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EFTA SURVEILLANCE AUTHORITY DECISION
OF 25 FEBRUARY 2004
WITH REGARD TO INTERNATIONAL TRADING COMPANIES
(ICELAND)

THE EFTA SURVEILLANCE AUTHORITY,

HAVING REGARD TO the Agreement on the European Economic Area¹, in particular to Articles 61 to 63 and to Protocol 26 thereof,

HAVING REGARD TO the Agreement between the EFTA States on the establishment of a Surveillance Authority and a Court of Justice², in particular to Article 24 and Article 1 in Part I of Protocol 3³ thereof,

HAVING REGARD TO the Procedural and Substantive Rules in the field of state aid⁴, in particular Chapter 17B⁵ thereof,

HAVING REGARD to the Authority's decision to open the formal investigation procedure⁶,

¹ Hereinafter referred to as the "EEA Agreement".

² Hereinafter referred to as the "Surveillance and Court Agreement".

³ It has to be noted that the amendments to Protocol 3 to the Surveillance and Court Agreement, following an agreement between EFTA States of 10 December 2001, amending Protocol 3 to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, entered into force on 28 August 2003. These amendments incorporated "Council Regulation (EC) No 659/1999 of 22 March 1999, laying down detailed rules for the application of [ex] Article 93 of the EC Treaty" into Protocol 3.

⁴ Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement and Article 1 of Protocol 3 to the Surveillance and Court Agreement, adopted and issued by the EFTA Surveillance Authority on 19 January 1994, OJ No L 231 of 3 September 1994, EEA Supplement No 32, last amended by the Authority's Decision No 198/03/COL of 5 November 2003, not yet published.

⁵ Chapter 17B on the Application of state aid rules to measures relating to direct business taxation, as adopted by the Authority's Decision No 149/99/COL of 30 June 1999, OJ L 137 of 8 June 2000, page 11, EEA Supplement No 26.

WHEREAS:

I. FACTS

1. PROCEDURE

In March 1999, Iceland adopted Act No. 31/1999 on International Trading Companies laying down terms and conditions for the establishment and registry in Iceland of new types of companies, so-called International Trading Companies (hereinafter referred to as “ITCs”). Together with Act No. 29/1999, which amended various fiscal acts for their application to ITCs, these bills belong to a single legislative package for the promotion of the establishment of ITCs in Iceland.

On the basis of the information available to it, the EFTA Surveillance Authority’s Competition and State Aid Directorate was of the preliminary opinion that the tax treatment of ITCs, as foreseen under the above-mentioned legal texts, could constitute state aid within the meaning of Article 61(1) of the EEA Agreement. By letter of 28 July 2000 (Doc. No: 00-4830-D), the Authority requested the Icelandic Government to provide all necessary information to determine whether the Icelandic tax measures in favour of ITCs constituted state aid and, in case there should be state aid involved, whether they could be declared compatible with Article 61 of the EEA Agreement.

After assessing the information provided by the Icelandic Government by letter dated 24 October 2000 (Doc. No: 00-7751-A), the Competition and State Aid Directorate still had doubts about the compatibility of the tax measures with the state aid rules of the EEA Agreement. Accordingly, the Authority urged the Icelandic Government by letter dated 24 July 2001 (Doc. No: 01-5609-D) to provide information to see whether the doubts could be removed.

Following the reply of the Icelandic Government dated 20 September 2001 (Doc. No: 01-7477-A), the Authority adopted a decision to open the formal investigation on 6 December 2001 (Dec. No. 392/01/COL) and informed the Icelandic Government by means of a copy of the decision on the same date (Doc. No: 01-9848-D).

By letter of 8 January 2002 (Doc. No: 02-243-A), the Icelandic Government submitted its comments to the decision of the Authority, restating the arguments already brought forward in the letters of 24 October 2000 and 20 September 2001. In addition, it informed the Authority of some amendments of the fiscal legislation generally applicable to taxable undertakings in Iceland. The Authority received no comments from third parties.

⁶ EFTA Surveillance Authority Decision 392/01/COL of 6 December 2001, OJ C 87 of 11 April 2002, page 10.

2. DESCRIPTION OF THE MEASURES: THE FISCAL LEGISLATION APPLICABLE TO ITCs IN ICELAND

In March 1999, the Icelandic Parliament passed Act No. 31/1999 which contains the necessary provisions for the establishment and registration of ITCs in Iceland. For the purposes of this law, an ITC is a company established in Iceland and registered as a public or private limited company. After registration, an ITC requires an operating license.

Act No. 31/1999 limits the scope of activities in which an ITC can engage to the following:

- trade in its own name with foreign entities outside Iceland, or as an intermediary in such trading, in goods which are not covered by the EEA Agreement and which do not originate in Iceland;
- act as an intermediary in the trading of services between foreign entities outside Icelandic jurisdiction;
- operate as a holding company that owns and invests in foreign enterprises, or intangible assets, officially registered outside of Iceland, such as trademarks, patents, design rights and publishing rights;
- own or control and register aircraft and vessels other than fishing vessels in Iceland, provided that such aircraft and vessels are only used for activities in which ITCs can engage;
- own or control and register aircraft or vessels other than fishing vessels in Iceland, and lease or sub-lease to foreign entities for transport outside Icelandic jurisdiction.
- it may not trade in its own name neither in goods with parties in Iceland nor with parties outside Iceland, nor may it serve as an intermediary in such trading and it may not process goods in Iceland partly or fully.

Parallel to the adoption of Act No. 31/1999, the Icelandic Parliament passed in March 1999 Act No. 29/1999 amending previously existing fiscal legislation for its application to ITCs, namely Act No. 75/1981 on Income and Net Wealth Tax, Act No. 83/1989 on Extra Net Wealth Tax, Act No. 36/1978 on Stamp Duty and Act No. 88/1991 on the Treasury's Extra Revenue.

According to the information provided by the Icelandic authorities, ITCs are covered by the Icelandic tax law and subject to the same rules and requirements regarding accounting, filing of returns and information availability to the tax authorities as other Icelandic companies. On matters such as definitions of income, movement of income, deduction and depreciation, the same rules apply to ITCs as to other Icelandic companies.

By virtue of Article 3 of Act No. 29/1999, ITCs are subject to payment of corporate income tax at a rate of 5 %, which is below the corporate income tax rate of 30 % (later reduced to 18 % - see below), generally applicable in Iceland.

According to Article 84 of Act No. 75/1981 on Income and Net Wealth Tax and Article 3 of Act No. 83/1989 on Extra Net Wealth tax, all Icelandic companies are subject to payment of the net wealth tax at the rate of 1.2 % (later reduced to 0.6 % - see below). ITCs are exempt from payment of this tax on the basis of Article 4 of Act No. 29/1999.

Although Icelandic companies are subject to payment of stamp duty in accordance with Act No. 36/1978 on Stamp Duty, ITCs have been partially exempt from this payment by Article 6 of Act No. 29/1999, which amended Article 3 of Act No. 36/1978 on Stamp Duty. In effect, the stamp duty exemption does not extend to operating assets that ITCs acquire in Iceland, transactions that are appropriately subject to payment of this duty.

Finally, Article 7 of Act No. 29/1999 added two new provisions to Act No. 88/1991 on the Treasury's Extra Revenue. In order to receive the required operating licence, ITCs are charged a fee of 100.000 ISK (approx. € 1,153). In addition, ITCs are subject to an annual surveillance charge of 100.000 ISK. Other Icelandic undertakings are not subject to any of these charges.

Following the adoption of Act No. 133/2001 amending several acts on taxation, and with effect from 1 January 2002, the corporate income tax rate applicable to limited liability companies was lowered from 30 % to 18 %. The net wealth tax rate was also reduced from 1,2 % to 0,6 %.

By virtue of Article 8 of Act 29/1999, its provisions containing the amendment of the fiscal acts regarding the taxation of ITCs entered into force as of 1st January 1999 and are therefore applicable for the fiscal year 1999 onwards.

3. COMMENTS SUBMITTED BY THE GOVERNMENT OF ICELAND

In the letter of 8 January 2002, the Government of Iceland pointed out that Chapter 17B of the State Aid Guidelines came into force three months after the Act on ITCs was passed.

Nonetheless, in various correspondence with the Authority, the Icelandic Government contested the nature of state aid of the tax measures applicable to ITCs, arguing that the mere fact that different tax regimes existed for different forms of undertakings could not in itself form a basis of presumption that such different treatment involved state aid. The Icelandic Government stated that the Act on ITC did not favour certain undertakings or the production of certain goods. The Icelandic tax regime on ITCs was neither sector-specific nor did it favour certain geographical areas. The Icelandic Government argued furthermore that the ITC regime permitted a wide range of activities and that all undertakings within the EEA, operating in these fields, could take advantage of the regime, regardless of the founder's domicile or other such factors. Additionally, all companies incorporated as ITCs paid the same rate, *i.e.* 5 %. Hence, the Icelandic Government concluded that the tax regime in favour of ITCs was of a general nature and

could not be characterised as “providing in favour of certain undertakings an exception of the application of the tax system”.

The Icelandic Government further stated that the Act on ITC did not distort competition or had an effect on trade. It was open to all that fulfil objective and transparent conditions laid down in law. The Icelandic Government was of the opinion that the fiscal treatment of ITCs under Icelandic law did not inherently benefit a specific undertaking or group of undertakings on a particular market vis-à-vis its competitors. The conditions for the establishment of ITCs were open to all persons and undertakings within the EEA and thus did not confer any competitive advantage to particular undertakings. In light of the equal and unhindered access of undertakings operating in sectors eligible for ITC status, there did not seem to be a *prima facie* reason to suspect that competition in any particular market would be distorted. Hence, the Government of Iceland considered that the onus of proving the measure’s incompatibility with Article 61 of the EEA Agreement had to rest with the Authority.

According to the Icelandic Government, when comparing the income tax rate of ITCs with the general rate, one had to take note of the fact that special rules applied to taxation of dividends from an ITC paid to an Icelandic resident shareholder. The general rule on taxation of dividends in Iceland was that dividends paid from a limited liability company to another company were tax exempt. Dividends paid from a limited liability company to individuals were taxed by a final withholding tax of 10 %. However, if the company which paid dividends was an ITC, these dividends were registered as income for the recipients and subject to regular income taxation, no matter whether the recipient was a company or an individual. Therefore, the 5 % corporate income tax was strictly a deferral of taxation until profits were distributed as dividends.

The Icelandic Government was also of the opinion that the criteria of the *de minimis* principle were met in this case. Hence, should the Authority reach a finding that state aid was involved, such aid would be below the *de minimis* ceiling and should be considered not to have an appreciable effect on trade and competition within the EEA.

Lastly, the Icelandic Government failed to see that international trading activity as such, between non-Contracting Parties, could be considered as a service falling within the scope of the EEA Agreement.

II. ASSESSMENT

Article 61 (1) of the EEA Agreement states that:

“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.”

Thus, in order for a measure to be considered state aid, it must constitute a selective advantage in favour of certain undertakings, be granted through state resources and affect competition and trade between the Contracting Parties to the EEA Agreement.

1. SELECTIVE ADVANTAGE IN FAVOUR OF CERTAIN UNDERTAKINGS

Firstly, the measure must confer on certain undertakings an advantage that reduces the costs they normally bear in the course of business and relieves them of charges that are normally borne from their budgets.

According to Chapter 17B.3(2) of the State Aid Guidelines, the advantage may be provided through a reduction in the firm's tax burden in various ways including *inter alia* a total or partial reduction in the amount of tax, such as an exemption or a tax credit.

The main criterion in applying Article 61(1) EEA Agreement to a tax measure is therefore that the measure provides in favour of certain undertakings in the EFTA State concerned an exception to the application of the tax system⁷. The common system applicable should thus first be determined. It must then be examined whether exceptions to the system or differentiations within that system are justified by the nature of the general scheme of the tax system, that is to say, whether they derive directly from the basis or guiding principles of the tax system in the State concerned. If this is not the case, state aid is involved.

The main advantage for ITCs is that they are subject to payment of a lower corporate income tax than the one generally applicable to any taxable undertaking in Iceland. Whereas the corporate income of undertakings is taxed at a rate of 30 % (with effect from January 2002 onwards, at the lower rate of 18 %), the corporate income tax rate applicable to ITCs only corresponds to 5 %. The reduced rate applicable to ITCs for the payment of corporate income tax meets the criterion established under Chapter 17B.3(2) of the State Aid Guidelines, since it reduces the tax burden on ITCs compared to other companies taxable in Iceland.

The Authority cannot share the reasoning put forward by the Icelandic Government according to which, when comparing the income tax rate of ITCs with the general rate, one has to take into account that special rules apply to taxation of dividends from an ITC paid to an Icelandic resident shareholder. The general rule on taxation of dividends in Iceland is that dividends paid from a limited liability company to another company are not subject to any further taxation. On the contrary, dividends from ITCs are currently taxed as part of the income of the receiving companies at a rate of 18 %. Moreover, dividends paid from a limited liability company to individuals are taxed by a final withholding tax of 10 % whereas the recipient must pay the income tax in full, if the company which pays dividends is an ITC. The taxation of dividends from ITCs to foreign resident shareholders is the same as for dividends from other Icelandic undertakings to foreign resident shareholders.

⁷ Chapter 17.B.3.1 of the State Aid Guidelines.

In the Authority's view, the tax scheme in favour of ITCs constitutes a tax credit. Profit which is retained in the undertakings is only taxed at a rate of 5 %. The taxation of dividends from ITCs implies that the total tax rate on distributed profit will be slightly higher for ITCs than for other Icelandic limited liability companies. Nevertheless, the shareholders have an influence on the distribution of profit and therefore have an influence on the length of the deferral of taxation. For these reasons, the tax scheme implies a favourable taxation of profit which has not been distributed to the shareholders but retained in the ITC company.

Additionally, ITCs are fully exempt from payment of net wealth tax and partially exempt from payment of stamp duty, with the exception being that of operating assets acquired in Iceland, which constitute a taxable transaction for ITCs as well. The above reasoning on the reduced corporate income tax rate applies equally with respect to these exemptions.

In order to be caught by Article 61(1) of the EEA Agreement, the measure must be specific or selective in that it favours certain undertakings or the production of certain goods. The favourable tax treatment applies only to undertakings which fulfil the conditions laid down in Act No. 31/1999 on ITCs. The more advantageous tax treatment (including the lower corporate income tax rate and the partial or total exemption from payment of net wealth tax and/or stamp duty) is only applicable to undertakings engaged in the limited activities provided for in Act No. 31/1999 and which take the legal form of an ITC, be it a public or a private limited company.

The Authority cannot accept the argument of the Icelandic Government according to which the tax regime in favour of ITCs laid down in the provisions of Act No. 29/1999 is of a general nature and does not confer any advantages on certain undertakings on the grounds that it is open to all persons and undertakings within the EEA, which operate in the fields of activity of ITCs. Contrary to this opinion, within the framework of the state aid investigation, the advantage must be assessed purely at national level, with reference in this case to any other undertaking subject to tax payment in Iceland⁸.

The European Court of Justice has held that any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general system, without there being any justification for this exemption on the basis of the nature and logic of the general scheme of this system, constitutes state aid⁹. In order to determine the nature of the general scheme of the tax system as a possible justification for the application of a reduced tax rate or for the exemption from payment of net wealth tax or stamp duty, it therefore has to be assessed whether the tax measures involved meet the objectives inherent in the tax system itself, or whether, on the contrary, they pursue other, possibly legitimate, objectives outside the tax system. In this respect,

⁸ Similarly, see, for example, Commission Decision of 17 February 2003 on the state aid implemented by the Netherlands for international financing activities, OJ L 180 of 18.7.2003, page 52, para 82.

⁹ Case 173/73 *Italy v Commission* [1974] ECR 709.

the Authority notes that it is up to the EFTA State concerned to establish that the tax measures concerned follow the internal logic of the tax system¹⁰.

In the Authority's view, the Icelandic Government has not provided any justification for this derogation from the general tax system on the basis of the nature of the general scheme. The Authority finds it hard to see that the favourable tax treatment of ITCs falls within the logic and the nature of the tax system but rather considers that a tax measure whose main effect is to promote a sector of activity fulfils the selectivity criteria to constitute state aid¹¹. Indeed, the corporate income tax rate applicable to all undertakings subject to taxation in Iceland corresponded to 30 % until 2002 and was reduced to a rate of 18 % with effect from 1st January 2002 onwards whereas ITCs are only taxed at the rate of 5 %. The tax regime under assessment is solely targeted at ITCs and foresees a more favourable fiscal treatment exclusively for this type of undertakings which shows the selective character of the measure. The objective pursued by the Icelandic Government when adopting the package on legislative measures regarding the establishment and registry of ITCs was not determined by primary tax concerns but by economic policy considerations, which are not directly linked with the tax system. Notwithstanding the fact that the Authority does not question the validity and legitimacy of any such considerations, it would like to recall the case law of the European Court of First Instance according to which the legitimate nature of the objectives pursued by a public measure is not sufficient for it to avoid being examined from a state aid perspective: *"if that argument were followed, it would be sufficient for the public authorities to invoke the legitimacy of the objectives which the adoption of an aid measure sought to attain for that measure to be regarded as a general measure outside the scope of [ex] Article 92 (1) of the Treaty. That provision does not distinguish between measures of state intervention by reference to their causes or aims but defines them in relation to their effects"*¹².

Finally, the Icelandic Government has argued that ITCs put up with a bigger burden than other Icelandic companies in as far as they require a licence to operate for which a fee of ISK 100.000 (approx. € 1,153) is charged and have to pay an annual surveillance charge of ISK 100.000, which no other undertaking in Iceland is bound to pay. The Authority is of the opinion that the imposition of those additional charges corresponds to a decision of the Icelandic State which does not follow the same rationale as the tax advantages currently under assessment but the objective of guaranteeing the legality and proper functioning according to the laws of Iceland of any ITC wishing to establish itself in the country.

2. STATE RESOURCES

Secondly, the advantage must be granted by the state or through state resources.

¹⁰ See in this context the opinion of Advocate-General Ruíz-Jarabo in Case C-6/97 *Italian Republic v Commission* [1999] ECR I-2981, para. 27.

¹¹ Chapter 17B.3.2 of the State Aid Guidelines.

¹² Case T-55/99 *Confederación Española de Transporte de Mercancías (CETM) v Commission* [2000] ECR II-3207, para. 53.

The favourable treatment of ITCs represents reduced tax receipts for the state for a given level of profit. The tax reductions awarded, irrespective of whether they take the form of an exemption, a lower tax rate or a tax deferral, lead to a reduction in the state revenues. According to Chapter 17B.3(3) of the Authority's State Aid Guidelines, such a loss of tax revenue is equivalent to consumption of state resources in the form of fiscal expenditure.

It is not relevant from the state aid point of view whether the beneficiary undertakings are fully or partially exempt from a given tax¹³. This is because any exemption from payment of a due tax reduces the burden of costs an undertaking must normally put up with in the normal course of business with respect to other undertakings taxed under the given national tax system.

Finally, the fact that a reduction in revenue can be compensated subsequently by an increase in the number of taxpayers as a result of the measure does not mean that the measure is not financed from state resources. Whether a measure constitutes aid must be assessed at a given time at the level of individual companies with a view to determining whether some companies receive more state aid or contribute less to financing public goods and services. Otherwise any type of aid would be justified in so far as it enticed a company to be set up in the given Contracting Party, which would enable it to increase its future taxable revenue.

3. DISTORTION OF COMPETITION AND EFFECT ON TRADE

Thirdly, the measure must distort competition and affect trade between the Contracting Parties.

The Authority points out that the analysis of the impact on trade of a particular tax regime, which is per definition abstract and general in character, can only be carried out at a general, abstract level¹⁴. The impact on a market, sector or specific product cannot be established since ITCs may be active in various fields of activity. Indeed, ITCs can trade in goods, which are not covered by the EEA Agreement, and which do not originate in Iceland. But the trading activity as such may be considered as a service falling inside the scope of the EEA Agreement. In this context, ITCs can act as intermediaries in the trading of services between foreign entities outside Icelandic jurisdiction. ITCs can also own or control and register aircrafts provided that these are being used for activities in which ITCs can engage and can own or control and register aircrafts and lease or sub-lease such aircrafts to foreign entities for transport outside Iceland. These are services which, contrary to the opinion of the Icelandic Government, are covered by the EEA Agreement.

It follows from the description above that the main activities ITCs can be involved in are international trade activities in which they are directly competing with other undertakings established in the EEA. The Icelandic Government has indeed indirectly admitted that the

¹³ Chapter 17B.3 of the State Aid Guidelines.

¹⁴ See in this context Commission Decision of 20 December 2001 on the state aid implemented by Spain in 1993 for certain newly established firms in Vizcaya (Spain), OJ L 40 of 14.2.2003, page 11, para 64.

tax measures in favour of ITCs affect competition and trade while arguing that were it not for the law on ITCs, the companies carrying out the activities open to ITCs would not be established in Iceland and hence would pay their taxes in other jurisdictions. The Authority consequently concludes that the tax regime applicable to ITCs affects competition and trade between the Contracting Parties.

Finally, the Icelandic Government argued in its letter dated 20 September 2001 that at the time only ten ITCs had been granted operating licences, and some were inactive. According to the Icelandic Government, the aid was not capable of affecting trade between Contracting Parties to the EEA Agreement, due to its minuscule extent and therefore the criteria of the *de minimis* principle¹⁵ were met in this case.

As regards the effects on trade between Member States, the European Court of Justice has consistently held that the relatively small amount of aid or the relatively small size of the undertaking which benefits from a state aid measure does not as such exclude the possibility that trade between the Contracting Parties might be affected¹⁶. Furthermore, the aid introduced by the tax measures under assessment does not comply with the *de minimis* requirements, in particular because there is no guarantee that the *de minimis* ceiling will not be exceeded and because overlapping with other state aid is not excluded.

4. NEW AID

The tax scheme under assessment cannot be considered as existing aid because it does not qualify under any of the requirements laid down in Article 1 in Part II of Protocol 3 to the Surveillance and Court Agreement. The EEA Agreement entered into force in Iceland in 1994 whereas the tax scheme was adopted in 1999.

According to Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement, Iceland is bound to inform the Authority on any plans to grant or alter aid. The tax measures under assessment should not have been put into effect until the Authority had reached a final conclusion regarding the aid measure. In this case the tax measure was not notified to the Authority and has never been authorised. Insofar as aid has been granted, it must be regarded as unlawful aid on procedural grounds.

Any state measure that fulfils the criteria laid down in Article 61(1) of the EEA Agreement constitutes state aid. Contrary to the reasoning of the Icelandic Government, it is irrelevant whether Chapter 17B of the State Aid Guidelines was adopted three months after the legislative package on ITCs. The adoption of Chapter 17B on the application of the State Aid rules to measures relating to direct business taxation changed nothing with respect to the nature of state aid of the tax measures in favour of ITCs. The state aid

¹⁵ Chapter 12 of the State Aid Guidelines which concerned the *de minimis* rule. This Chapter was deleted by the EFTA Surveillance Authority Decision No. 198/03/COL of 5 November 2003. By EEA Joint Committee Decision No. 88/2002 of 25 June 2002 (OJ L 266. 03.10.2002, p. 56) Commission Regulation (EC) No. 69/2001 of 12 January 2001 on the application of Articles 87 and 88 of the EC Treaty to *de minimis* aid (OJ L 10, 13.01.2001, p. 30) was incorporated into Annex XV of the EEA.

¹⁶ See, i.e., Case C-142/87 *Belgium v Commission* (“*Tubemeuse*”) [1990] ECR I-959, para. 43 and Joined Cases C-278/92, C-279/92 and C-280/92 *Spain v Commission* [1994] ECR I-4103, paras. 40 to 42.

assessment of the Authority is based on the provision of the EEA Agreement which implies that a measure which fulfils the criteria set out in Article 61(1) of the EEA Agreement constitutes state aid. The Authority issued the State Guidelines on the application and interpretation of Articles 61 and 62 of the EEA Agreement on 19 January 1994 and has progressively amended the different chapters according to the need for clarification regarding the assessment of certain state aid measures. Nonetheless, the Guidelines simply contain the interpretation of Article 61 of the EEA Agreement by the Authority, which is ultimately subject to control by the EFTA Court.

Based on the foregoing considerations, the Authority is of the opinion that the tax measures in favour of ITCs constitute new state aid within the meaning of Article 61(1) of the EEA Agreement. It is therefore necessary to determine whether they are compatible with the functioning of the EEA Agreement under the exceptions laid down in Article 61(2) and (3) of the EEA Agreement.

5. COMPATIBILITY WITH THE FUNCTIONING OF THE EEA AGREEMENT

The Authority would like to point out that the tax measures applicable to ITCs under assessment, *i.e.* the reduced corporate income tax, the total exemption from net wealth tax and the partial exemption from stamp duty, constitute an aid scheme. Due to this nature, the situation of each individual potential beneficiary cannot be independently examined but the assessment concerns the overall terms and conditions for the application of the tax measures.

With regard to Article 61(2) of the EEA Agreement, the Authority considers neither of the derogations mentioned in this provision to be applicable to the case at hand. On the basis of Article 61(3) (a) and (c) of the EEA Agreement, aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment as well as aid to facilitate the development of certain economic activities or certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest, can be considered compatible with the EEA Agreement. According to point 17B.4 of the State Aid Guidelines, if it is to be considered by the Authority to be compatible with the functioning of the EEA Agreement, state aid intended to promote the economic development of particular areas must be in proportion to, and targeted at, the desired aims. Where a derogation is granted on the basis of regional criteria, the Authority must ensure in particular that the relevant measures contribute to regional development and relate to activities having a local impact, relate to regional handicaps and are examined in an EEA context¹⁷.

The state aid measures under assessment do not qualify as regional aid to be considered compatible. Firstly, they are not limited to assisted areas but apply generally to the whole territory of Iceland. In addition, they do not comply with the further criteria set out for regional aid under Chapter 25 of the State Aid Guidelines, because they are not linked to material or immaterial investments, job creation or specific projects as required by the relevant provisions for regional aid.

¹⁷ Case 730/79 *Philip Morris v Commission* [1980] ECR 2671.

The derogation provided for under Article 61(3)(b) of the EEA Agreement, which refers to aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of an EC Member State or an EFTA State, is not applicable to the case at hand. Indeed, the more favourable tax treatment applicable in Iceland in favour of ITCs does not qualify for the category project of common European interest. Nor does it remedy a serious disturbance in the economy of Iceland.

Considering that the tax regime in favour of ITCs in Iceland constitutes state aid within the meaning of Article 61 of the EEA Agreement and does not qualify for any of the derogations set out in Article 61(2) and (3), the Authority considers it incompatible with the functioning of the EEA Agreement.

6. RECOVERY OF AID ALREADY PAID

According to Article 14 in Part II of Protocol 3 to the Surveillance and Court Agreement, where negative decisions are taken in cases of unlawful aid, the Authority decides that the EFTA State concerned shall take all necessary measures to recover the aid from the beneficiary.

On the basis of Article 14 (1) second sentence in Part II of Protocol 3 to the Surveillance and Court Agreement, the Authority may not require recovery of the aid if this would be contrary to a general principle of EEA law. A recovery decision constitutes an infringement of a general principle of EEA law in so far as the Authority creates, by its actions, a legitimate expectation on the part of the recipients that the aid was granted in accordance with EEA law.

Insofar as it has been granted any aid according to the tax measures in question, the Icelandic Government should calculate the aid element and reclaim the aid from the recipients. Recovery should be effected from the fiscal year 1999.

7. CONCLUSION

The Authority finds that the special tax regime applicable to ITCs in Iceland constitutes state aid within the meaning of Article 61(1) of the EEA Agreement. Iceland has unlawfully implemented the aid scheme in question in breach of Article 1(3) in Part I of Protocol 3 to the Surveillance and Court Agreement. The aid is, furthermore, incompatible with the functioning of the said agreement and must be terminated.

According to Article 14 in Part II of Protocol 3 to the Surveillance and Court Agreement, all aid that is incompatible with the functioning of the EEA Agreement is to be recovered from the beneficiaries. In so doing, Iceland can deduct any payment already made to the respective authorities.

HAS ADOPTED THIS DECISION:

1. The tax measures in favour of ITCs enacted in Iceland with Act No. 31/1999 and Act No. 29/1999 and related legislation constitute state aid within the meaning of Article 61

of the EEA Agreement. The tax regime applicable to ITCs in Iceland is incompatible with the functioning of the EEA Agreement.

2. Iceland shall terminate the tax measures referred to in point 1.

3. Iceland shall take all necessary measures to recover from the beneficiary the aid referred to in point 1 and unlawfully made available to the beneficiary, deducting any repayment already made to the respective authorities.

Recovery shall be accomplished without delay and in accordance with the procedures of national law provided that they allow the immediate and effective execution of the decision. The aid to be recovered shall include interest from the date on which it was at the disposal of the beneficiary until the date of its recovery. Interest shall be calculated on the basis of the reference rate set by the Authority and shall be net of interest that has already been charged by the respective authorities.

4. Iceland shall inform the Authority, within two months of notification of this Decision, of the measures taken to comply with it.

5. This decision is addressed to Iceland. The Icelandic Government shall be informed by means of a letter containing a copy of the decision.

6. This decision is authentic in the English language.

Done at Brussels, 25 February 2004.

For the EFTA Surveillance Authority

Hannes Hafstein
President

Einar Bull
College Member