

JUDGMENT OF THE COURT (Grand Chamber)

6 September 2006

(Action for annulment – State aid – Decision 2003/442/EC – Tax measures adopted by a regional or local authority – Reductions on the rate of income tax for natural and legal persons having their tax residence in the Azores – Classification as State aid – Selective nature – Justification by the nature and overall structure of the tax system – Obligation to state reasons – Compatibility with the common market)

In Case C-88/03,

ACTION for annulment under [Article 263 TFEU], brought on 24 February 2003,

**Portuguese Republic**, represented by L. Fernandes, acting as Agent, and J. da Cruz Vilaça and L. Romão, advogados, with an address for service in Luxembourg,

applicant,

supported by

**Kingdom of Spain**, represented by N. Díaz Abad, acting as Agent, with an address for service in Luxembourg,

and

**United Kingdom of Great Britain and Northern Ireland**, represented by R. Caudwell, acting as Agent, and D. Anderson QC, with an address for service in Luxembourg,

interveners,

v

**Commission of the European [Union]**, represented by V. Di Bucci and F. de Sousa Fialho, acting as Agents, with an address for service in Luxembourg,

defendant,

THE COURT (Grand Chamber),

composed of V. Skouris, President, P. Jann, C.W.A. Timmermans, A. Rosas (Rapporteur) and J. Malenovský, Presidents of Chambers Puissechet, R. Schintgen, N. Colneric, S. von Bahr, J. Klučka and U. Løhmus, Judges,

Advocate General: L.A. Geelhoed,

Registrar: M. Ferreira, Principal Administrator,

having regard to the written procedure and further to the hearing on 6 September 2005,

after hearing the Opinion of the Advocate General at the sitting on 20 October 2005,

gives the following

## Judgment

- 1 By its application, the Portuguese Republic seeks the annulment of 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 2003 L 150, p. 52) ('the contested decision').

### Legal background

[Union] law

- 2 [Article 107(1) TFEU] states:

'Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market'.

- 3 The Commission Notice of 10 December 1998 on the application of the State aid rules to measures relating to direct business taxation (OJ 1998 C 384, p. 3) ('the Notice on State aid in the field of direct taxation') states, in paragraph 2, that it proposes to provide clarification on the classification of aid under [Article 107(1) TFEU] in the case of tax measures.

- 4 [Article 107(3) TFEU] provides that the following may be regarded as compatible with the common market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious under-employment;

...

(c) 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;

...?.

- 5 [Article 355(1) TFEU] states that the provisions of the Treaty apply to the French overseas departments, the Azores, Madeira and the Canary Islands. However, the [Union] legislature may adopt specific measures aimed, in particular, at laying down the conditions for the application of the Treaty to those regions, given that their economic situation and social structure are adversely affected by a number of factors, the permanence and combination of which severely restrict their development.

- 6 Under Paragraph 4.15 of the Commission Guidelines on national regional aid (OJ 1998 C 74, p. 9), as amended on 9 September 2000 (OJ 2000 C 258, p. 5) ('the Guidelines on national regional aid'), regional aid aimed at reducing an undertaking's current expenses, namely operating aid, is prohibited.

- 7 However, under Paragraph 4.16.2 of the Guidelines, in the outermost regions qualifying for exemption under [Article 107(3)(a) and (c) TFEU], aid which is not both progressively reduced and limited in time may be authorised in so far as it is intended to offset the

additional costs arising in the pursuit of economic activity from the factors identified in [Articles 349 and 355(1) TFEU], the permanence and combination of which severely restrain the development of such regions. That provision also states that it is the task of the Member State to determine the amount of the additional costs and to prove that such costs are linked to those factors. Furthermore, the proposed aid must be justified in terms of its contribution to regional development, and its nature and level must be proportional to the additional costs it is intended to offset.

#### *National legislation*

- 8 The Constitution of the Portuguese Republic of 2 April 1976 provides that ‘the Azores and Madeira archipelagos shall be autonomous regions with their own political and administrative statutes and self-government institutions’. In that connection, it provides for a series of provisions regulating the powers, functions and areas of competence of those regions and their respective political and administrative institutions.
- 9 It is clear from those provisions that the autonomous regions have their own tax revenue as well as part of the State tax revenue, as established by a principle ensuring active national solidarity. Furthermore, the legislative assemblies of those regions have exclusive power under the conditions laid down by a framework law adopted by the Portuguese Republic’s National Assembly, to exercise their own fiscal competence and to adapt State taxes to regional particularities.
- 10 By Law No 13/98 of 24 February 1998 on the finances of the autonomous regions (lei No 13/98 de 24 de Fevereiro. Lei de Finanças das Regiões Autónomas, *Diário da República* I, series A, No 46, of 24 February 1998, p. 746) (‘Law No 13/98’), the Portuguese State defined precisely the conditions for that financial autonomy. That law sets out the principles and objectives of regional financial autonomy, provides for the finances of the autonomous regions to be coordinated with State finances, and establishes the principle of national solidarity and the obligation for the central government and the autonomous regions to cooperate.
- 11 As regards cooperation between the State and the autonomous regions, Article 5(1) to (3) of Law No 13/98 states, in particular:
  - ‘1. In discharging the constitutional and statutory duty of solidarity, the State, which is to take account in this regard of the funds available and the need to ensure equal treatment for all parts of its national territory, shall contribute together with the authorities of the autonomous regions to the achievement of economic development, the correction of inequalities deriving from insularity and to economic and social convergence with the rest of Portugal and the European Union.
  2. National solidarity requires, notably, in the financial sphere, budgetary transfers provided for in this Law and which must adapt continuously to the level of development of the autonomous regions and seek above all to create conditions for better financial coverage by own resources.
  3. National solidarity aims to guarantee the fundamental principle of equal treatment for all Portuguese citizens and the opportunity for them to benefit from social policies defined at national level, and to contribute to economic and social convergence with the rest of Portugal and the Union ... it requires, in particular, budgetary transfers, which must be carried out in accordance with the provision of this Article.’
- 12 As stated in point 7 of the grounds of the contested decision, Law No 13/98 also provides that national income and corporation tax constitute revenue for the autonomous regions, under

the conditions determined by that law itself. Under Article 37 of the Law, the regional legislative assemblies are authorised to reduce the rates of income and corporation tax applicable there, by up to 30% as compared to those laid down by national legislation.

*The scheme specific to the Autonomous Region of the Azores*

- 13 By Regional Legislative Decree No 2/99/A of 20 January 1999, as amended by Regional Legislative Decree No 33/99/A of 30 December 1999 ('Decree No 2/99/A'), the legislative body of the Azores Region adopted the arrangements for adapting the national tax system to the region's specific characteristics under the powers devolved to it in the matter. The decree took effect on 1 January 1999 and includes, in particular, a section concerning reductions in the rates of income and corporation tax.
- 14 Those reductions apply automatically to all economic operators (natural and legal persons). According to the Portuguese authorities, they are intended, inter alia, to allow undertakings in the Azores to overcome the structural handicaps resulting from their location in an insular region on the periphery of the [Union]. For that purpose, all persons subject to income or corporation tax in the Azores Region enjoy a reduction in the rate of personal income tax of 20% (15% for 1999) and a reduction in the rate of corporation tax of 30%. The budgetary cost of the reductions is estimated by the Portuguese authorities, as measured by the resulting tax shortfalls, to be approximately EUR 26.25 million a year.

**The contested decision**

- 15 By letter of 5 January 2000, the Portuguese authorities notified the Commission of the European [Union] of a scheme adapting the national tax system to the specific characteristics of the Autonomous Region of the Azores. That scheme, which was notified late in response to a request for information made by Commission staff on 7 December 1999 following the appearance of articles in the press, and which entered into force without the authorisation of the Commission, was entered in the register of non-notified aid.
- 16 Following the examination of the information sent by the Portuguese authorities, the Commission decided to initiate the procedure laid down in [Article 108(2) TFEU], with respect to the part of the scheme concerning reductions in the rate of income tax. In the course of that procedure the Regional Government of the Åland Islands (Finland) sent observations to the Commission in support of the position of the Portuguese authorities.
- 17 At the conclusion of that procedure the Commission adopted the contested decision.
- 18 In paragraph 23 of the grounds of that decision, referring to its Notice on State aid in the field of direct taxation, the Commission sets out the criteria which define State aid for the purpose of [Article 107(1) TFEU]. The measure concerned must confer an advantage on recipients which relieves them of charges that are normally borne from their budget. Such an advantage must be granted by a Member State or through State resources, in whatever form. The measure concerned must affect competition and trade between Member States. Finally, it must be specific or selective in that it favours certain undertakings or the production of certain goods.
- 19 In paragraph 24 of the grounds of the contested decision, the Commission concludes that each of those criteria is fulfilled as regards the reduced rates of income and corporation tax in question. It takes the view, in particular, as regards the first three criteria, that:

— [I]n so far as the tax reductions in question apply to firms ... they provide an advantage which relieves them of charges that are normally borne from their budgets,

- granting a tax reduction involves a loss of tax revenue, which ... “is equivalent to consumption of State resources in the form of fiscal expenditure”. In so far as this principle also applies to aid granted by regional or local bodies in the Member States, the tax reductions in question are granted through State resources, i.e. resources which in the Portuguese public finance system are allotted to the Autonomous Region of the Azores,
- the criterion of competition and trade between Member States being affected presupposes that the beneficiary of the measure pursues an economic activity, regardless of the beneficiary’s legal status or means of financing. Under settled case-law the criterion of trade being affected is met since the recipient firms carry on an economic activity involving trade between Member States ... . In view of the extent of its sectoral scope and in so far as at least some of the firms concerned will carry on an activity involving trade between Member States, this is the case of the tax reductions under analysis’.

20 As regards the criterion of selectivity, the Commission cites paragraph 17 of its Notice on State aid in the field of direct taxation. According to that paragraph, the Commission’s decision-making practice shows ‘that only measures whose scope extends to the entire territory of the State escape the specificity criterion laid down in [Article 107(1) TFEU]’, which ‘itself qualifies as aid measures which are intended to promote the economic development of a region’. The Commission takes the view that the reductions in the tax rates concerned constitute, for firms situated in a particular region in Portugal, an advantage which other undertakings wishing to carry out similar economic operations in other areas of Portugal cannot enjoy. According to paragraph 24 of the grounds of the contested decision, those reductions thereby favour undertakings subject to tax in the Azores as compared with all other Portuguese undertakings within the terms of [Article 107(1) TFEU].

21 The Commission bases that conclusion on the following reasoning, set out in paragraphs 26, 27, 31 and 33 of the grounds of the contested decision.

22 First, in so far as the element of selectivity in the concept of aid is based on a comparison between two groups in the same reference framework (those which benefit from the scheme and those which do not), it can only be established in relation to taxation defined as normal. According to the Commission, ‘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 undertakings 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. ... The settled practice of the Commission ... 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 Second, it is not consistent with the concept of aid, which encompasses all measures which relieve charges which are normally borne from the budget of one or more undertakings, regardless of their purpose, justification, objective and the status of the public authority which establishes them or whose budget bears the charge, to submit, as the Portuguese authorities have done, that the benefits of limited territorial scope become general measures in the region concerned simply because they are established by the regional, rather than by the central, authority and that they apply throughout the territory under the region’s jurisdiction. ‘A distinction based solely on the body that decides the measure would remove all effectiveness from [Article 107 TFEU], which seeks to cover the measures concerned exclusively according to their effects on competition and [Union] trade ...’.

- 24 The Commission adds that ‘the present decision does not concern a mechanism that would allow all local authorities of a particular level (regions, districts or others) to introduce and levy local taxes with no reference at all to national taxation. On the contrary, the case in point involves a reduction, applicable solely in the Azores, in the rate of tax established by national legislation and applicable on mainland Portugal. Under the circumstances, the measure adopted by the regional authorities clearly constitutes a derogation from the national tax system’.
- 25 Third, the reductions in the rate of income tax referred to above cannot be justified by the nature or the general scheme of the Portuguese tax system. The Commission takes the view, in particular, that ‘in so far as these reductions do not derive from applying principles such as proportionality or progressive taxation, since on the contrary they favour firms in a specific region regardless of their financial situation, the objectives of regional development attributed to them cannot be considered to be inherent in the Portuguese tax system’.
- 26 After classifying the measures at issue as State aid, in paragraph 34 of the grounds of the contested decision, the Commission takes the view in paragraph 35 that that aid is operating aid, since it aims to overcome permanent structural handicaps resulting from the insularity of the Azores and the region’s remoteness from mainland economic centres by reducing undertakings’ current expenses. The Commission adds that such aid may be authorised if it is intended to offset the additional costs arising in the pursuit of economic activity from the handicaps identified in [Articles 349 and 355(1) TFEU], in compliance with the conditions laid down in point 4.16.2 of the Guidelines on national regional aid; specifically, it may be justified by its contribution to regional development and by its nature, and if it is of a level proportional to the additional costs it is intended to compensate.
- 27 In that connection, the Commission states, in paragraph 38 of the grounds of the contested decision, that, in so far as the reductions in the rates of income and corporation tax are applicable to ‘firms that operate outside the financial sector’, it is able to regard that aid as aid compatible with the common market under the derogation in [Article 107(3)(a) TFEU].
- 28 On the other hand, the Commission submits that, in so far as it is applicable to undertakings which operate in the financial sector, the reduced rates of income and corporation tax are not justified by their contribution to regional development and their level is not proportional to the handicaps they are intended to alleviate. The Commission is therefore unable to consider those reductions as compatible with the common market, within the meaning of [Article 107(3)(a) TFEU], particularly as it is still not in possession of quantified data enabling it to measure objectively the level of the additional costs facing undertakings liable for tax in the Azores operating in the financial sector. That aid is also not covered by any other derogation laid down in the Treaty.
- 29 It should be noted that, in paragraph 18 of the grounds of the contested decision, the Commission remarked on the absence of undertakings from the financial sector among those in the basic sample in the study provided by the Portuguese authorities. The Commission observed that the Portuguese authorities had simply explained such an absence by a lack of statistical data relating to those activities, while acknowledging that it was not possible for them to demonstrate rigorously in relation to such activities that the tax reductions in question were, by their nature and level, capable of resolving the specific problems of the Azores.
- 30 Furthermore, the Commission adds, in paragraph 42 of the grounds of the contested decision, that it is also appropriate, for reasons of transparency and legal certainty, to exclude from the benefit of a decision of compatibility with the common market ‘activities of the “intra-group services” type (activities the economic basis of which is to provide services to undertakings belonging to the same group, as coordination, financial or distribution centres)’.The

Commission takes the view that 'such activities do not contribute sufficiently to regional development and therefore cannot be declared compatible under [Article 107(3)(a) TFEU], or by virtue of other derogations laid down by the Treaty, for the same reasons indicated in relation to the financial sector'.

31 Accordingly, in Article 1 of the contested decision, the Commission declared 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 to be compatible with the common market, subject to the provisions of Article 2, under which the part of the aid scheme referred to in Article 1 is incompatible with the common market in so far as it applies to undertakings that carry on financial activities and undertakings which carry on activities of the 'intra-group services' type. In Article 3 of the contested decision, the Commission instructed Portugal to take all the necessary measures to recover from the undertakings that carry on the activities referred to in Article 2 the aid made available under the part of the aid scheme referred to in Article 1.

### **Forms of orders sought**

32 By order of the President of the Court of 16 September 2003, the United Kingdom of Great Britain and Northern Ireland was granted leave to intervene in support of the Portuguese Republic.

33 By order of the President of the Court of 9 June 2003, the Kingdom of Spain was granted leave to intervene in support of the Portuguese Republic.

34 The Portuguese Republic claims that the Court should:

- declare the action admissible;
- declare this action well-founded and, accordingly, annul the contested decision in so far as it classifies the reductions in the rates of income and corporation tax of natural and legal persons having their tax residence in the Azores as State aid;
- alternatively, and without prejudice to the foregoing, declare this action well-founded and annul in part the contested decision, in so far as it declares incompatible with the common market the reductions in the rate of tax applicable to undertakings operating in the financial sector and undertakings which carry on activities of the 'intra-group services' type, and in so far as Article 3 of the decision orders the Portuguese Republic to recover the amount of those reductions;
- order the Commission to pay all the costs, including those incurred by the Portuguese Republic.

35 The Commission contends that the Court should:

- dismiss the action as unfounded;
- order the Portuguese Republic to pay the costs.

36 The United Kingdom, intervening in support of the form of order sought by Portugal, contends that the Court should declare the action well-founded and, accordingly, annul the contested decision in so far as it classifies as State aid the reduced rates of income and corporation tax on natural and legal persons having their tax residence in the Azores.

## The action

37 The Portuguese Government puts forward three pleas in law in support of its action. First, it submits, the contested decision is vitiated in two respects by an error of law in the application of [Article 107(1) TFEU]. Second, that decision is not sufficiently reasoned, which constitutes an infringement of [Article 296 TFEU]. Third, it is vitiated by a manifest error of assessment of the facts which influence the application of [Article 107(3)(a) TFEU].

*The first plea: error of law in the application of [Article 107(1) TFEU]*

Arguments of the parties

38 By its first plea, the Portuguese Government submits that the reduced rates of income and corporation tax provided for by Decree No 2/99/A for natural and legal persons established in the Azores are not selective but general measures and that, in any event, the differences in the charges operated by those reductions are justified by the nature or the structure of the Portuguese tax system.

39 As regards the determination of the selective nature of those measures, the Portuguese Government submits, first of all, that the Commission was wrong to take the whole of Portuguese territory as the reference framework. In order to determine whether a measure is selective in nature it is not necessary to place that measure within a national reference framework. Therefore, where tax concessions whose scope is limited to part of the country are granted by a regional or local authority of a State for the area within its jurisdiction, the reference framework must be the region concerned. Since tax concessions granted in such circumstances are applicable to all undertakings subject to tax in that region, those measures are general, not selective.

40 Next, the Portuguese Government points out that the reduced rates of tax result directly from the founding principles of the Portuguese tax system, in particular the principles of redistribution and national solidarity, and from the degree of autonomy of the region concerned. They are the result of the exercise of constitutional sovereignty and are inspired by the factors set out in [Articles 349 and 355(1) TFEU], namely insularity, difficult climate and the economic dependence of the Azores on a small number of products.

41 In any event, according to the Portuguese Government, the contested decision disregards the fact that the tax reductions concerned are justified by the nature and structure of the Portuguese tax system. It submits, in that connection, that those measures contribute to the achievement of the structural objectives of the Portuguese tax system, namely the allocation of the tax burden in accordance with ability to pay, with the aim of redistribution. It adds that objective differences exist between the taxpayers in mainland Portugal and those in the Azores. Furthermore, those two factors derive directly from the constitutional and statutory texts which lay down the founding principles of the Portuguese tax system and the principle of autonomy of the outermost regions.

42 According to the Commission, it is clear from the scheme of the Treaty that the selectivity of a measure must be determined by reference to the national framework. To take the region which adopted the measure as the reference framework would be to disregard the functioning and rationale of the Treaty rules on State aid. Even in the absence of substantive selectivity, advantages reserved for undertakings operating in certain regions of a Member State are selective in nature and are therefore capable of constituting State aid. In this case, the contested tax reductions favour undertakings which are liable to tax in the Azores as compared with all other Portuguese undertakings because, in the regions of mainland Portugal, the relevant national taxes cannot be reduced by the local authorities and are therefore applicable in full, which is sufficient for a finding that the contested measure is

selective in nature for the purposes of [Article 107(1) TFEU]. The fact that the tax reductions concerned were decided on by a body other than the central State is irrelevant: only the effects of the measure, and not its form, may be taken into consideration for the purposes of its classification.

- 43 The Commission considers, furthermore, that the degree of autonomy of the Autonomous Region of the Azores is in fact limited. The Portuguese State continues to play a crucial role in the definition of the economic framework within which undertakings operate. As an example, undertakings operating in the Azores are able to benefit from infrastructures financed by the central State or a social security system whose financial balance is guaranteed by it. Moreover, the reduction in tax revenue for the region concerned, which results from the reduced tax rates, is indirectly offset at budgetary level by transfers from the central State, by virtue of the principle of financial solidarity.
- 44 As regards the justification for the tax advantages deriving from the nature and general structure of the Portuguese tax system, the Commission submits that that justification may be accepted only if those advantages result from objective differences between taxpayers. That is not the case with regard to the reductions at issue since they apply to all undertakings established in the Azores, whatever their financial situation, and derive from the economic characteristics of the region, which are factors extrinsic to the tax system. The Commission states that the concept of the nature or overall structure of the system refers to the internal logic of the system of compulsory taxation and to the necessary and proportionate technical distinctions which are intended to deal with the objectively different situations to which the levy system applies, and which meet the requirement that such a system must operate in the best possible manner in all the cases covered by it.
- 45 The United Kingdom Government, intervening in support of the Portuguese Republic, concentrated its arguments on an appraisal of the selectivity criterion. Dismissing the Commission's argument that measures which do not cover all the territory of the Member State satisfy the criterion of specificity laid down in [Article 107(1) TFEU], it argues that that criterion is sometimes not satisfied by tax measures which are adopted by devolved or autonomous regions, which apply to all the territory within their competence, and which are not sector-specific.
- 46 According to the United Kingdom Government, where, as in this case, the legislature of an autonomous region sets tax rates which apply uniformly across the region concerned but which are lower than those applied by decision of the national legislature to other parts of the Member State, the selectivity of the measure cannot be inferred simply from the fact that the other regions are subject to a different level of taxation. Depending on the circumstances, it may be appropriate to determine that selectivity in the context of the region itself and not in the context of the Member State as a whole. Such will be the case where there is a constitutional system which recognises sufficient fiscal autonomy so that a tax reduction granted by a local authority may be regarded as being decided by an autonomous or devolved region which not only has the power to take that decision but which must also bear the financial and political consequences of it.
- 47 Therefore, the United Kingdom Government submits, before classifying regional tax rates which are lower than the national tax rate as State aid, the Commission should have had regard to the degree of autonomy of the regional or local authority that established the reduced rates taking into account a number of factors, such as the fact that jurisdiction in tax matters is part of a constitutional system conferring a significant degree of political autonomy on the region, the fact that the decision to reduce the tax rate is taken by a body elected by the population of the region or accountable to that population, and the fact that the financial consequences of that decision are borne by the region and are not offset by subsidies or contributions from other regions or from central government.

- 48 According to the United Kingdom Government, the assessment of a regional tax system for State aid purposes raises broader issues of regional autonomy of considerable constitutional importance. In particular, the United Kingdom's 'asymmetrical' constitutional system of devolution could be called into question, having regard to the position of Scotland and Northern Ireland.
- 49 The Kingdom of Spain, also intervening in support of the Portuguese Republic, emphasises that devolution, where it exists, forms part of the Member States' constitutional framework. Following the Commission's arguments would result in upsetting this constitutional structure, particularly as policy concerning direct taxation remains within the specific competence of the Member States.
- 50 In its statement in response to the United Kingdom's intervention, the Commission denies that the approach adopted in the contested decision may hinder the exercise by Scotland or Northern Ireland of the powers conferred on them in tax matters.
- 51 The Commission adds that the fact that tax reductions applicable in a particular region decided at national level and similar reductions decided by a regional authority are treated in the same way is consistent with the principle that the concept of aid is defined according to the effects of the measure on undertakings or producers, without it being necessary to take account of its causes or aims or the situation of the bodies distributing or managing the aid (Case 173/73 *Italy v Commission* [1974] ECR 709, paragraphs 27 and 28, and Case 78/76 *Steinike & Weinlig* [1977] ECR 595, paragraph 21). By contrast, the criteria proposed by the United Kingdom, according to which, 'depending on the circumstances', the framework within which the selectivity of measure is assessed is the region or the Member State as a whole is irreconcilable with that principle and would lead to legal uncertainty liable to hinder the review of State aid.

#### Findings of the Court

- 52 [Article 107(1) TFEU] prohibits State aid 'favouring certain undertakings or the production of certain goods', that is to say, selective aid (Case C-66/02 *Italy v Commission* [2005] ECR I-10901, paragraph 94). However, according to settled case-law, the concept of State aid does not refer to State measures which differentiate between undertakings and which are, therefore, *prima facie* selective where that differentiation arises from the nature or the overall structure of the system of charges of which they are part (see, to that effect, Case 173/73 *Italy v Commission*, paragraph 33, and Case C-148/04 *Unicredito Italiano* [2005] ECR I-11137, paragraph 51).
- 53 Accordingly, it is appropriate to examine, first, whether the measures reducing the tax rates in question are selective in nature and, if necessary, to examine whether, as the Portuguese Government submits, those measures are justified by the nature and overall structure of the Portuguese tax system.
- 54 As regards the assessment of the condition of selectivity, which is a constituent factor in the concept of State aid, it is clear from settled case-law that [Article 107(1) TFEU] requires assessment of whether, under a particular statutory scheme, a State measure is such as to 'favour certain undertakings or the production of certain goods' in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question (see, to that effect, Case C-143/99 *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke* [2001] ECR I-8365, paragraph 41, Case C-308/01 *GIL Insurance and Others* [2004] ECR I-4777, paragraph 68, and Case C-172/03 *Heiser* [2005] ECR I-1627, paragraph 40).

- 55 Such an analysis is also required in respect of a measure adopted not by the national legislature but by an infra-State authority, since a measure adopted by a regional authority and not the central power is likely to constitute aid if the conditions laid down by [Article 107(1) TFEU] are satisfied (see, Case 248/84 *Germany v Commission* [1987] ECR 4013, paragraph 17).
- 56 It is clear from the foregoing that in order to determine whether the measure at issue is selective it is appropriate to examine whether, within the context of a particular legal system, that measure constitutes an advantage for certain undertakings in comparison with others which are in a comparable legal and factual situation. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with 'normal' taxation. The 'normal' tax rate is the rate in force in the geographical area constituting the reference framework.
- 57 In that connection, the reference framework need not necessarily be defined within the limits of the Member State concerned, so that a measure conferring an advantage in only one part of the national territory is not selective on that ground alone for the purposes of [Article 107(1) TFEU].
- 58 It is possible that an infra-State body enjoys a legal and factual status which makes it sufficiently autonomous in relation to the central government of a Member State, with the result that, by the measures it adopts, it is that body and not the central government which plays a fundamental role in the definition of the political and economic environment in which undertakings operate. In such a case it is the area in which the infra-State body responsible for the measure exercises its powers, and not the country as a whole, that constitutes the relevant context for the assessment of whether a measure adopted by such a body favours certain undertakings in comparison with others in a comparable legal and factual situation, having regard to the objective pursued by the measure or the legal system concerned.
- 59 The Commission's argument that such an analysis is rendered inadmissible by the wording of the Treaty and the well-established case-law in that field cannot be accepted.
- 60 It is true, as the Court has already ruled, that the fact that an aid programme has been adopted by a regional authority does not prevent the application of [Article 107(1) TFEU] if the relevant conditions are satisfied (see, to that effect, Case 248/84 *Germany v Commission*, paragraph 17). Furthermore, as the Commission stated, in paragraph 26 of the grounds of the contested decision, the text of the Treaty itself, which in [Article 107(3)(a) and (c) TFEU] classifies measures intended to 'favour certain undertakings or the production of certain goods' as State aid which may be declared 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. However, it cannot be inferred from that that a measure is selective, for the purposes of [Article 107(1) TFEU], on the sole ground that it is applicable only in a limited geographical area of a Member State.
- 61 Furthermore, it cannot be inferred from the judgment in Case C-156/98 *Germany v Commission* [2000] ECR I-6857 that a measure the benefit of which is reserved for undertakings situated in certain regions is selective for that reason alone. In paragraph 23 of that judgment the Court held that the fact that a tax concession favoured certain undertakings situated in the new Länder or West Berlin prevented its being a general measure of tax or economic policy. However, the tax concession concerned had been adopted by the national legislature and was applicable to only some of the undertakings in a number of regions in Germany, namely those employing a maximum of 250 employees and whose head office and management were situated in the new Länder or West Berlin, by way of derogation from the national system which is otherwise homogeneous.

- 62 In order to determine the selectivity of a measure adopted by an infra-State body which, like the measure at issue, seeks to establish in one part of the territory of a Member State a tax rate which is lower than the rate in force in the rest of that State it is appropriate, as stated in paragraph 58 of this judgment, to examine whether that measure was adopted by that body in the exercise of powers sufficiently autonomous vis-à-vis the central power and, if appropriate, to examine whether that measure indeed applies to all the undertakings established in or all production of goods on the territory coming within the competence of that body.
- 63 In paragraph 50 *et seq* of his Opinion, the Advocate General specifically identified three situations in which the issue of the classification as State aid of a measure seeking to establish, in a limited geographical area, tax rates lower than the rates in force nationally may arise.
- 64 In the first situation, the central government unilaterally decides that the applicable national tax rate should be reduced within a defined geographic area. The second situation corresponds to a model for distribution of tax competences in which all the local authorities at the same level (regions, districts or others) have the autonomous power to decide, within the limit of the powers conferred on them, the tax rate applicable in the territory within their competence. The Commission has recognised, as have the Portuguese and United Kingdom Governments, that a measure taken by a local authority in the second situation is not selective because it is impossible to determine a normal tax rate capable of constituting the reference framework.
- 65 In the third situation described, a regional or local authority adopts, in the exercise of sufficiently autonomous powers in relation to the central power, a tax rate lower than the national rate and which is applicable only to undertakings present in the territory within its competence.
- 66 In the latter situation, the legal framework appropriate to determine the selectivity of a tax measure may be limited to the geographical area concerned where the infra-State body, in particular on account of its status and powers, occupies a fundamental role in the definition of the political and economic environment in which the undertakings present on the territory within its competence operate.
- 67 As the Advocate General pointed out in paragraph 54 of his Opinion, in order that a decision taken in such circumstances can be regarded as having been adopted in the exercise of sufficiently autonomous powers, that decision must, first of all, have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government. Next, it must have been adopted without the central government being able to directly intervene as regards its content. Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government.
- 68 It follows that political and fiscal independence of central government which is sufficient as regards the application of [Union] rules on State aid presupposes, as the United Kingdom Government submitted, that the infra-State body not only has powers in the territory within its competence to adopt measures reducing the tax rate, regardless of any considerations related to the conduct of the central State, but that in addition it assumes the political and financial consequences of such a measure.
- 69 Since the Portuguese Government disputes the Commission's assessment of the selective nature of the tax reduction measures in question, it is necessary to examine whether those measures which favour undertakings liable for tax in the Azores Region fulfil the requirements set out in paragraphs 67 and 68 of this judgment.

- 70 In that connection, it must be observed that under the Constitution of the Portuguese Republic the Azores form an autonomous region with its own political and administrative status and its own self-government institutions which have the power to exercise their own fiscal competence and adapt national fiscal provisions to regional specificities in accordance with Law No 13/98 and Decree No 2/99/A.
- 71 As far as concerns economic autonomy, the Portuguese Government, in answer to the Commission's arguments that the Autonomous Region of the Azores lacks autonomy on account of compensatory financial transfers from the central State, merely observed that the Commission had not submitted any evidence on the merits of those arguments, without itself demonstrating that the Autonomous Region of the Azores does not receive any State financing to make good the fall in tax revenue which may result from reductions in the tax rates.
- 72 In that regard, it must be observed that, under Article 5(1) of Law No 13/98 and in the context of the adaptation of the national tax system to regional specificities, the constitutional principle of national solidarity was stated to mean that the central State contributes, with the autonomous regional authorities, to the achievement of economic development and the correction of inequalities deriving from insularity and to economic and social convergence with the rest of the national territory.
- 73 According to Article 32 of that Law, the application of that principle gives rise to a duty incumbent on both the central and regional authorities to promote the correction of inequalities arising from insularity by reducing local tax burden and by an obligation to ensure an appropriate level of public services and private activities.
- 74 As the Portuguese Government recognises, it is as a corollary to that constitutional and legislative system that Decree No 2/99/A adapts the national tax system to regional specificities.
- 75 Although the reduction in tax revenue which may result, for the Azores region, from reductions in tax rates may affect the attainment of the objective, recognised by the Portuguese Government, of correcting inequalities in economic development, it is in any event offset by a financing mechanism which is centrally managed. In this case, that financing is expressly provided for in Article 5(2) of Law No 13/98 in the form of budgetary transfers.
- 76 It follows that the two aspects of the fiscal policy of the regional government, namely the decision to reduce the regional tax burden by exercising its power to reduce tax rates on revenue and the fulfilment of its task of correcting inequalities deriving from insularity, are inextricably linked and depend, from the financial point of view, on budgetary transfers managed by central government.
- 77 In that context, it must be held that the decision of the government of the Autonomous Region of the Azores to exercise its power to reduce the rates of national tax on revenue in order to allow economic operators in the region to overcome the structural disadvantages deriving from their insular situation on the periphery of the [Union], was not adopted in accordance with all the requirements set out in paragraphs 67 and 68 of this judgment.
- 78 Accordingly, the relevant legal framework for determining the selectivity of the tax measures at issue cannot be defined exclusively within the geographical limits of the Azores region. Those measures must be assessed in relation to the whole of Portuguese territory, in the context of which they appear to be selective.
- 79 It follows, as the Commission rightly held in the contested decision, that the reductions in the tax rates at issue are selective and not general measures.

- 80 In accordance with the case-law cited in paragraph 52 of this judgment, it is therefore appropriate to examine whether the tax measures at issue may be justified by the nature or overall structure of the Portuguese tax system, a matter which it is for the Member State concerned to demonstrate.
- 81 A measure which creates an exception to the application of the general tax system may be justified by the nature and overall structure of the tax system if the Member State concerned can show that that measure results directly from the basic or guiding principles of its tax system. In that connection, a distinction must be made between, on the one hand, the objectives attributed to a particular tax scheme which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives.
- 82 Measures such as those at issue, which apply to all economic operators without any distinction as to their financial circumstances, cannot be regarded as ensuring that for the purpose of redistribution the criterion of ability to pay is observed. Although it is true that the disadvantages related to the insularity of the Azores might, in principle, be suffered by all economic operators regardless of their financial circumstances, the mere fact that the regional tax system is conceived in such a way as to ensure the correction of such inequalities does not allow the conclusion to be drawn that every tax advantage granted by the authorities of the autonomous region concerned is justified by the nature and overall structure of the national tax system. The fact of acting on the basis of a regional development or social cohesion policy is not sufficient in itself to justify a measure adopted within the framework of that policy.
- 83 Therefore, the Portuguese Government has not shown that the adoption by the Autonomous Region of the Azores of the measures at issue was necessary for the functioning and effectiveness of the general tax system. It simply made a general statement to that effect without providing specific evidence in support of it. It has not, therefore, been demonstrated that the measures at issue are justified by the nature or overall structure of the Portuguese tax system.
- 84 The Commission was therefore right to hold, in the contested decision, that the difference between the charges resulting from the tax reductions on revenue in question is not justified by the nature or the overall structure of the Portuguese tax system.
- 85 It follows from all of the foregoing considerations that the first plea in the action must be rejected.

*The second plea: inadequate statement of reasons with respect to the existence of an adverse effect on intra-[Union] trade and significant restrictions on competition*

Arguments of the parties

- 86 By its second plea the Portuguese Government argues essentially that the reasoning in the contested decision does not meet the requirements of [Article 296 TFEU], in so far as that decision fails to set out or justify the impact on trade between Member States of the reductions of tax rates at issue or the significant effect of the distortion of competition resulting from those measures.
- 87 The Commission denies that contention, basing its argument, inter alia, on the case-law of the Court to the effect that, as regards an aid scheme of general application, it is sufficient to state that at least in respect of certain beneficiaries the measure affects trade and that the Commission is not obliged to give further details in that regard in its decisions (Case C-310/99 *Italy v Commission* [2002] ECR I-2289). In this case, the tax rate reductions apply to all

economic operators liable to tax in the Azores region. Since at least some of the undertakings concerned carry on an activity involving trade between the Member States and subject to [Union] competition, the decision contains an adequate statement of reasons.

#### Findings of the Court

- 88 According to settled case-law, the statement of reasons required by [Article 296 TFEU] must be appropriate to the act at issue and must disclose in a clear and unequivocal fashion the reasoning followed by the institution which adopted the measure in question in such a way as to enable the persons concerned to ascertain the reasons for the measure and to enable the Court to carry out its review. It is not necessary for the reasoning to go into all the relevant facts and points of law, since the question whether the statement of reasons meets the requirements of [Article 296 TFEU] must be assessed with regard not only to its wording but also to its context and to all the legal rules governing the matter in question (see, *inter alia*, Case C-56/93 *Belgium v Commission* [1996] ECR I-723, paragraph 86, Case C-278/95 P *Siemens v Commission* [1997] ECR I-2507, paragraph 17, and Case C-501/00 *Spain v Commission* [2004] ECR I-6717, paragraph 73).
- 89 Applied to the classification of a measure as aid, that principle requires a statement of the reasons for which the Commission considers that the measure concerned falls within the scope of [Article 107(1) TFEU]. In that connection, even in cases where it is clear from the circumstances under which it was granted that the aid is liable to affect trade between Member States or to distort or threaten to distort competition, the Commission must at least set out those circumstances in the statement of reasons for its decision (Case 57/86 *Greece v Commission* [1988] ECR 2855, paragraph 15, Joined Cases C-329/93, C-62/95 and C-63/95 *Germany v Commission* [1996] ECR I-5151, paragraph 52, and Case C-156/98 *Germany v Commission*, paragraph 98).
- 90 In this case, it is sufficient to observe, in that connection, that the contested decision sets out clearly and applies to the situation in this case the criteria which must be satisfied in order to constitute State aid.
- 91 As regards the assessment by the Commission of the effects of the aid on intra-[Union] trade, it must be held that the contested decision, in paragraph 24 of its grounds, and as indicated in paragraph 19 of this judgment, logically deduced from the characteristics of the system in question and from the general scope of the reduced rates of tax that the result of that system, since those reductions apply to all economic sectors in the Azores, is that at least some of the undertakings concerned carry on economic activities involving such trade and, therefore, trade between Member States is likely to be affected.
- 92 It follows that the second plea raised by the Portuguese Government, relating to an inadequate statement of reasons, must be rejected.

*The third plea: manifest error of assessment in the application of [Article 107(3)(a) TFEU]*

#### Arguments of the parties

- 93 By its third plea, the Portuguese Government complains that the Commission committed a manifest error of assessment in the application of [Article 107(3)(a) TFEU] in excluding from the benefit of the derogation laid down by that provision the reductions in the tax rates at issue as they apply to undertakings carrying out financial activities or activities of the 'intra-group services' type and in holding them incompatible with the common market in Article 2 of the contested decision.

- 94 The Portuguese Government submits, first, that activities of the ‘intra-group services’ type do not exist in the Portuguese legal system and, second, that undertakings operating in the financial sector are liable to bear the same additional costs deriving from the remoteness and insularity of the Azores Region as those which have been identified, in respect of other sectors of the economy, by a study carried out by the Centre for European Policy Studies submitted on 3 November 1999 in the context of State aid proceedings relating to the Autonomous Region of Madeira. That study sought to determine the implications of [Articles 349 and 355(1) TFEU] as regards the autonomous regions of Madeira and the Azores.
- 95 The Commission denies having committed any manifest error of assessment and states first of all that it enjoys, in regard to the assessment of the compatibility of aid, a wide margin of discretion the exercise of which requires assessments of an economic and social nature.
- 96 The Commission submits, second, that the study by the Centre for European Policy Studies on which the Portuguese Government relies is not relevant for the assessment of the compatibility of the reductions of the tax rates applicable to undertakings operating in the financial sector. That study sets out the costs connected to the situation of the region concerned on the periphery of the [Union], without quantifying the impact of the additional costs on the various economic sectors. Although it may legitimately be accepted that all the undertakings located in the Azores Region are confronted with the same permanent structural handicaps, arising from the insular nature of the Azores archipelago and its distance from the economic centres on the mainland, it does not follow that the impact of such handicaps on the additional costs arising from carrying on economic activities are identical in all sectors.
- 97 According to the Commission, given that the services offered are extremely mobile, the financial sector is in a different situation from other economic sectors in the Azores. For that reason, since the beginning of the proceedings, the Commission has repeatedly requested the Portuguese authorities to provide it with evidence demonstrating that the advantages conferred on the financial sector were justified. The Commission argues that, in the absence of such specific evidence, it was unable, on the basis of the documents provided by the Portuguese authorities, to regard the tax reductions applicable to undertakings operating in that sector as aid compatible with the common market under the derogation provided for in [Article 107(3)(a) TFEU].
- 98 The Commission states once again that, if a Member State does not provide it with the information requested or provides it only with partial information, the lawfulness of its decision is to be assessed in the light of the information available when the decision was adopted (Case C-382/99 *Netherlands v Commission* [2002] ECR I-5163, paragraph 49). That principle should be applied even more rigorously in this case since the Portuguese authorities were asked on numerous occasions and the burden of proof that the advantages conferred were justified is on the Member State in accordance with point 4.16.2 of the Guidelines on national regional aid.

#### Findings of the Court

- 99 As a preliminary point, it must be recalled that, for the purposes of [Article 107(3) TFEU], the Commission enjoys a wide margin of discretion, the exercise of which involves assessments of an economic and social nature which must be made within a [Union] context. The Court, in reviewing whether that freedom was lawfully exercised, cannot substitute its own assessment for that of the competent authority but must restrict itself to examining whether the authority’s assessment is vitiated by a manifest error or misuse of powers (see, in particular, Case C-310/99 *Italy v Commission*, paragraph 45, Case C-456/00 *France v Commission* [2002] ECR I-11949, paragraph 41, and Case C-66/02 *Italy v Commission*, paragraph 135).

- 100 The Guidelines on national regional aid prohibit regional aid aimed at reducing an undertaking's current expenses, namely operating aid. However, under point 4.16.2 of the Guidelines, in the outermost regions qualifying for exemption under [Article 107(3)(a) and (c) TFEU], operating aid may be authorised in so far as it is intended to offset the additional costs arising in the pursuit of economic activity from the factors identified in [Articles 349 and 355(1) TFEU], the permanence and combination of which severely restrict the development of such regions.
- 101 That point of the Guidelines states that it is the task of the Member State concerned to determine the amount of those additional costs and to prove that they are linked to those factors. Such aid must be justified in terms of its contribution to regional development, and its nature; its level is to be proportional to the additional costs it is intended to offset.
- 102 It must be observed that, when it argues that the measures at issue fulfil the criteria laid down by the Guidelines not only as regards the sectors of economic activity other than the financial sector, as the Commission recognises in the contested decision, but also as regards the financial sector itself, the Portuguese Government does not dispute the terms of the Guidelines on national regional aid. The Portuguese Government challenges solely the manner in which the Commission applied those guidelines to the financial sector in the Azores region. It takes the view that it has shown that undertakings carrying on financial activities have to contend with the same additional costs arising from the geographical specificity of the region concerned as do any other undertakings located there.
- 103 As was stated in paragraph 101 of this judgment, according to the Guidelines on national regional aid, it is the task of the Member State which granted the aid to determine the amount and to prove that it is justified in terms of its contribution to regional development and that its level is proportional to the additional costs it is intended to offset. It is clear from the case-file and from paragraph 18 of the grounds of the contested decision that the Portuguese authorities were not in a position to provide such evidence in relation to the financial sector.
- 104 Although it is true that the contested decision does not state the reason why the Commission deemed it necessary to have quantified evidence with respect to the financial sector, it cannot be inferred from this that the Commission exceeded the limits of its discretion.
- 105 Therefore, by declaring the part of the aid scheme referred to in Article 1 of the contested decision to be incompatible with the common market, in so far as it applies to undertakings carrying on financial activities, the Commission did not commit a manifest error of assessment.
- 106 Furthermore, it must be observed, with regard to undertakings carrying on activities of the 'intra-group services' type, that, in answer to the Portuguese authorities' argument that such activities do not currently exist in the Portuguese legal system, the Commission held, in paragraph 42 of the grounds of the contested decision, that, for reasons of transparency and legal certainty, where those activities might in practice be likely to be carried out in the context of services provided mainly to undertakings in a group, the reductions in tax rates applicable to undertakings carrying on such activities must, in the same way as undertakings in the financial sector, be excluded by law from the benefit of the derogation under [Article 107(3)(a) TFEU]. The Commission considers that, in so far as their effects on the decision as to the place of establishment by undertakings in a group and the external effect on the local economy are insignificant, such activities do not contribute sufficiently to regional development to be declared compatible in accordance with [Article 107(3)(a) TFEU] or other derogations provided by the Treaty, for the reasons already stated as regards the financial sector and regardless of whether such activities exist at a given time in the Portuguese legal system. In the absence of any arguments by the Portuguese Government challenging those

assertions, it has not been shown that a manifest error of assessment was committed in respect of such undertakings.

107 Accordingly, the third plea, alleging infringement of [Article 107(3)(a) TFEU], must be rejected.

108 Since none of the pleas raised by the Portuguese Republic can be upheld, the action must be dismissed.

#### **Costs**

109 Under Article 69(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the Commission has applied for costs and the Portuguese Republic has been unsuccessful, the latter must be ordered to pay the costs. Pursuant to the first subparagraph of Article 69(4) of the Rules of Procedure, the Member States which have intervened in the proceedings must bear their own costs.

On those grounds, the Court (Grand Chamber) hereby

- 1. Dismisses the action;**
- 2. Orders the Portuguese Republic to pay the costs;**
- 3. Orders the United Kingdom of Great Britain and Northern Ireland and the Kingdom of Spain to bear their own costs.**