually run by a single person and occupying small premises) and are engaged in asset management activities, so that the only income they generate consists of capital gains deriving from the assets they manage. Given that the basis of the reform is taxation according to the number of the company's employees and the surface area of its premises, as well as the tax exemption of capital gains, most firms established in Gibraltar would not pay any corporation tax.

Comments from the United Kingdom on the third party observations

(88) The United Kingdom supports the observations of the Åland Executive. In commenting on the observations of the Spanish Government and the Spanish Confederation of Business Organisations, the United Kingdom repeated and cross-referred to some of the arguments it had made in its response to the opening of procedure. The additional comments of the United Kingdom can be summarised as follows.

⁽¹⁵⁾ Joined Cases C-400/97, C-401/97 and C-402/97, [2000] ECR I-1073.

- (89) The reform will not cause 'serious damage' to the Spanish Public Exchequer. Underdevelopment in the Campo area does not stem from Gibraltar's fiscal system. The opposite is true, since the region derives a considerable amount of income from Gibraltar. Employment figures for January 2003 show, for instance, that Spanish nationals lawfully employed in Gibraltar represent approximately 18 % of Gibraltar's workforce. Gibraltar thus provides a substantial source of employment and income for Spanish workers coming from the surrounding area, as well as considerable income for the Campo area from Gibraltarians who spend in this region. Spain is also the second largest exporter to Gibraltar. Gibraltar is not as wealthy as implied and is an Objective 2 region for the purposes of the European Regional Development Fund.
- (90) Differences in tax rates and tax bases between Member States and between autonomous tax regions is a sovereign matter not within the scope of Article 87 of the EC Treaty. The purpose of the State aid rules is to attack advantages given by the State or through State resources to certain specific enterprises. Lower tax rates applicable generally within an autonomous tax territory do not satisfy this material specificity requirement and therefore do not constitute State aid. Competition between the tax systems of autonomous tax regions may arise not only from differences in tax rate, but also from differing methods of calculating taxable income. Such differences in method of calculation do not constitute State aid if the tax system is applied in a genuinely non-discriminatory manner inside the autonomous tax territory. It is unclear how the reform could substantially harm the Spanish economy by provoking the relocation of businesses to Gibraltar. The United Kingdom is not aware of any Spanish company that has relocated to Gibraltar in order to benefit from the alleged 'favourable tax system' provided by the present corporate tax regime. Indeed, other EU countries, such as Greece and Ireland, and EU accession countries, such as Estonia, Hungary and Cyprus, also have relatively 'low' general corporate tax rates.
- (91) The criticism of the system as a combination of various taxes is misconceived. The logic of the reformed system is that employment and occupation constitute the tax base, whilst profitability constitutes a lower threshold to liability. The system simply abandons the taxation of profit as the taxable event in the case of companies. The criteria of employment and occupation apply horizontally to all companies in all sectors. They do not benefit, for example, larger companies over smaller companies or vice versa. The dropping of the GBP 500 000 profit tax limit removes all possibility that the reform could benefit larger companies over smaller ones. The fact that the registration fee is GBP 150 for non-profit-making companies and GBP 300 for active companies does not constitute State aid as the difference in registration fee of GBP 150 must be considered to be *de minimis*.
- (92) Although the reform may correctly be described as 'zero-rate profit tax' (due to the choice of employment and occupation, and not profit, as tax bases), to describe it as 'zero rate tax' is wrong. The accurate position is that the essential element of the reform is the general abolition of taxation of company profit (save for a top-up taxation on financial services and utilities activities) and its replacement with a payroll tax payable by all companies.
- (93) Neither of the top-up taxes (on financial services or utilities) constitutes State aid. While material selectivity could be argued, such taxes do not qualify as 'advantages' in comparison with the general norm for the purposes of the definition of aid; their purpose is quite the contrary. For this reason, the claim that non-financial service sectors are not covered by the top-up tax is unfounded.
- (94) The suggestion that the reform represents an advantage for Gibraltar companies over United Kingdom companies is incorrect and represents a misunderstanding of the concept of regional specificity, of the constitutional status of Gibraltar, and of its status for the purposes of the EC Treaty. It is assumed that the Spanish Government does not intend to maintain such an argument, which would prevent any effective decentralisation of taxation powers by Member States, and which could undermine, *inter alia*, the tax autonomy of its Basque provinces. The cases quoted by the Spanish Government⁽¹⁶⁾, in the context of regional specificity, have no relevance as neither involved situations where the regions concerned had independent autonomy in the fields where relief from the general fiscal system was granted. The tax autonomy referred to in certain Basque cases⁽¹⁷⁾ is applied to grant tax rebates in relation to the general Spanish tax system, while in Gibraltar's case its autonomy is applied to create a fundamentally different tax system to that of the United Kingdom.
- (95) The allegations relating to, *inter alia*, tax evasion and money laundering are unfounded and irrelevant to the current State aid procedure. It would not therefore be appropriate to make a detailed rebuttal. However, Gibraltar observes high standards of supervision and financial regulation, in both the public and private sectors. The Gibraltar Financial Services Commission is an independent and respected body. This view has been corroborated by several international bodies, which have also commended Gibraltar's actions in combating money

⁽¹⁶⁾ Commission Decision of February 13, 2001, N 147 A/2000 France (Loi d'orientation pour l'Outre-mer) and case 248/84 *Germany v Commission* [1987] ECR 4013.

⁽¹⁷⁾ Joined cases T-127/99, T-129/99 and T-148/99 *Diputación Foral de Álava and others v Commission*, p. 142.

laundering. Gibraltar was one of the first jurisdictions within the EU to implement the EU's Money Laundering Directive on an all-crimes basis. A report of the Financial Action Task Force (FATF), published in November 2002, states that 'Gibraltar has in place a robust arsenal of legislation, regulations and administrative practices to counter money laundering' and is 'close to complete adherence with the FATF 40 Recommendations' ⁽¹⁸⁾. An IMF report from October 2001 judged that Gibraltar was compliant with 66 out of 67 established international standards on financial regulation, and concluded that 'supervision is generally effective and thorough ... Gibraltar ranks as a well-developed supervisor' ⁽¹⁹⁾. Under OECD rules, Gibraltar has been classified as a cooperative tax jurisdiction.

VI. ASSESSMENT

Existence of aid

- (96) In order to be considered to be State aid within the meaning of Article 87(1) of the EC Treaty, a measure must satisfy the four following criteria. First, the measure must afford the beneficiaries an advantage that reduces the costs they normally bear in the course of their business. Second, the advantage must be granted by the State or through State resources. Third, the measure must affect competition and trade between Member States. Finally, the measure must be specific or selective in that it favours certain undertakings or the production of certain goods.
- (97) According to point 16 of the Notice, the main criterion in applying Article 87(1) EC to a tax measure is that it 'provides in favour of certain undertakings in the Member State an exception to the application of the tax system. The common system should thus first be determined'. However, given that the reform raises issues both of material selectivity and of regional selectivity, the Commission will first examine the regional selectivity aspect. The question of material selectivity of the different components of the reform in the Gibraltar context is examined separately below in paragraphs 128 to 152.

Regional selectivity

- (98) In its decision to open the formal State aid investigation procedure ⁽²⁰⁾, the Commission identified the ways in which the reform as a whole provides for advantages to Gibraltar companies compared with companies in the United Kingdom. Neither the United Kingdom nor the Government of Gibraltar has contested the factual basis of this comparison and it is therefore repeated and refined below.

- (99) Under the United Kingdom corporation tax regime the maximum rate of corporation tax is 30 % of companies' profits. In contrast, under the reform, the maximum rate of corporation tax for all Gibraltar companies except utility companies is 15 %.

- (100) The differences between on the one hand, the United Kingdom corporation tax regime and the company taxation regime in Gibraltar as envisaged by the reform on the other hand, have the consequence that companies operating in the United Kingdom will be taxed at a maximum rate of 30 % of profits whereas companies (other than utility companies) operating in Gibraltar will be taxed at a maximum rate of 15 % of profits. In addition, as described in paragraphs 128 to 152 below, certain types of company will either escape tax or will be taxed at a rate of 5 % of profits. These differences in tax treatment represent an advantage to companies other than utility companies established in Gibraltar compared with companies established in the United Kingdom.

- (101) Further advantages arise to companies in Gibraltar as compared with those in the United Kingdom through other differences in the tax regime. The Commission notes that under the reform, capital gains are excluded from any calculation of profit. In contrast, capital gains are generally chargeable to corporation tax in the United Kingdom. Similarly, the differences in capital allowance give rise to advantages. In contrast to the 33 1/3 % allowance for capital expenditure on plant and machinery, the United Kingdom tax regime provides for an allowance of 25 % of the declining balance and has no generally applicable first year allowances.

- (102) As is evident from the previous paragraphs, the essence of the Commission's view on the regional selectivity of the Gibraltar tax reform proposals is that they provide, in general, for a lower level of taxation than that applicable in the United Kingdom and that this difference amounts to a selective advantage for companies active in Gibraltar. This premise is consistent with point 16 of the Notice. This states '[t]hat the main criterion in applying Article 87(1) to a tax measure' is that it 'provides in favour of certain undertakings in the Member State an exception to the application of the tax system'. As pointed out in point 17 of the Notice, 'the Commission's decision-making practice so far shows that only measures whose scope extends to the entire territory of the State escape the specificity criterion laid down in Article 87(1)' and 'the Treaty itself qualifies as aid measures which are intended to promote the economic

⁽¹⁸⁾ FATF Offshore Group of Banking Supervisors, Mutual Evaluation Report (November 2002), p. 29.

⁽¹⁹⁾ IMF Report (October 2001) 'Gibraltar: Assessment of the Regulation and Supervision of Financial Services', paragraph 9.

⁽²⁰⁾ See footnote 1.

development of a region' ⁽²¹⁾. Even if they were to apply automatically and equally to all economic operators liable for tax in Gibraltar, without introducing any difference in treatment in favour of one or more sectors of activity, which is not the case here, the abovementioned tax reductions 'are intended exclusively for companies situated in a particular region of the Member State in question and constitute for them an advantage which companies intending to carry out similar economic operations in other areas in the same State cannot enjoy' ⁽²²⁾. In this case the abovementioned tax reductions do in fact favour firms taxed in Gibraltar, in comparison with all firms active in the United Kingdom.

(103) The United Kingdom, the Government of Gibraltar and the Åland Executive disagree with the view that the measure is selective, i.e. that it favours 'certain firms or certain products'. They argue that a distinction should be drawn between cases in which the State grants tax benefits of limited scope to part of national territory and cases in which such benefits are granted by an infra-State regional authority for the part of the territory that falls within its jurisdiction: the former are selective because their scope is limited to some of the firms under State jurisdiction, while the latter are general measures since they apply to all firms under the jurisdiction of the regional authority.

(104) The Commission considers first that the element of selectivity in the concept of aid is based on a comparison between the advantageous treatment granted to certain firms and the treatment that applies to other firms in the same reference framework. The definition of this framework takes on added importance in the case of tax measures since the very existence of an advantage can only be established in relation to taxation defined as normal. In theory it follows both from the general scheme of the Treaty, which concerns aid granted by the State or through State resources, and from the fundamental role the central authorities of the Member States play in defining the political and economic environment in which firms operate, thanks to the measures they adopt, the services they provide and possibly the financial transfers they make, that the framework in which such a comparison should be made is the economy of the Member State. In this respect the text of the Treaty itself, which classifies measures intended 'to promote the economic development' of a particular region (Article 87(3)(a) and (c)) as State aid that may be considered to be compatible, indicates that benefits whose

scope is limited to part of the territory of the State subject to the rules on aid may constitute selective benefits. It is clear that if the reference context for assessing the territorial selectivity of a measure is the territory in which it applies, measures that benefit all the firms in the territory would by definition become general measures. The settled practice of the Commission, confirmed by the Court of Justice, on the contrary consists of classifying as aid tax schemes applicable in particular regions or territories which are favourable in comparison to the general scheme of a Member State ⁽²³⁾.

(105) Second, the United Kingdom's argument according to which benefits of limited territorial scope become general measures in the region concerned only because they are established by the regional rather than by the central authority, and that they apply throughout the territory under the region's jurisdiction, cannot be reconciled with the concept of aid. This concept is objective, covering all aid that reduces the charges that are normally borne from the budget of one or more firms in various forms, regardless of its purpose, justification or objective or the status of the public authority that establishes it or whose budget bears the charge. A distinction based solely on the body that decides the measure would remove all effectiveness from Article 87 of the Treaty, which seeks to cover the measures concerned exclusively according to their effects on competition and Community trade ⁽²⁴⁾. Such aid therefore cannot be treated differently from measures which have the same objectives, use the same resources and have the same

⁽²¹⁾ See in particular Commission Decision 93/337/EEC of 10 May 1993 concerning a scheme of tax concessions for investment in the Basque country (OJ L 134, 3.6.1993, p. 25).

⁽²²⁾ Opinion of Mr Advocate General Saggio in Joined Cases C-400/97, C-401/97 and C-402/97 [2000] ECR I-1073.

⁽²³⁾ See in particular, in the case of measures adopted by central authorities, the Commission Decision of 21 May 1997, aid N 847/96, on the creation of priority outermost regions and measures on improved economic access in the French Overseas Territories (OJ C 245, 12.8.1997), the Commission Decision of 16 December 1997, aid N 144/A/96, on the scheme of regional aid to investment and operating aid which amends the economic and tax system of the Canary Islands (OJ C 65, 28.2.1998) and Commission Decision 2002/780/EC of 28 February 2001 on the aid scheme 'Investment allowance 1999', which Germany is planning to implement for certain undertakings in the new *Länder*, including Berlin (OJ L 282, 19.10.2002, p. 15). See also Commission Decision 98/476/EC of 21 January 1998 on tax concessions under Article 52(8) of the German Income Tax Act (*Einkommensteuergesetz*) (OJ L 212, 30.7.1998, p. 50), on which the Court of Justice delivered judgment on 19 September 2000 in Case C-156/98 *Germany v Commission* [2000] ECR I-6857. In the case of measures granted by regional authorities, see Commission Decision 93/337/EEC of 10 May 1993 concerning a scheme of tax concessions for investment in the Basque country and Commission Decision 2003/442/EC of 11 December 2002 on the part of the scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores which concerns reductions in the rates of income and corporation tax (OJ L 150, 18.6.2003, p. 52).

⁽²⁴⁾ Case 173/73 *Italy v Commission* [1974] ECR 713, Case 323/82 *Intermills v Commission* [1984] ECR 3809 and Case C-248/84 *Germany v Commission* [1987] ECR 4013.

effects on trade and competition, according only to the formal criterion of the degree of autonomy of the infra-State authority that establishes it. According to the abovementioned conclusions of Mr Advocate General Saggio in Joined Cases C-400/97, C-401/97 and C-402/97, 'the fact that the measures at issue were adopted by regional authorities with exclusive competence under national law is (...) merely a matter of form, which is not sufficient to justify the preferential treatment reserved to companies which fall under the provincial laws. If this were not the case, the State could easily avoid the application, in part of its own territory, of provisions of Community law on State aid simply by making changes to the internal allocation of competence on certain matters, thus raising the general nature, for that territory, of the measure in question'.

(106) The Commission points out that the use of a purely institutional criterion to differentiate 'aid' from 'general measures' would inevitably lead to differences in treatment in the application of the rules on aid to Member States, according to whether they had adopted a centralised or decentralised model of allocating tax competence (or other competence, such as in the area of social security). If the United Kingdom's argument were accepted, Member States whose internal administrative organisation allowed certain regional authorities below State level to make changes to the general tax system in the form of tax benefits applicable to firms that operated in the respective regions would escape the rules on regional aid in relation to those regions and measures.

(107) The Commission considers that if measures completely identical in their objectives, technique and effects were not subject to the same rules it would be contrary to equal treatment and would create serious distortions in the functioning of the common market. The existence of the rules on aid to regional tax benefits should be based on objective criteria and cannot depend on a purely institutional factor such as the application at a particular time of more or less extensive tax autonomy in favour of an infra-State authority of more or less broad territorial scope. If this technique were generalised it would undermine equality in applying the rules on State aid and therefore render them ineffective.

(108) In the Commission's approach the tax autonomy of the regional authority that grants the benefits has never been considered as a factor that would make it possible not to regard measures as aid. In Decision

93/337/EEC⁽²⁵⁾, recognition that 'the competent institutions in each of the three Basque provinces may, under certain conditions, maintain, establish and regulate the tax system within their territory' did not prevent the Commission from finding that the tax benefits in question created by the three provinces were covered by Article 87(1) and from declaring them incompatible because they did not comply with the rules on regional and sectoral aid⁽²⁶⁾. Other cases concerning measures adopted by the authorities of the Basque provinces were decided on grounds of material selectivity⁽²⁷⁾. The issue of regional selectivity was not addressed by the Community Courts when assessing the validity of such decisions⁽²⁸⁾ since the Commission had not relied upon this criterion in its decision: the comments of United Kingdom and the Government of Gibraltar on territorial competence are therefore not relevant. In subsequent decisions on tax concession schemes implemented by autonomous tax authorities the Commission, while taking the view that the measures examined constituted aid because of their material selectivity, expressly left open the possibility of examining their territorial selectivity⁽²⁹⁾. In a recent decision concerning tax advantages granted by the authorities of the Azores region, the Commission came to the conclusion that the measures at stake were selective although they applied to all undertakings active in that region⁽³⁰⁾.

(109) Lastly, the Commission would stress that classing these measures as aid does not call into question the tax autonomy of Gibraltar, resulting from the relevant constitutional arrangements and practice. It seeks merely to ensure that, in cases where Gibraltar exercises its autonomy by reducing the amount of tax levied at national level, the tax benefits granted thereby comply with the Community rules on regional aid and the other applicable frameworks on the basis of equality throughout Community territory. It is without prejudice to the possibility that such benefits are compatible with the common market.

⁽²⁵⁾ Cited above.

⁽²⁶⁾ See in this respect the judgment of the Court in Joined Cases T-127/99, T-129/99 and T-148/99 *Territorio Histórico de Álava and Others v Commission* [2002] ECR II-1275, paragraph 237.

⁽²⁷⁾ See, for instance, Commission Decision 2000/795/EC of 22 December 1999 on the State aid implemented by Spain for Ramondín SA and Ramondín Cápsulas SA (OJ L 318, 16.12.2000, p. 36).

⁽²⁸⁾ See Joined Cases T-92/00 and T-103/00, cited above, concerning Decision 2000/795/EC.

⁽²⁹⁾ See in particular Commission Decision 2003/28/EC of 20 December 2001 on a State aid scheme implemented by Spain in 1993 for certain newly established firms in Álava (Spain) (OJ L 17, 22.1.2003, p. 20), Commission Decision 2003/86/EC of 20 December 2001 on a State aid scheme implemented by Spain in 1993 for certain newly established firms in Vizcaya (Spain) (OJ L 40, 14.2.2003, p. 11) and Commission Decision 2003/192/EC of 20 December 2001 on a State aid scheme implemented by Spain in 1993 for certain newly established firms in Guipúzcoa (Spain) (OJ L 77, 24.3.2003, p. 1).

⁽³⁰⁾ See Decision 2003/442/EC, cited above.

- (110) Nor can the Commission take the view that the above-mentioned tax reductions are justified by the nature or the general scheme of the tax system, or that because of their economic rationality they are necessary or functional in relation to the effectiveness of that system. In particular, in so far as these reductions do not derive from applying principles such as proportionality or progressive taxation, since on the contrary they generally favour firms in a specific region regardless of their financial situation and cannot be considered to be inherent in the tax system.
- (111) The United Kingdom and the Government of Gibraltar advance a number of arguments in support of their view that the fact that the proposed reform provides in general for lower company taxation in Gibraltar than in the United Kingdom does not of itself give rise to State aid within the meaning of Article 87(1) of the EC Treaty. Those arguments are examined below.
- (112) To suggest that State aid is only present if State resources are used through a tax foregone and that in the Gibraltar case, no tax is foregone as there is no United Kingdom rate of tax for an activity which would also apply in Gibraltar is also an argument about the form of the measure. Equally formalistic, in the sense of Advocate General Saggio, is the argument to the effect that even if the alleged aid measure were abolished, the United Kingdom standard or normal rate would not apply and that therefore any comparison where the tax system is devised locally is not meaningful for the purposes of State aid. Given that the same result can be achieved by different legal techniques — by providing for an explicit derogation to a system that would otherwise apply or by establishing formally separate systems that apply to similar situations — the selectivity of a measure cannot be established solely by reference to a 'but for' test, comparing the situation resulting from the relevant measure with the situation which would exist 'but for' that measure. On the contrary, it is necessary to compare the measure at hand with other measures which apply to similar situations, in this case company taxation in the United Kingdom. Although the assessment of a measure under State aid rules does not depend on the nature of the measures previously in force, it can be noted 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.
- (113) In the same way, the arguments of the Gibraltar Government contrasting regional (or secondary) powers to reduce a national tax rate with its own, independent powers over the entire tax system concern the internal competences of the United Kingdom and its territories. In any event, the extent of the tax autonomy conferred upon a given territory cannot be the decisive factor, since this element is at the disposal of Member States, it would be impossible to establish a clear distinction in this respect and this would lead to unequal treatment of similar situations. Such a result would also run against the principle that, in order to assess the State aid character of a given measure, one must have regard to its effects.
- (114) The United Kingdom states that there is no common system of reference to which the Gibraltar companies would be subject in the case that the measure would be abolished. This is a circular reasoning, as the absence of a common system is a consequence of granting fiscal autonomy and the very existence of a specific tax jurisdiction in a given region is the result of a choice made by the relevant Member State. Whenever a central government decides to give up its power to establish a uniform taxation framework for enterprises and allows a sub-national entity to reduce the tax rate or to introduce another taxation system that is more advantageous, the result of this decentralisation of power is a derogation from a common system of reference. De facto, providing directly for a reduction of the tax rate, or granting to a territory the possibility to reduce a common tax rate, or exempting a territory from a common system and granting to it a power to establish a more advantageous taxation system comes to the same result; it allows companies in a certain region to pay lower taxes while State resources are foregone.
- (115) The Commission cannot accept the United Kingdom suggestion that a tax jurisdiction not covering the whole Member State would be prevented from adopting any tax rate except the one applicable in the other tax jurisdiction in the State. As mentioned above, the key to any State aid analysis of tax measures is to establish the common system applicable, in this case, the United Kingdom tax system. In this context it should be noted that the present decision does not concern a mechanism that would allow all local authorities of a particular level (regions, territories or others) to introduce and levy local taxes. On the contrary, the case in point involves a reduction applicable solely in Gibraltar. In any event, the fact that a fiscal advantage constitutes State aid does not mean that it cannot be held compatible with the common market.
- (116) The argument that imposing a higher rate of taxation in a given region would automatically have as a consequence that lower tax rates applied in the rest of the State become State aid has nothing to do with the present case, does not follow from the reasoning of the Commission and is not accurate. In such a case, there would be a common system applied in all regions but one. By definition, such a system would not constitute State aid. Obviously, the derogation resulting from the

higher rate applied in a given region would not constitute an advantage and therefore would not be qualified as State aid either. This shows again that it remains possible for a Member State to grant fiscal autonomy to certain regions without necessarily granting State aid to given companies.

(117) The parallels that the United Kingdom draws with the WTO agreement on subsidies are not relevant, as the legal order within the European Union is quite distinct from any international law provided for by WTO agreements, the regime of State aid control in a single market must obviously be stricter than rules applicable to subsidies laid down in a world agreement and the fact that a measure might not be considered to be a 'specific subsidy' under the Agreement on subsidies cannot cut down the scope of the definition of aid in Article 87(1) of the EC Treaty ⁽³¹⁾.

(118) As for the consequences, in terms of State aid, of any future decision by the United Kingdom to share sovereignty over Gibraltar with Spain, the arguments advanced are purely hypothetical in nature and refer to a situation which, in any event, should be dealt with by specific arrangements concerning the application of EC law. The current facts of the case do not accord with the hypothesis put forward by the United Kingdom and therefore have no relevance in ascertaining the existence, or otherwise, of State aid.

(119) The United Kingdom objects to the comparison made by the Commission of the different exemptions and allowances available in Gibraltar with those in the United Kingdom. The grounds for this objection are that where the tax systems or the tax bases are different, meaningful comparisons cannot be made. However, contrary to that which the United Kingdom asserts, meaningful comparisons can be made as set out in paragraph 100 above. The differences identified constitute further elements of an analysis which demonstrates that when compared with the United Kingdom tax system (the common system applicable), undertakings in Gibraltar in general enjoy a lower fiscal pressure.

(120) The United Kingdom invokes the subsidiarity principle in order to argue that if a Member State can function with two or more autonomous tax jurisdictions competing for corporate tax revenue within its territory without suffering significant distortive effects on competition, it does not under the subsidiarity principle of the EC Treaty become a Community task to intervene in the constitutional arrangements of the Member State. This argument is based both on a false premise that there are no significant distortive effects (or that such effects are contained entirely within the United Kingdom and

Gibraltar without any spillover into other Member States) and on a misunderstanding of the subsidiarity principle. Article 5 of the EC Treaty is quite explicit that the principle of subsidiarity only applies in those areas which do not fall within the Community's exclusive competence. Since the control of State aid is an area of exclusive Commission competence, the subsidiarity principle does not apply. In examining the proposed reforms, including the question of regional selectivity, as in any State aid investigation into fiscal measures, the Commission is not pursuing tax uniformity but is merely fulfilling its Treaty obligation to control State aid.

(121) Contrary to what the United Kingdom asserts, the principle that a Member State cannot plead its own national law to avoid its Community law obligations is indeed relevant to the issue of selectivity. As already established, the way in which a Member State is organised for the purposes of taxation is a matter of form: it cannot plead the existence of autonomous tax regions, however extensive their powers might be, in order to escape the application of the rules on State aid. This does not, nevertheless, interfere with the possibilities of Member States to decentralise their powers. The issue concerns the exercise of those decentralised powers. Member States and the bodies to which powers have been devolved must ensure that Community law, including that on State aid, is upheld. More concretely, where tax powers are devolved but a central reference system remains, Member States must ensure that reductions in tax, insofar as they constitute aid, are compatible with the common market.

(122) The United Kingdom argues, *inter alia*, that Gibraltar: is not part of the United Kingdom; has its own distinct institutions and constitutional order; and is autonomous, self-governing and economically self-sufficient.

(123) The Commission accepts that Gibraltar does not form part of the United Kingdom for domestic law purposes and has distinct institutions, although the United Kingdom authorities retain certain competences and prerogatives, including the power to ensure that measures adopted by Gibraltar in domestic matters do not conflict with the United Kingdom's obligations under the EC Treaty. However, as in the case of other autonomous regions, this fact does not alter the assessment of the measures adopted by the Gibraltar authorities. Gibraltar is part of the Community by virtue of its links with the United Kingdom. All Community rules apply to Gibraltar, subject to the exceptions resulting from Article 28 of the Act of Accession, since the United Kingdom became a Member State and because of this membership. As a consequence, British dependent

⁽³¹⁾ Cases C-351/98 *Spain v Commission* [2002] ECR I-8031, point 44, and C-409/00 *Spain v Commission* [2003] ECR I-1487, point 56.

territories citizens who acquire their citizenship from a connection with Gibraltar are citizens of the Union. These citizens and companies registered in Gibraltar enjoy the rights and freedom recognised by the Treaty, including freedom to provide services, freedom of establishment and free movement of capital, which are relevant for the economic activities of the beneficiaries. The United Kingdom is responsible for ensuring respect for Community law in Gibraltar, which for these purposes is treated as a part of its territory⁽³²⁾. Gibraltar must therefore be considered to form part of the United Kingdom for the purposes of the rules on State aid, including the application of Articles 87 and 88 to fiscal measures.

(124) Whilst it may be true that EC law applies to Gibraltar by virtue of Article 299(4) of the EC Treaty rather than Article 299(1), that fact does not afford Gibraltar special status for the purposes of the application of the rules on State aid in general and on regional State aid in particular. Paragraphs 1, 2 and 4 of Article 299 all provide that the provisions of the Treaty shall apply and no difference can be detected between the legal regime of the different territories enumerated in each paragraph, subject to specific and express derogations. As explained above, the Act of Accession does not exclude Gibraltar from the application of State aid rules. The way in which EU law is given effect in Gibraltar, including the transposition of directives and the establishment of competent authorities, is not relevant for the purposes of establishing whether or not the reform constitutes State aid. The manner in which a Member State gives effect to EU law is purely matter of the internal division of competences within the State. The fact that a measure is adopted at a sub-national level does not in any way affect the application of Article 87 of the EC Treaty⁽³³⁾.

(125) Finally, the fact that the budget of a given territory is self-sufficient is not immediately relevant for the assessment under State aid rules of the measures adopted by the authorities of that territory. Such an assessment must be based on the effects of the measures for the benefiting undertakings and not on the situation of the granting authority. In particular, a small territory like Gibraltar may well become self-sufficient precisely as a result of its ability to apply lower taxes and to attract business, in particular off-shore activities. In any event, it is common ground that Gibraltar depends on the United Kingdom, *inter alia*, for its foreign policy, including membership of the European Union, for its defence and for its monetary policy. It thus benefits from a number of services provided by the United Kingdom. In addition, it appears from the institutional arrangements in place that financial responsibility for Gibraltar falls in the last resort to the United Kingdom.

(126) As for the Åland Executive's comments to the effect that a general tax measure within a self-governing region is

not selective, they rely on similar arguments to those advanced by the United Kingdom and the Government of Gibraltar. The Commission refers to its reasoning developed above, and in particular in paragraphs 104 to 109. The Commission further notes that in the case of Åland Islands captive insurance companies it was able to establish the material selectivity of the measure. It was not therefore necessary for the purposes of reaching a final negative decision on the measure to rely on its regional selectivity.

(127) The Commission therefore concludes that by providing for a system of corporate taxation under which enterprises in Gibraltar are taxed, in general, at a lower rate than those in the United Kingdom, the reform confers a selective advantage on enterprises in Gibraltar.

Material selectivity

The requirement to make a profit before incurring a tax liability

(128) One consequence of the limitation of the combined liability for payroll tax and business property occupation tax to 15 % of profits is that regardless of their payroll and occupation of business property, companies that make no profit are not taxed. This in effect acts as an exemption for unprofitable companies and constitutes an advantage which relieves such companies of the liability for payroll tax and business property occupation tax which would normally be borne by their budgets.

(129) This exemption from the payroll and business property occupation taxes is selective as it applies only to those companies that make no profit. In addition to enterprises in difficulty and those whose principal source of income is derived from capital gains, in any particular year such companies might include, for example, enterprises operating in cyclical business environments, enterprises in the initial stage of their business and companies where profits are eliminated through additional payments to shareholder-employees or to other employees. The Commission cannot accept the United Kingdom's arguments to the effect that the inherent quantitative limitation in the system which exempts unprofitable companies applies in the same way to all companies regardless of their size or sector and is therefore not selective. Although apparently general, certain definable categories of companies benefiting from the exemption from tax can in fact be identified, as will be shown later.

(130) Nor can the Commission accept the United Kingdom's arguments that even if the exemption for unprofitable companies were selective, it is justified by the nature or scheme of the corporate tax system.

⁽³²⁾ Case C-218/02 *Commission v United Kingdom*, judgment of 29 January 2004 not yet reported, point 15 of the grounds and point 1 of the operative part.

⁽³³⁾ Case 248/84 *Germany v Commission* ECR [1987] 4013, p. 17.

- (131) 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. In this sense, the parallel drawn by the Commission with social security contributions is valid, regardless of the fact, as the United Kingdom observes, that their purpose is different from a tax measure. 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.
- (132) The United Kingdom states that the system 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.
- (133) The Commission therefore concludes that the exemption of unprofitable companies from payroll tax and business property occupation tax through the operation of the 15 % cap is selective and, if the other conditions are fulfilled, may constitute State aid to those companies that benefit from it. It cannot be justified by the nature or general scheme of the proposed tax system. This is without prejudice to the assessment of the compatibility of such a measure.
- The 15 % cap on liability to payroll tax and business property occupation tax**
- (134) A second consequence of the limitation of the combined liability for payroll tax and business property occupation tax to 15 % of profits 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. 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.
- (135) The 15 % cap is also selective, as only a limited number of companies will enjoy a reduction in their tax liability through its application. Although the United Kingdom and Gibraltar no longer claim that as few as 10 enterprises will benefit from the cap, it nevertheless limits the scope of application of the payroll tax and the business property tax. 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. The application of a pure payroll and business property tax system might imply a very high level of taxation for such companies.
- (136) The Commission notes the United Kingdom's and Gibraltar's arguments that a specific group of companies cannot be identified and that the rules are generally applicable to all companies in Gibraltar. However, this does not prevent the 15 % cap from being de facto selective in the manner described in the previous paragraph. In this respect, the references made to point 14 of the Notice by the United Kingdom and Gibraltar are not relevant since it does not exclude the possibility that apparently general measures may constitute state aid. In particular point 14 covers, for example, tax incentives for specific investment and measures designed to reduce the taxation of labour 'for all firms', which is not the case with the 15 % cap, benefiting only companies that make relatively small profit as compared to their number of employees. In addition, the 15 % cap is not a purely technical measure in the sense of the first indent of point 13 of the Notice. 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. 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 (point 24 of the Notice). Nor is the 15 % cap a measure pursuing a general economic policy objective, in the sense of the second indent of point 13 of the Notice, as it does not reduce the tax burden related to certain production costs for the whole economy of Gibraltar, but it only benefits a limited number of undertakings. Furthermore, the cap is not directly linked to the labour or business property costs but rather to the profitability of companies. The latter is an element external to a payroll and business property tax.

(137) The Commission does not accept the United Kingdom's argument that if the 15 % cap is selective, it is justified by the nature and 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. The arguments put forward by the United Kingdom are essentially economic in nature. They are not related to the internal logic of the proposed system.

(138) The United Kingdom suggests that the Gibraltar economy is more vulnerable than most to shocks created by tax competition and that companies may not be able to afford to leave a large Member State as easily as they can move out of Gibraltar. However, the Commission notes that little evidence has been adduced to support this hypothesis, which, if true, suggests that the 15 % cap is part of a strategy designed to retain if not attract mobile capital to Gibraltar, which given the physical constraints of the territory, is likely to be targeted at financial and other services. Similarly, the argument that a regressive element is not required in the taxation of utilities, which occupy monopoly or quasi-monopoly positions in the Gibraltar market, indicates that mobile capital is the target of the 15 % cap.

(139) As for the suggestion that without a regressive element, a labour tax could trigger mass layoffs and instability in times of cyclical market fluctuations, the Commission would simply note that this is an inherent feature of such a system. In any event, at GBP 3 000 per employee, the payroll tax would represent only a small proportion of the overall unit labour costs⁽³⁴⁾. Therefore the incentive to shed labour in order to control costs will exist to a similar extent with or without a payroll tax.

(140) The Commission also notes the impact of the 15 % cap on the offshore and onshore sectors of the Gibraltar economy. The offshore sector comprises exempt companies and qualifying companies, the legislation for which will be repealed as part of the reform. Exempt companies tend not to have a physical presence in Gibraltar (no employees or premises) and pay a fixed tax of between GBP 200 and GBP 300 per annum. In contrast, qualifying companies have a physical presence in Gibraltar (they are significant employers) and negotiate their rate of tax with the authorities. The vast majority

of qualifying companies pay corporation tax at a rate of between 2 % and 10 % of profits. The 15 % cap therefore limits any increase that qualifying companies would face on implementation of the reform. In contrast, the onshore economy (other than utilities) would see their rate of tax fall from the current standard corporation tax rate of 35 %. The Government of Gibraltar also appears to admit that the reform as a whole (which includes the 15 % cap) has been designed to suit the particular tax 'needs and preferences' of sectors within the offshore financial services industry⁽³⁵⁾. The Commission also observes that, in dropping the original plan for a GBP 500 000 cap on tax liability, the United Kingdom has indicated that Gibraltar will, as a consequence, reduce the top-up tax on financial services from 8 % to between 4 and 6 %. This suggests that capping tax liability is intended to favour financial services companies, many of which are qualifying companies, the principal source of employment in the Gibraltar 'Finance Centre'.

(141) The Commission therefore concludes that in the circumstances of the present case the 15 % cap is selective and, if the other conditions are fulfilled, may constitute State aid to those companies that benefit from its application. It cannot be justified by the nature or general scheme of the proposed tax system. This is without prejudice to the assessment of the compatibility of such a measure.

The proposed application of the payroll tax and of the business property occupation tax to the Gibraltar economy

(142) Point 13 of the Notice states that '[t]ax measures which are open to all economic agents operating within a Member State are in principle general measures. They must be effectively open to all firms on an equal access basis, and they may not de facto be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production. Provided that they apply without distinction to all firms and to the production of all goods, the following measures do not constitute State aid:

— tax measures of a purely technical nature (for example, setting the rate of taxation, depreciation rules and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance),

⁽³⁴⁾ The Gibraltar Government website (www.gibraltar.gov.gi) states that 'wages [in Gibraltar] are broadly in line with the United Kingdom'. Average full-time wages in the United Kingdom are around GBP 24 000 (source: New Earnings Survey 2002, <http://www.statistics.gov.uk/pdfdir/nes1002.pdf>). Labour costs to employers include other costs (e.g. social security contributions).

⁽³⁵⁾ Government of Gibraltar Press Release 008/2003, 14 January 2003.

- measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (research and development (R & D), the environment, training, employment).'

(143) Without prejudice to the considerations with regard to the effects of the reform proposals (as a whole) in paragraphs 147 to 152 or those concerning regional selectivity in paragraphs 98 to 127, a payroll tax under which all undertakings are liable in the amount of a fixed sum per employee per year can at least under certain circumstances be considered as selective when it is applied in the absence of a general system of taxation of company profits and replaces such a system. This is the case when one takes into account the specific features of the Gibraltar economy and in particular the existence of a large offshore sector without any fiscal presence, which would escape any taxation under the payroll and property tax system. Even though such a system formally applies without discrimination to all enterprises, *de facto* it benefits the current 'exempt companies' that do not have any employees in Gibraltar. It constitutes a specific advantage in favour of these undertakings with no real presence in Gibraltar, who as a consequence do not incur corporate tax. This advantage is not effectively open to all firms on an equal basis in the sense of the second sentence of point 13 of the Notice. Indeed, the practical effect of the advantage is restricted to certain enterprises. In addition, the payroll tax proposed by Gibraltar essentially does not constitute a tax measure of a purely technical nature in the sense of the first indent of point 13 of the Notice, because it is not a technical adjustment of a general system, but it concerns the tax base. In this specific case the exemption does not represent a measure pursuing general economic policy in the sense of the second indent of point 13 of the Notice as it does not reduce any production costs, but rather increases the labour costs. The same reasoning applies equally to a business property occupation tax applied in the absence of a general system of taxation of company profits and replacing such a system, under which each undertaking's liability for tax is set at a rate equivalent to the same fixed percentage of its liability to general property rates. Such a measure also advantages the current 'exempt companies' that normally have no physical presence in Gibraltar. Accordingly, the Commission concludes that, in the circumstances of the present case and taking into account the existence of a large offshore economy in Gibraltar the proposed system is materially selective aid.

(144) In addition 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 aim at taxing the result of the economic activity as a whole. It may therefore be considered as selective at least in circumstances such as those in the present case.

This situation is to be distinguished from a system where a payroll tax or a business property tax is added on top of a general profit tax, which ensures a wide taxation of all sectors of the economy, and represents thus a minor aspect of the taxation of enterprises.

The registration fee

- (145) Whilst it may be true, as Spain suggests, that the registration fee provisions discriminate in favour of companies that do not generate income, this discrimination is not a source of State aid. As the United Kingdom points out, the GBP 150 (about EUR 225) difference in registration fee between the two classes of company falls well below the *de minimis* threshold⁽³⁶⁾ of EUR 100 000 over a three year period. Provided that all relevant conditions are complied with, the difference in registration fee is therefore *de minimis* and does not constitute State aid.

The top-up taxes on financial services and utilities activities

- (146) Spain suggests that the absence of top-up taxation on sectors other than financial services and utilities confers an advantage on companies in such sectors. The Commission does not share this view. Whilst it may be the case that where the State confers a benefit on an identifiable group of companies, this may *prima facie* constitute State aid, the same is not true where the State creates a disadvantage. Where the State imposes an exceptional fiscal burden on companies, such as a penalty tax, it can only be State aid if it can be demonstrated as occasioning a corresponding advantage for identifiable business competitors of those which have to bear the detriment. Contrary to what the United Kingdom suggests, the purpose of the top-up taxes is not relevant in establishing whether they are a source of State aid. Nevertheless, the Commission concludes that the immediate effect of the top-up taxes, taken in isolation, is to create a disadvantage for the companies affected. This conclusion is without prejudice to the consideration of this top-up tax as part of a system which *de facto* foresees different taxation rates for different kinds of undertakings.

The advantages arising for certain sectors of the economy from the proposed tax system as a whole

- (147) Table 1 below sets out data⁽³⁷⁾ on various categories of company in Gibraltar and their level of liability for tax, measured on profits, as a result of the proposed reform. It must be noted that, although in some cases the tax liability of any given company will also be determined by the number of employees or by the commercial use of property, the combined effect of the various caps and top-ups amounts to setting different overall level of taxation, measured on profits, for different sectors of the economy.

⁽³⁶⁾ See Commission Regulation (EC) No 69/2001 on *de minimis* aid (OJ L 10, 13.1.2001, p. 30).

⁽³⁷⁾ Figures for the number of companies are approximate. Source: information supplied by the United Kingdom and/or Gibraltar in the course of this investigation and the investigations into exempt and qualifying companies.

Table 1: Data on Gibraltar companies

	Number	Tax rate	
		Current	Post-reform
All companies (breakdown by sector)	29 000		
Financial services	179	0-35 %	5-15 % ⁽¹⁾
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	540	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.

- (148) 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.

(149) The offshore sector in Gibraltar is currently the subject to two parallel State aid investigations into exempt companies and qualifying companies. In this respect, the Commission has considered that by exempting them from tax, the Gibraltar authorities grant State aid to exempt companies⁽³⁸⁾. Similarly, in a decision adopted on the same day as the present one, the Commission has established that by providing for a low rate of tax compared with the standard rate of corporation tax, the Gibraltar authorities grant State aid to qualifying companies⁽³⁹⁾.

(150) It is clear from Table 1 that on implementation of the reform, exempt companies outside the financial services sector will continue to be taxed at an effective rate of zero. The reason for this is that exempt companies tend not to have a physical presence in Gibraltar. Accordingly, they have neither employees nor business premises in Gibraltar and therefore will incur liability neither for the payroll tax nor for the business property occupation tax. Their privileged position of zero tax is preserved by the reform, which in effect, continues to grant them State aid. Exempt companies in the financial services sector will experience the imposition of tax of 5 % on implementation of the reform. However, even if they are taxed for the first time, their privileged position in the Gibraltar economy will be largely maintained since 5 % of profits will be the limit of their tax liability. In contrast, the rest of the Gibraltar economy will be subject to an upper limit of either 15 % or 35 %.

(151) The Commission concludes that the reform perpetuates the existing situation in which exempt companies are the beneficiaries of State aid. More generally, the system provides for different levels of profits taxation in respect to different sectors of the economy and thereby grants a selective advantage to undertakings belonging to the sectors where lower rates apply. For this reason too, the notified scheme is materially selective.

(152) 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.

Advantage granted by the State or through State resources

(153) The grant of the tax exemptions and reductions assessed in detail in paragraphs 98 to 152 above involves a loss of tax revenue which, according to point 10 of the Notice, is equivalent to the use of State resources in the form of fiscal expenditure. As confirmed by the Court

of Justice, this principle also applies to advantages granted by regional or local bodies of Member States⁽⁴⁰⁾. The argument that no tax revenue is foregone because United Kingdom taxes would not apply to Gibraltar has already been discussed above. It therefore follows that the advantage is granted by the State and through State resources.

Effect on trade and distortion of competition

(154) Gibraltar is an open market economy. Many of the companies established in Gibraltar (and the groups to which they belong) are likely to be active in sectors where there is trade between Member States. This is particularly true in the sector of services, where the relevant provisions of Community law fully apply to Gibraltar. The Court of Justice has repeatedly ruled that when aid granted by the State strengthens the position of an undertaking vis-à-vis other undertakings competing in intra-Community trade, the latter must be regarded as affected by that aid. For that purpose, it is not necessary for the recipient undertaking itself to export its products. Where a Member State grants aid to an undertaking, domestic production may for that reason be maintained or increased with the result that undertakings established in other Member States have less chance of exporting their products to the market in that Member State. Similarly, where a Member State grants aid to undertakings operating in the service and distribution industries, it is not necessary for the recipient undertakings themselves to carry on their business outside the Member State for the aid to have an effect on Community trade, especially in the case of undertakings established close to the frontier between two Member States. The relatively small amount of aid, or the relatively small size of the undertaking which receives it, does not as such exclude the possibility that intra-Community trade might be affected⁽⁴¹⁾. Therefore to the extent that Gibraltar companies operating in sectors in which there is intra-Community trade benefit from this exemption, it affects trade between Member States, distorting or threatening to distort competition.

General remarks

(155) The United Kingdom, the Government of Gibraltar and Spain each make observations about the compliance of the reform with the criteria set out in the Code of Conduct and with other international norms. However, as observed by the Government of Gibraltar, the assessment of a measure as harmful (or otherwise, as is the case with the reform⁽⁴²⁾) under the Code has no direct

⁽³⁸⁾ Case E7/2002, appropriate measures proposed by letter C(2002) 4481 final of 27 November 2002.

⁽³⁹⁾ Case C-52/2001.

⁽⁴⁰⁾ See Case 284/84 *Germany v Commission* [1987] ECR 4013, point 17.

⁽⁴¹⁾ See Cases 730/79 *Philip Morris v Commission* [1980] ECR 2671, 142/87 *Belgium v Commission* [1990] ECR I-959, Joined Cases C-278/92, C-279/92 and C-280/92 *Spain v Commission* [1994] ECR I-4103, paragraphs 40 to 42, and Case C-310/99 *Italy v Commission* [2002] ECR I-2289, paragraphs 84 to 86.

⁽⁴²⁾ See conclusions of the meeting of the Council of Economic and Finance Ministers, 3.6.2003.

bearing on its evaluation for State aid purposes under Article 87 of the EC Treaty. Equally, the allegations made by Spain and rebutted by the United Kingdom relating to tax evasion and money laundering are, as the United Kingdom points out, not relevant to the State aid investigation.

- (156) The Commission rejects the comment from the Government of Gibraltar that in its State aid actions, the Commission has not respected equality of treatment. No specific evidence has been adduced in support of this suggestion. In any event, when investigating possible State aid within the meaning of Article 87 of the EC Treaty, the Commission is obliged to look at each measure solely on its own merits. Although the Government of Gibraltar suggests that measures under Articles 95 to 97 of the EC Treaty constitute the appropriate course of action, the Commission notes that point 15 of the Notice must be read in conjunction with point 6 which clearly refers to possible courses of action in relation to the effects of general tax measures within Member States. Implicit in this suggestion is a demand for Gibraltar to be treated as if it were a Member State in its own right, in the same way that the Åland Executive claims that direct taxation measures adopted by self-governing regions should be assessed as if they were adopted by a Member State. However, there is no basis in the EC Treaty for such a claim.

Compatibility

- (157) Neither the United Kingdom nor the Government of Gibraltar has attempted to argue that if it constitutes aid, the reform can be considered to be compatible with the common market. The Commission therefore maintains its position set out in its assessment of compatibility in the opening of the procedure. That assessment is repeated and refined as follows.
- (158) None of the exceptions under Article 87(2) of the EC Treaty can be applied in this case as the reform is not aimed at the objectives listed in that provision.
- (159) Under Article 87(3)(a), an aid measure is considered compatible with the common market when it is designed to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment. Such areas are defined by the United Kingdom's regional aid map for the period 2000 to 2006, as approved by the Commission under State aid number No 265/00⁽⁴³⁾. Since Gibraltar is not such an area, this provision does not apply.

⁽⁴³⁾ OJ C 272, 23.9.2000, p. 43.

- (160) As regards the exceptions laid down in Article 87(3)(b) and (d), the reform is not intended to promote the execution of an important project of common European interest nor to remedy a serious disturbance in the economy of the United Kingdom, nor is it intended to promote culture or heritage conservation.

- (161) Lastly, it is necessary to examine whether the reform can qualify for the exception laid down in Article 87(3)(c) which states that aid to facilitate the development of certain economic activities or of certain economic areas where such aid does not adversely affect trading conditions to an extent contrary to the common interest may be considered to be compatible with the common market.

- (162) The elements of the reform identified as giving rise to an advantage and the reform as a whole when compared with the system of company taxation in the United Kingdom relieve the enterprises concerned of charges that would usually be borne by their budgets in the normal course of their business. This relief is not linked either to investment or to job creation and therefore constitutes operating aid, the benefits of which will cease as soon as it is withdrawn. According to the constant practice of the Commission, such aid cannot be considered to facilitate the development of certain economic activities or of certain economic areas. In addition, Gibraltar is not included in the regional aid map for the United Kingdom⁽⁴⁴⁾.

VII. CONCLUSIONS

- (163) The Commission concludes that the reform constitutes a scheme of State aid within the meaning of Article 87(1) of the EC Treaty. None of the derogations provided for in Article 87(2) or Article 87(3) apply. Therefore the United Kingdom is not authorised to implement the reform.

HAS ADOPTED THIS DECISION:

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.

⁽⁴⁴⁾ See previous footnote.

Article 2

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

Done at Brussels, 30 March 2004.

For the Commission
Mario MONTI
Member of the Commission
