

Case No: 69193
Event No: 587669
Dec No: 88/11/COL

EFTA SURVEILLANCE AUTHORITY DECISION
of 23 March 2011
on a scheme to support innovation companies
(Iceland)

The EFTA Surveillance Authority (“the Authority”)

HAVING REGARD to the Agreement on the European Economic Area (“the EEA Agreement”), in particular to Article 61 (3) (c),

HAVING REGARD to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (“the Surveillance and Court Agreement”), in particular to Article 24,

HAVING REGARD to Protocol 3 to the Surveillance and Court Agreement (“Protocol 3”), in particular to Article 1(3) of Part I and Article 4(3) of Part II,

HAVING REGARD to the consolidated version of the Authority’s Decision No 195/04/COL of 14 July 2004 on the implementing provisions referred to under Article 27 of Part II of Protocol 3 (“the Implementing Provisions Decision”)¹,

Whereas:

I. FACTS

1. Procedure

On 1 July 2010 the Icelandic authorities notified a scheme to the Authority (Event No 562547) on aid to innovation companies. The Icelandic authorities submitted further information on 24 September 2010 (Event No 570847). Following discussions between the Authority and the Icelandic authorities, the latter withdrew the notification on 30 November 2010 (Event No 579149).

By letter submitted on 21 December 2010 (Event No 581392) the Icelandic authorities requested to have pre-notification discussions with the Authority on an amended scheme on support to innovation companies. Pre-notification discussions between the Icelandic authorities and the Authority took place during January 2011.

¹ Available at: <http://www.eftasurv.int/media/decisions/195-04-COL.pdf>

By letter submitted on 15 February 2011 (Event No 587234) the Icelandic authorities notified a new scheme on support for innovation companies, pursuant to Article 1(3) of Part I of Protocol 3 by letter

2. Description of the proposed measures

2.1. The objective, legal basis and operation of the scheme on support for innovation companies

2.1.1. Background

The Icelandic authorities notified a scheme on support for innovation companies in September 2010. In October 2010, the Authority stated that it had doubts as to whether the scheme would be compatible with Article 61 of the EEA Agreement. Consequently, the Icelandic authorities withdrew the notification. In December 2010, the Icelandic authorities initiated pre-notification discussions with the Authority. Those discussions led to the notification of a new scheme on support for innovation companies. The objective of the scheme is to improve and foster research and development by offering companies tax credits.²

2.1.2. Legal basis

In October 2009, two bills of law were submitted to the Icelandic Parliament, one on the original scheme on support for innovation companies (“the Innovation Act”)³ and one introducing necessary amendments to the Income Tax Act no. 90/2003. The two bills of law were adopted by the Parliament on 29 December 2009 as Acts No. 152/2009 and 137/2009.

On 28 December 2010, the Innovation Act was amended by Act No. 165/2010 in order to ensure that the scheme on support for innovation companies is in line with the Authority’s Guidelines on Aid for research and development and innovation (“the R&D&I Guidelines”).⁴ The amended scheme on support for innovation companies is referred to in the following as “the Innovation Scheme”.

2.1.3. Eligible projects

The Innovation Scheme offers a tax credit for companies carrying out research and development (“R&D”) projects.

The Innovation Act defines R&D projects as:

- (i) those that involve planned research or critical investigation aimed at the acquisition of new knowledge and skills for developing new products, processes or services or for bringing about a significant improvement in existing products, processes or services. It comprises the creation of components of complex systems necessary for research, notable for generic technology validation, to the exclusion of prototypes as covered by [option (ii)];⁵ and

² Article 1 of Act No. 152/2009 on support for innovation companies.

³ Act No. 152/2009 on support for innovation companies.

⁴ OJ L 305, 19.11.09, p. 1 and EEA Supplement No 60. Also available at: <http://www.eftasurv.int/state-aid/legal-framework/state-aid-guidelines/>

⁵ Point 6 of Article 3 of the Innovation Act. The definition corresponds with the definition of “industrial research” in paragraph 50(f) of the R&D&I Guidelines.

- (ii) those that acquire, combine, shape and use existing scientific, technological, business and other relevant knowledge and skills for the purpose of producing plans and arrangements or designs for new, altered or improved products, processes or services. These may also include, for example, other activities aiming at the conceptual definition, planning and documentation of new products, processes and services. The activities may comprise producing drafts, drawings, plans and other documentation, provided that they are not intended for commercial use.⁶

2.1.4. *Eligible costs*

Eligible costs are defined in section 5 of Article 3 of the Innovation Act. The definition is further clarified in Article 3 of a draft implementing Regulation on the Innovation Scheme. The latter defines eligible costs as:

- (a) personnel costs (researchers, technicians and other supporting staff to the extent employed on the research project);
- (b) costs of instruments and equipment to the extent and for the period used for the research project. If such instruments and equipment are not used for their full life for the research project, only the depreciation costs corresponding to the life of the research project, as calculated on the basis of good accounting practice, are considered as eligible;
- (c) costs for building and land, to the extent and for the duration used for the research project. With regard to buildings, only the depreciation costs corresponding to the life of the research project, as calculated on the basis of good accounting practice are considered as eligible. For land, costs of commercial transfer or actually incurred capital costs are eligible;
- (d) cost of contractual research, technical knowledge and patents bought or licensed from outside sources at market prices, where the transaction has been carried out at arm's length and there is no element of collusion involved, as well as costs of consultancy and equivalent services used exclusively for the research activity;
- (e) additional overheads incurred directly as a result of the research project;
- (f) other operating expenses, including costs of materials, supplies and similar products incurred directly as a result of the research activity.⁷

2.1.5. *The tax credit*

Companies with qualifying R&D projects are eligible for a tax credit. The tax credit is 20% of ISK 100 million of the cost of the project - irrespectively whether the total cost of the project may be higher. However, the tax credit of 20% is calculated of ISK 150 million of the project cost (i) if the company purchases services (that qualify as eligible costs) from another company and are necessary to carry out the project; or (ii) if two companies (or more) collaborate on a R&D project.⁸ The maximum support is therefore ISK 20 or 30

⁶ Point 10 of Article 3 of the Innovation Act. The definition corresponds with the definition of "experimental development" in paragraph 50(g) of the R&D&I Guidelines.

⁷ The definition of eligible cost corresponds with paragraph 80 of the R&D&I Guidelines.

⁸ In case of collaboration project the credit will be divided *pro rata* between the undertakings that participate in the project. See Article 10 of the Innovation Act.

million.⁹ Finally, it is a condition for eligibility that the costs of the project are ISK 1 million at a minimum.

The tax credit is granted in form of a reimbursement of paid income tax for the year in which the costs incurred to companies with qualifying projects.¹⁰

2.1.6. Operation of the Innovation Scheme

In order to benefit from a tax credit, applicants must submit R&D projects to the Icelandic Centre for Research (“Rannís”) before 1 September each year. The application must be accompanied by a detailed description of the project, a project plan, a business plan and a cost projection. Both the project and the business plan must be well defined and it must be documented that the amount for the project equals or exceeds the minimum costs over a 12 month period. Rannís examines and determines whether projects qualify as R&D projects based on option (i) and (ii) above. In addition, Rannís verifies whether the staff has the training, education and experience within the type of research and development covered by the project.¹¹

Upon receipt of an application, Rannís has two months to decide whether the project can be approved. Rannís may consult an independent professional committee consisting of three representatives with relevant experience. Rannís informs the Directorate of Internal Revenue (“tax authorities”) of approved R&D projects. The tax authorities determine whether the costs are eligible based on the draft Regulation. In the affirmative the tax credit is awarded on 31 October of the year following that in which the costs are incurred.¹²

The approval of Rannís is valid for the costs incurred in the calendar year in which the application was submitted. An application for an extension of the approval must be submitted no later than 1 April the following year. If approved, the extension applies for the year in which the extension was requested.¹³

2.2. Recipients

Beneficiaries of the Innovation Scheme can be all undertakings, irrespective of size and sector.¹⁴ Undertakings participating jointly in a collaboration project may also benefit from the Innovation Scheme. Universities and public agencies are not considered as undertakings.¹⁵

2.3. Cumulation

In case an undertaking receiving support under the Innovation Scheme also receives support from other public sources, the Innovation Act provides that total support may not exceed the following aid intensities:

- (i) In the case of small enterprises, the sum of the support may not exceed 70% of the eligible cost for a research project or, in the case of a collaboration project, 80%. The sum of the support for a development project may not exceed 45% of the eligible cost or, in the case of a collaboration project, 60%.

⁹ Section 1 of the notification letter and Article 10 of the Innovation Act.

¹⁰ Article 11 of the Innovation Act. See also Article 71 of the Income Tax Act.

¹¹ Section 1 of the notification letter and Articles 4 and 5 of the Innovation Act.

¹² Article 8 of the Innovation Act. The decisions taken by Rannís are final at an administrative stage.

¹³ Article 9 of the Innovation Act.

¹⁴ Section 4 of Part I in the Standard Notification Form. Definition of small and medium-sized enterprises can be found in points 1-2 of Article 3 of the Innovation Act.

¹⁵ Article 2 of the Innovation Act.

- (ii) In the case of medium-sized enterprises, the sum of the support may not exceed 60% of the eligible cost for a research project or, in the case of a collaboration project, 75%. The total support for a development project may not exceed 35% of eligible cost or, in the case of a collaboration project, 50%.
- (iii) In the case of large enterprises, the total support may not exceed 50% of the eligible cost for a research project or, in the case of a collaboration project, 65%, provided that the collaboration project is between countries in the European Economic Area or with at least one small or medium-sized enterprise. The total support for a development project may not exceed 25% of eligible cost or, in the case of a collaboration project, 40%, provided that the collaboration project is between countries in the European Economic Area or with at least one small or medium-sized enterprise.¹⁶

2.4. Budget and duration

The Icelandic authorities have estimated that the operation of the Innovation Scheme will result in an annual revenue loss of about ISK 450-750 million, except for the first two years (where the loss will be somewhat lower).

The Innovation Act entered into force on 1 January 2010. It appears from the explanatory notes to the Innovation Act and Act No. 165/2010 that no aid can be granted prior to the Authority's approval of the Innovation Scheme. The Icelandic authorities have explained that this rule has been reiterated to Rannís and the tax authorities: Only if the approval of the Authority has been obtained, the Icelandic central authorities will give Rannís and the tax authorities the green light for the grant of the aid under the Innovation Scheme.¹⁷

The undertakings that have submitted an application to Rannís can therefore neither receive approval for projects, nor receive a tax credit before the Authority approves the Innovation Scheme.¹⁸

¹⁶ Article 15 of the Innovation Act and Article 4 of the draft Regulation on support for innovation companies.

¹⁷ Letter dated 3 February 2011 from the Icelandic authorities (Event No 585588).

¹⁸ Section 2.2 of the notification letter.

II. ASSESSEMENT

1. The presence of state aid

State aid within the meaning of Article 61(1) EEA

Agreement Article 61(1) of the EEA Agreement reads as follows:

“Save as otherwise provided in this Agreement, any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Contracting Parties, be incompatible with the functioning of this Agreement.”

To constitute state aid within the meaning of Article 61(1) EEA a measure must satisfy the following four cumulative criteria; (i) the measure must confer on recipients an economic advantage which is not received in the normal course of business; (ii) the advantage must be granted by the State or through State resources; (iii) the measure must be selective by favouring certain undertakings or the production of certain goods; and (iv) the measure must distort competition and affect trade between Contracting Parties. In the following it is examined whether the four cumulative criteria are met in the present case.

1.1. Economic advantage

The measure must confer on recipients an economic advantage which is not received in the normal course of business.

Under the Innovation Scheme the Icelandic authorities can award tax credits (via reimbursements of paid income tax) to undertakings. The undertakings receiving such reimbursements therefore receive an economic advantage which they would not have received in their normal course of business.

1.2. Presence of state resources

The aid measure must be granted by the State or through state resources.

Under the Innovation Scheme the State may award tax credits to undertakings. By doing so the State foregoes tax revenue and a loss of tax revenue is equivalent to the consumption of state resources in the form of fiscal expenditure.¹⁹

1.3. Favouring certain undertakings or the production of certain goods

The aid measure must be selective in that it favours *“certain undertakings or the production of certain goods”*.

Rannís and the tax authorities enjoy discretionary powers for purposes of determining whether projects are eligible. Furthermore, there are no objective criteria linked to the assessment of whether the companies have the necessary expertise.

The Authority recalls that the Court of Justice of the European Union has held that discretionary powers enjoyed by the public authorities, administering a financial support

¹⁹ Section 3.3 of the State Aid Guidelines on the application of state aid rules to measures relating to business taxation.

scheme, means that the scheme is, de facto, selective.²⁰ As a result, the Authority concludes that the Innovation Scheme is, de facto, selective.

1.4. Distortion of competition and affect on trade between Contracting Parties

The aid measure must distort competition and affect trade between the Contracting Parties to the EEA Agreement.

The Innovation Scheme applies to all sectors of the economy established in Iceland. In view of the fact that, for the year 2010, exports to the EU represented about 23% of total exports from Iceland, whereas imports from the EU represented approximately 61% of total imports to Iceland, there is extensive trade between Iceland and the EU.²¹

In such circumstances, the Authority considers that the tax credit granted under the Innovation Scheme will strengthen the relative position of recipients in Iceland compared to undertakings located in other EEA countries and competing in similar sectors or businesses. The Innovation Scheme is therefore liable to affect trade and distort, or threaten to distort, competition in the EEA.

1.5. Conclusion

In light of the above, the Authority concludes that the grant of tax credit under the Innovation Scheme constitutes state aid within the meaning of Article 61(1) EEA.

2. Procedural requirements

Pursuant to Article 1(3) of Part I of Protocol 3, “*the EFTA Surveillance Authority shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid (...). The State concerned shall not put its proposed measures into effect until the procedure has resulted in a final decision*”.

According to Article 3 of Part II of Protocol 3 to the Surveillance and Court Agreement, aid “*shall not be put into effect before the EFTA Surveillance Authority has taken, or is deemed to have taken, a decision authorising such aid.*”

While the Innovation Act entered into force on 1 January 2010, the Innovation Scheme was only notified by the Icelandic authorities to the Authority on 15 February 2011 (Event No 587234). First, the Authority notes that it appears that no aid can be granted under the Innovation Scheme until the tax assessment for the income year 2010 is done, which is on 31 October 2011.²² Secondly, the Authority notes that it appears from the preparatory legislative works to the Innovation Act that no aid can be granted unless the Authority approves the Innovation Scheme as compatible with the functioning of the EEA Agreement.²³

The Icelandic authorities have also explained that even though the Innovation Act entered into force in 2010 (and thus enabled companies to submit applications to Rannís) the

²⁰ See Case C-241/94 *France v. Commission* [1996] ECR I-4551, paragraphs 23 and 24; Case C-200/97 *Ecotrade v. AFS* [1998] ECR I-7907, paragraph 40; and Case C-295/97 *Piaggio v. Ifitalia* [1999] ECR I-3735, paragraph 39.

²¹ The relevant statistics have been issued by “*Statistics Iceland*” and are entitled “*Vöruútflutningur eftir löndum desember 2010*” and “*Vöruinnflutningur eftir löndum desember 2010*”. The statistics are available at: <http://hagstofa.is/Hagtolar/Utanrikisverslun>.

²² Article 93 of Act No 90/2003 on Income Tax.

²³ See footnote 17 above.

applicants can neither receive approval for their projects nor receive tax credits prior to the Authority's approval of the Innovation Scheme.²⁴

In light of the above, the Authority concludes that the Icelandic authorities have respected their obligations pursuant to Article 1(3) of Part I of Protocol 3.

3. Compatibility of the aid

As the conclusion of the Authority is that the Innovation Scheme involves state aid, it has to be examined whether the Scheme may be considered compatible with the functioning of the EEA Agreement under Article 61(2) or (3) EEA.

3.1. Compatibility with Article 61(3) EEA

In the present case the exception laid down in Article 61(3)(c) EEA, which provides that state aid may be considered compatible with the common market where it facilitates the development of certain economic activities or of certain economic areas and does not adversely affect trading conditions to an extent contrary to the common interest, may be applicable.

In the following the Authority considers the compatibility of the Innovation Scheme with the functioning of the EEA Agreement under Article 61(3)(c) EEA on the basis of the R&D&I Guidelines.

3.1.1. Aid for R&D&I

According to the R&D&I Guidelines, compatibility of aid is generally assumed, provided the conditions set out in Section 5 of those Guidelines are fulfilled and where the aid constitutes an incentive to engage in more research and development pursuant to Section 6 of the Guidelines.²⁵

Section 5 of the R&D&I Guidelines lists different types of research and development, such as “*fundamental research*”, “*industrial research*” and “*experimental development*” and indicates the aid intensities which apply to each category of research.

It appears from Section 2.2 subparagraph (f) of the R&D&I Guidelines that;

““industrial research” means the planned research or critical investigation aimed at the acquisition of new knowledge and skills for developing new products, processes or services. It comprises the creation of components of complex systems, which is necessary for the industrial research, notably for generic technology validation, to the exclusion of prototypes as covered by [experimental development] point (g)”.

Subparagraph (g) of the same Section provides that;

““experimental development” means the acquiring, combining, shaping and using of existing scientific, technological, business and other relevant knowledge and skills for the purpose of producing plans and arrangements or designs for new, altered, or improved products, processes or services. These may also include, for example, other activities aiming at the conceptual definition, planning and documentation of new products, processes and services. The activities may comprise producing drafts, drawings, plans and other documentation, provided that they are not intended for commercial use. The

²⁴ Notification letter, Section 2.2.

²⁵ Paragraphs 29 and 30 of Section 1.4 of the R&D&I Guidelines.

development of commercially usable prototypes and pilot projects is also included where the prototype is necessarily the final commercial product and where it is too expensive to produce for it to be used only for demonstration and validation purposes. In case of a subsequent commercial use of demonstration or pilot projects, any revenue generated from such use must be deducted from the eligible costs”.

The Authority considers that the description of eligible projects under the Innovation Scheme (set out above in Section 2.1.3 of Part I) are in line with the definition of “*industrial research*” and “*experimental development*” given in subparagraphs (f) and (g) of Section 2.2 of the R&D&I Guidelines.

(i) Eligible costs

Section 5.1.4 of the R&D&I Guidelines sets out a list of costs which are to be regarded as eligible for the purposes of calculating the aid intensity. Such cost items include (i) personnel costs which cover the costs of researchers, technicians and other support staff employed solely for the research activity; (ii) costs of instruments and equipment to the extent and for the period used for the research project; (iii) costs for building and land, to the extent and for the duration used for the research project; (iv) cost of contractual research, technical knowledge and patents bought or licensed from outside sources at market prices, where the transaction has been carried out at arm’s length; (v) additional overheads incurred directly as a result of the research project; and (vi) other operating expenses, including costs of materials, supplies and similar products incurred directly as a result of the research activity.²⁶

The eligible costs set out in the Innovation Act are identical to those set out in Section 5.1.4 of the R&D&I Guidelines. The Authority therefore considers that the eligible costs under the Innovation Scheme qualify as eligible costs under the R&D&I Guidelines.

(ii) Aid intensities

According to Section 5.1.2 of the R&D&I Guidelines, the permissible gross aid intensity for industrial research and experimental development are fixed at 50% and 25% respectively, of eligible costs. Moreover, according to Section 5.1.3 where the aid is given to SMEs (as defined in the Annex to the block exemption Regulation on aid to SMEs) an extra 10 (medium-sized) or 20 (small) percentage points may be granted.²⁷ This brings the permissible aid intensity up to 60% (medium-sized) or 70% (small) of eligible costs in the case of industrial research. In the case of experimental development the maximum aid intensity becomes 35% (medium-sized) or 45% (small).

The Innovation Act states that the tax credit is 20% of ISK 100 or 150 million of the project costs (irrespective whether the total cost of the project may be higher). Not only is this a lower aid intensity than that allowed under the R&D&I Guidelines, but there is also a limitation on the amount of the aid as the tax credit is calculated on the basis of ISK 100 or 150 million, resulting in maximum aid of ISK 20 or 30 million.²⁸ Furthermore, the

²⁶ Corresponds to subparagraphs (a), (b), (c), (d), (e) and (f) of Section 5.1.4 of the R&D&I Guidelines.

²⁷ Commission Regulation (EC) No. 70/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to State aid to small and medium-sized enterprises (OJ L 10, 13.1.2001, p. 33), as amended by Commission Regulation (EC) No. 364/2004 of 25 February 2004 (OJ L 63, 28.2.2004, p. 22). Both Regulations have been incorporated into point 1(f) of Annex XV to the EEA Agreement. The definition contained therein corresponds to the definition in the State Aid Guidelines on aid to SMEs (see Section 1.3 in Part II thereof).

²⁸ Article 10 of the Innovation Act.

Innovation Act sets out aid cumulation limits which are in line with the rules set out in the R&D&I Guidelines.²⁹

In conclusion the Authority considers the aid intensity under the Innovation Scheme to be in line with the R&D&I Guidelines.

(iii) Incentive effect

Section 6 of the R&D&I Guidelines states that “*state aid must have an incentive effect, i.e. result in the recipient changing its behaviour so that it increases its level of R&D&I activity. As a result of the aid, the R&D&I activity should be increased in size, scope, amount spent or speed.*”³⁰ For the aid to have incentive effect it must therefore be established that companies would not undertake the R&D projects without the aid.

The qualifying projects under the Innovation Scheme may have started before the Authority’s approval of the Innovation Scheme. However, the Innovation Act entered into force already on 1 January 2010 and was published in the Icelandic Legal Gazette on 31 December 2009. Companies therefore started their projects in anticipation of getting the aid (i.e. tax credit) on the basis of the Innovation Act. The European Commission has taken a similar approach in its decision practise.³¹

On this basis the Authority considers that the aid (i.e. tax credits) under the Innovation Scheme has an incentive effect pursuant to Section 6 of the R&D&I Guidelines.

(iv) Duration

The Innovation Scheme is based on the Innovation Act which entered into force on 1 January 2010 and will expire on 31 December 2014.³²

3.2. Conclusion on the compatibility of the Innovation Scheme with the EEA Agreement

As appears from the above the Authority considers that both the projects and cost elements under the Innovation Scheme qualify as eligible under the R&D&I Guidelines. Aid intensities are in line with the Guidelines and an incentive effect has been demonstrated. The Authority has therefore taken the view that the Innovation Scheme is compatible with Article 61(3)(c) of the EEA Agreement.

4. Conclusion

On the basis of the foregoing assessment, the Authority considers that the Innovation Scheme which the Icelandic authorities are planning to implement is compatible with the functioning of the EEA Agreement within the meaning of Article 61(3)(c) of the EEA Agreement.

The Icelandic authorities are reminded that all plans to modify this scheme must be notified to the Authority.

²⁹ See Part I, Chapter 2.3.2 above.

³⁰ Paragraph 122 of the R&D&I Guidelines.

³¹ See e.g. Commission Decision of 6 December 2006, N357a/2006 “2007 Investment Premium Act (application for projects started before 2007)”, OJ C 23 of 01.02.2007, p. 2.

³² See Article 5 of the draft implementing Regulation on the Innovation Scheme (Event No 591169).

HAS ADOPTED THIS DECISION:

Article 1

The EFTA Surveillance Authority considers that the aid is compatible with the EEA Agreement and raises no objections to the Innovation Scheme on the basis of Article 61(3)(c) of the EEA Agreement.

Article 2

The implementation of the measure is authorised accordingly.

Article 3

This Decision is addressed to the Republic of Iceland.

Article 4

Only the English language version of this decision is authentic.

Decision made in Brussels, on 23 March 2011.

For the EFTA Surveillance Authority

Per Sanderud
President

Sabine Monauni-Tömördy
College Member