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EFTA SURVEILLANCE AUTHORITY

REASONED OPINION

delivered in accordance with Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice concerning Iceland's failure to comply with its obligations under Articles 31 and 40 of the EEA Agreement by maintaining in force restrictive rules on exit taxation

1 Introduction and Correspondence

By a letter dated 27 February 2014,[1] the EFTA Surveillance Authority ("the Authority") informed the Icelandic Government that it had opened an own initiative case regarding the Icelandic system for exit taxation. In that letter, the Authority invited Iceland to provide specific information concerning (1) the statutory provisions and administrative practice regarding exit taxation of cross-border movement/transactions, and (2) the requirement for appropriate guarantees in cases of cross-border mergers when the amount of the deferred tax exceeds 50 million ISK.

By letter dated 31 March 2014, the Icelandic Government provided the requested information,[2] as well as a copy of the English translation of Act No 90/2003 on Income Tax (*lög nr. 90/2003 um tekjuskatt)* ("the ITA").[3]

The case was discussed at the package meeting in Iceland on 19 May 2014. In a follow-up letter to that meeting of 12 June 2014, the Authority asked Iceland to provide further information on the case, *inter alia*, as concerns whether Iceland intended to amend its exit tax rules.

The Icelandic Government replied by letter of 4 July 2014,[4] and stated, *inter alia*, therein that it was currently looking into which changes need to be made to the ITA in order to fulfil Iceland's obligations under the EEA Agreement. Legislation to the effect that companies would be able to apply for a deferral of the payment of their taxes in exit situations along with the requirement for the provision of a guarantee in such situations would especially be examined. Iceland noted that necessary legislative amendments would hopefully be passed before the end of the year.

On 22 October 2014, the Authority issued a letter of formal notice to Iceland.[5] In this letter, the Authority concluded that,

(1) by maintaining in force a tax system, such as the one foreseen in the Act on Income Tax, which requires immediate taxation when companies transfer their registered seat from Iceland to another EEA State, divide cross-border or transfer assets for use outside Iceland, Iceland has failed to fulfil its obligations arising from Articles 31 and 40 of the EEA Agreement, and

(2) by maintaining in force a tax system, such as the one laid down in Article 51(7) of the Act on Income Tax, which, without any prior assessment of the risk of non-recovery, requires guarantees in cases of cross-border mergers when the amount of the deferred tax exceeds 50 million ISK, Iceland has failed to fulfil its obligations arising from Article 31 of the EEA Agreement.

The reply to the letter of formal notice was submitted by the Icelandic Government by letter of 15 January 2015.[6] In its reply the Icelandic Government informed the Authority that it had decided to form a working group to formulate and put forward comprehensive proposals

[1] Document No 700714
[2] Document No 704022
[3] Document No 704059.
[4] Document No 714795
[5] Document No 719988
[6] Document No 735096

for change and reform of the Icelandic exit tax system. The letter stated that it was expected that a bill would be brought before the Parliament in its spring session of 2015.

The case was discussed at the package meeting in Reykjavík on 27 May 2015. At the meeting, the representatives from the Icelandic Government explained that a working group had been established and had met on a few occasions. However, the process of the adoption of the amendments to the Icelandic exit tax system had been prolonged due to an increased workload in relation to the capital controls. As regards a timetable, the Government stated that it expects to submit a bill in the autumn session of the Parliament in 2015.

2 Relevant national law – The Act on Income Tax

3.1 The Act on Income Tax and explanations provided by the Icelandic Government regarding exit taxation

This section summarises the current state of the Icelandic tax legislation as understood by the Authority following correspondence with the Icelandic Government.

In its correspondence with the Authority, Iceland has explained that the general rule according to Icelandic income tax law is that a company that is dissolved and transfers all its assets to another company is subject to taxation if the market value of the assets that are being transferred to another company is higher than the book value for tax purposes. The same applies to the shareholders of that company if the market value of the shares they receive is higher than the purchase price of the shares they owned in the transferring company.

2.1.1 Division of companies

There is an exception to this aforementioned general rule in Article 52 paragraph 1 ITA. This provision implies that a tax exemption is granted if a company in Iceland divides in Iceland and the shareholders of the company being divided are only given shares in the overtaking companies as payment for their shares in the divided company. In its letter of 27 February 2014, the Authority requested Iceland to describe the tax consequences for cases of cross border divisions of limited liability companies. The Authority asked whether companies and shareholders would benefit from an exemption from immediate taxation of unrealised capital gains in such situations.

In its letter of 31 March 2014 to the Authority the Icelandic Government stated that:

"When a company is split up and the division is not according to Article 52 of Act No 90/2003 on Income Tax, assets which are taken out of the company shall be treated in the same manner as if they had been sold or redeemed. The company will be taxed on difference between the market price of assets and its book value for tax purposes after deduction of carry-forward losses. Transfer of assets will be treated as shareholders withdrawal and will result in possible tax consequences for the shareholders of the company.

Tax consequences of cross-border divisions are therefore immediate taxation on all capital gains for both the companies that are being dissolved and their shareholders. The exemption in Article 52 ITA is therefore not applied in the case of cross-border mergers, which constitutes a restriction on the freedom of establishment and the free movement of capital under Articles 31 and 40 of the EEA Agreement. Furthermore, the preparatory works to Act

No 142/2013, amending ITA, confirm that, given the current state of the Icelandic tax legislation, companies and their shareholders would not be granted a deferral from immediate taxation (which is granted in the case of cross-border mergers) when companies are divided cross-border.

2.1.2 Companies that move their registered seat

In its letter of 31 March 2014 to the Authority, the Icelandic Government stated that: *"[t]here are no tax consequences when a company moves its registered seat within the Icelandic territory."*

However, with regard to companies that transfer their registered seat from Iceland to another EEA State, the Government stated in the same letter that *"[t]here are possible tax consequences for a company that moves its registered seat from Iceland to another State, regardless whether it is to an EEA State or not. When a company moves its registered seat from Iceland it is treated in the same manner as if it had been dissolved. The company will be taxed on the difference between the market price of assets and its book value for tax purposes after deduction of carry-forward losses. Deferral of capital gains will also be taxed. Transfer of assets will be treated as shareholders withdrawal and will be taxed as dividends."*

2.1.3 Transfer of assets

In its letter of 31 March 2014 to the Authority the Icelandic Government stated that: *"[t]here are no tax consequences when a company transfers assets within the Icelandic territory."*

However, with regard to a company that transfers assets from Iceland to another EEA State, the Government stated that *"[t]here are possible tax consequences for a company that transfers assets from Iceland to another State, regardless whether it is to an EEA State or not. When a company transfers assets from Iceland it is treated in the same manner as if the assets have been sold. The difference between the market price of assets and its book value for tax purposes will be taxed after deduction of carry-forward losses. The same applies regarding settlement of profit or losses when assets are moved from a fixed place of business in Iceland to its headquarters abroad. Transfer of assets will be treated as shareholders withdrawal and will be taxed as dividends."*

2.2 The Act on Income Tax – Relevant provisions[7]

Article 2 paragraph 1 ITA, on the legal persons liable for taxation, reads:

> *"The obligation to pay income tax on all income, regardless of where it is made, ... rests on the following legal entities resident in Iceland:*
>
> *1. Registered public limited companies and private limited companies, as well as associate limited companies, provided that the associate limited company has requested at the time of registration to be entered as an independent entity for tax purposes. Married couples, alone or with their children who are not financially competent, cannot form an associate limited company as an independent tax entity.*

[7] English tanslation provided by the Icelandic Government by letter dated 31 March 2014.

2. Mutual insurance- and non-life-insurance companies, cooperative societies, other cooperative enterprises and partnerships of cooperative enterprises .

3. Limited partnership companies and general partnership companies with unlimited member liability, provided that the company is registered in the Company Registry in this country, that it has been registered as an independent tax entity and that Articles of Incorporation have been established at the time of registration. The Articles of Incorporation must stipulate proportions of ownership, equity and how the company is to be dissolved. The Director of Internal Revenue is to be sent a certificate of registration and a verified copy of the Articles of Incorporation alongside the first tax return from these companies. Married couples, alone or with their children who are not financially competent, can neither form a limited partnership company nor a general partnership company that is an independent tax entity.

4. Partnerships and organisations whose core purpose is to manufacture or sell the products of its partners, buy supplies or provide service to a business or their independent activity, provided that they are listed in the Company Registry in this country and it has been noted on registration that they are independent tax entities. A company's Articles of Incorporation must be handed in when the company is registered. The Articles of Incorporation must stipulate proportions of ownership, equity and how the company is to be dissolved. The Director of Internal Revenue is to be sent a certificate of registration and a verified copy of the company's ownership contract alongside the first tax return from such companies.

5. Other companies, funds and institutions, including private non-profit institutions resident in Iceland, though in accordance with point 5 and 6 of Article 4, as well as estates of a deceased person and bankruptcy estates."

Distributions to shareholders of a company which is dissolved is taxed according to Article 11 paragraph 4 ITA, which reads:

"If a company, as noted in point 1 of paragraph 1 in Article 2, is dissolved and companies are not being merged, as noted in Article 51, the difference between the money handed out and their original purchase price is to be regarded as dividends. [...]"

According to Article 18 paragraph 2 ITA, the profits from the sale of shares are considered to be the difference between their sale price and their purchase price. The provision reads as follows:

"Profits from the sale of shares ...1) are considered to be the difference between their sale price on the one hand, and their purchase price on the other, though with consideration of paragraph 4. With the exception that the purchase price of shares owned by business operators, including individuals, at the end of the year 2001, is to be noted as their original purchase price after having been brought up according to price index changes for every year until the end of the year 2001, on the condition that the shares are registered property of the business activity. The purchase price of shares that a tax entity acquired through merger of public limited companies according to Article 51 is to be set as equal to the purchase price of the shares given up. The purchase price of B-division shares in the initial capital of a cooperative enterprise that a tax entity has acquired through a special re-evaluation of the A-division of a capital fund, according to temporary provision in the Act on

Cooperative Enterprises, is to be deemed equal to the amount of increase in the privately owned part of the A-division initial capital transferred. The purchase price of shares that a seller has acquired through put options, according to Article 9, is to be deemed equal to the current price used as the basis for determining income according to the Article. When calculating the profit from a share sale, the purchase price of each share is to be regarded as equal to the average purchase price of all of the seller's same shares."

The general rule according to the ITA is that a trade of assets is regarded as a sale for tax purposes, cf. for example Article 25 paragraph 1 ITA, which reads:

"When an asset is given up in barter trade, it is to be regarded as a sale, and the profits are to be taxed according to the provisions of Articles 12-27 of this Act.
If the determination of purchase and sale prices in a barter agreement differ significantly from the norm in comparable transactions where direct sales or purchases take place, the tax authorities can assess a normal price and base the taxation of sale profits thereon."

Article 52 paragraph 1 describes the tax consequences of domestic divisions where the shareholders of the company being divided are only given shares in the overtaking companies as payment for their shares in the divided company. The provision reads:

"If a limited company is divided so that all its assets and liabilities are divided between the divided company and those companies that succeeded it or were created through the breakup, and the shareholders of the divided company only receive shares in the companies to which the assets and liabilities were allocated at the time of the breakup, the breakup as such shall not lead to taxable income for the entity that ceded the shares. Ownership shares in the companies shall be in the same ratio as the ownership was in the divided company. Assets and debt are to be transferred at book value. The provisions of this paragraph also apply when a limited company is divided in such a way that more than one limited company takes over in part the assets and debt of the original company. The provisions of this paragraph also apply when cooperative enterprises are divided in such a way that more than one cooperative or limited company take over the assets and debt. Privately owned portions of members in cooperative enterprises are to be in relative proportion to the privately owned portions of the divided company, but if a limited company takes over the assets and debt of the cooperative enterprise then all shares in the limited company are to be owned by the divided cooperative."

Article 51 paragraph 7: The requirement of a guarantee

Article 51 ITA was amended with Act No 142/2013, which entered into force on 1 January 2014. Provisions were added regarding tax treatment of cross-border mergers of limited liability companies. According to Article 51 ITA, as amended by Article 6 of Act no. 142/2013, unrealised capital gains originating from a limited liability company exiting Iceland will be taxed when merging cross-border with a limited liability company in another Member State of the European Economic Area, EFTA state or the Faroe Islands. However, a tax deferral for up to five years will be granted upon request. Interest must be paid during

this deferral period. In cases of postponement, a bank guarantee is required in accordance with Article 51(7) ITA, without exemption, for the full payment of the tax and interests when the deferred tax amount is more than 50 million ISK.

3 Relevant EEA law

Article 31 of the EEA Agreement on the right of establishment provides that:

> "*1. Within the framework of the provisions of this Agreement, there shall be no restrictions on the freedom of establishment of nationals of an EC Member State or an EFTA State in the territory of any other of these States. This shall also apply to the setting up of agencies, branches or subsidiaries by nationals of any EC Member State or EFTA State established in the territory of any of these States.*
>
> *Freedom of establishment shall include the right to [...] set up and manage undertakings, in particular companies or firms within the meaning of Article 34, second paragraph under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of Chapter 4.[...]*"

Article 34 of the EEA Agreement extends the right of establishment to companies and provides that:

> "*Companies or firms formed in accordance with the law of an EC Member State or an EFTA State and having their registered office, central administration or principal place of business within the territory of the Contracting Parties shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of EC Member States or EFTA States. [...]*"

Article 40 of the EEA Agreement on the free movement of capital provides that:

> "*Within the framework of the provisions of the Agreement, there shall be no restrictions between the Contracting Parties on the movement of capital belonging to persons resident in EC Member States or EFTA States and no discrimination based on the nationality or on the place of residence of the parties or on the place where such capital is invested.*
> *Annex II contains the provisions necessary to implement this Article.*"

Article 1 of the Act referred to at point 1 of Annex XII to the EEA Agreement, as adapted by Protocol 1 thereof (*Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty;* ("Directive 88/361/EEC")), which implements Article 40 of the EEA Agreement, obliges the EEA States to abolish restrictions on movements of capital taking place between persons resident in the EEA States. Article 1 of Directive 88/361/EEC refers to a non-exhaustive Nomenclature in Annex I to the Directive, in which capital movements operations are classified.

The Nomenclature in Annex I to Directive 88/361/EEC lists, non-exhaustively, *inter alia* the following as constituting capital movements.

Under Heading III – Operations in Securities Normally Dealt in on the Capital Market:
(a) *Shares and other securities of a participating nature*
[...]

4 The Authority's Assessment

4.1 No deferral of taxation is foreseen for companies that move their seat from Iceland to another EEA State, divide cross-border or transfer assets for use outside Iceland

4.1.1 Relevance of the rules on the right of establishment and the free movement of capital

4.1.1.1 Introduction

As already mentioned, according to the Icelandic legislation, unrealised capital gains are subject to taxation when a company moves its seat from Iceland, divides cross-border or transfers assets for use outside Iceland, whereas similar transactions within the Icelandic territory do not attract any immediate tax consequences.

4.1.1.2 Taxation of the companies' shareholders is covered by the right of establishment or the free movement of capital

According to established case-law, the question of whether national legislation falls within the ambit of the free movement of capital or the freedom of establishment must be assessed in light of the purpose behind the legislation concerned.[8]

It is settled case-law that cross-border mergers and transfers of activities of a company from one EEA State to another EEA State, irrespective of whether the company transfers its registered office and effective management outside of an EEA State or whether it transfers assets of a permanent establishment from one EEA State to another fall within the scope of the right of establishment enshrined in Articles 31 and 34 EEA.[9]

National provisions applicable to holdings of the capital of a company which give the owner definite influence on the company's decisions and allow him to determine its activities, fall within the substantive scope of the provision of the freedom of establishment, whereas acquisition of shares below this threshold, by a non-resident, constitutes a capital movement within the meaning of Article 40 EEA.[10]

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[8] Cases C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* ECLI:EU:C:2006:544, paragraphs 31-33; C-452/04 *Fidium Finanz* ECLI:EU:C:2006:631, paragraphs 34 and 43-49; C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* ECLI:EU:C:2006:773, paragraphs 37 and 38; C-524/04 *Test Claimants in the Thin Cap Group Litigation* ECLI:EU:C: 2007:161 , paragraphs 26-34; C-492/04 *Lasertec Gesellschaft für Stanzformen mbH* v. *Finanzamt Emmendingen* ECLI:EU:C:2007:273, paragraphs 19-26; C-48/11 *A Oy,* ECLI:EU:C:2012:485, paragraph 17; and C- 164/12 *DMC Beteiligungsgesellschaft mbH*, judgment of 23 January 2014 ECLI:EU:C:2014:20, paragraph 29.

[9] See e.g. Cases C-371/10 *National Grid Indus* ECLI:EU:C:2011:785; C-378/10 *Vale* ECLI:EU:C:2012:440; C-261/11 *Commission v Denmark* ECLI:EU:C:2013:480 and E-15/11 *Arcade Drilling* [2012] EFTA Ct. Rep. 676.

[10] See *e.g.* Cases C-231/05 *Oy AA* ECLI:EU:C:2007:439, paragraph 20; C-112/05 *Commission* v. *Germany* ECLI:EU:C:2007:623, paragraph 13; C-284/06 *Burda* ECLI:EU:C:2008:365, paragraph 72; C-212/09 *Commission v Portuguese Republic* ECLI:EU:C:2011:717, paragraph 42; and C-164/12 *DMC Beteiligungsgesellschaft mbH*, cited above, paragraph 34; Case E-9/11 *ESA v Norway* [2012] EFTA Ct. Rep. 442, paragraph 79; Case E-14/13 *ESA v Iceland* [2013] EFTA Ct. Rep 924, paragraph 27.

Accordingly, the national measure in question, which requires the shareholders of a company established in Iceland to pay tax on the unrealised capital gains, based on increases in the value of those shares when cross-border transfers take place, fall to be assessed under the free movement of capital in Article 40 EEA, with regard to situations where shareholders hold shares below the threshold of definite influence, and under the right of establishment in Article 31 when the holding is above the threshold.[11]

Based on the above, the Authority will proceed to assess the restrictive national measures on the basis of both Article 31 and Article 40 of the EEA Agreement, in parallel.[12]

4.1.2 Shortcomings in the national law – The existence of a restriction

It should be recalled that Article 31 EEA requires the abolition of restrictions on the freedom of establishment. That freedom entails, for companies formed in accordance with the laws of an EEA State and having their registered office, central administration or principal place of business within the EEA, the right to pursue their activities in other EEA States through a subsidiary, a branch or an agency.[13] Furthermore, national rules which are liable to impede the free movement of capital and to dissuade investors from exercising that freedom must be regarded as restrictions within the meaning of Article 40 EEA.[14]

It is a well established principle that, although direct taxation falls within the EEA States' competence, they must, nonetheless, exercise that competence consistently with EEA law.[15]

Discrimination in the field of taxation consists of treating, for tax purposes, comparable situations differently or different situations in a similar way. According to settled case-law, for a difference in treatment between purely domestic and cross-border situations to be regarded as compatible with the fundamental freedoms, it must either concern situations which are not objectively comparable or be justified by overriding reasons in the general interest.[16]

As mentioned above, companies merging cross-border may, according to Article 51(5) ITA, choose to defer the payment of tax in Iceland for up to five years. However, as confirmed by the Icelandic Government at the package meeting in Iceland on 19 May 2014, no deferral of taxation is foreseen for companies that transfer their registered seat from Iceland to another EEA State, divide cross-border or transfer assets from Iceland to another EEA State.

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[11] Case E-9/11 *ESA v Norway*, cited above, paragraphs 79-82 and Case E-14/13 *ESA v Iceland*, cited above, paragraph 228.

[12] In Case E-14/13 (cited above), the EFTA Court assessed the restrictive national measures at issue on the basis of both Article 31 and Article 40 of the EEA Agreement. See, in particular, paragraphs 27 and 28.

[13] See Case C-157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* ECLI:EU:C:2008:588, paragraph 28, and Case C-337/08 *X Holding* ECLI:EU:C:2010:89, paragraph 17.

[14] See *e.g.* Cases C-367/98 *Commission v. Portugal* ECLI:EU:C:2002:326, paragraphs 44-46; C-483/99 *Commission* v. *France* ECLI:EU:C:2002:327, paragraphs 40-42, C-98/01 *Commission* v. *United Kingdom*, ECLI:EU:C:2003:273, paragraph 47; C-463/00 *Commission* v. *Spain* ECLI:EU:C:2003:272, paragraph 61; and C-212/09, cited above, paragraph 65.

[15] See *e.g.* Cases E-6/98 *Norway* v *EFTA Surveillance Authority* [1999] EFTA Ct. Rep. 74, paragraph 34; E-1/01 *Hörður Einarsson* [2002] EFTA Ct. Rep. 1, paragraph 17; and E-1/03 *EFTA Surveillance Authority* v *Iceland* [2003] EFTA Ct. Rep. 143, paragraph 26.

[16] See *e.g.* Cases C-279/93 *Schumacker* ECLI:EU:C:1995:31, paragraph 30; C-80/94 *Wielockx* ECLI:EU:C:1995:271, paragraph 17; C-107/94 *Asscher* ECLI:EU:C:1996:251, paragraph 40; C-311/97 *Royal Bank of Scotland* ECLI:EU:C:1999:216, paragraph 26 and C-386/04 *Centro di Musicologia Walter Stauffer* ECLI:EU:C:2006:568, paragraph 32.

In its letter of 31 March 2014, the Icelandic Government stated that: *"[t]here are no tax consequences when a company moves its registered seat within the Icelandic territory."* In that same letter, the Icelandic Government stated that: *"[t]here are no tax consequences when a company transfers assets within the Icelandic territory."* Furthermore, the Icelandic Government has confirmed that the tax exemption in Article 52 ITA is only applicable when all the parties to the division are domiciled in Iceland. Consequently, the tax exemption in Article 52 ITA is available only when a company divides within Iceland.

However, if a company moves from Iceland to another EEA State by dividing or relocating, it will become subject to tax on capital gains of its assets. The company has to pay tax on the difference between the book value and the market value of its assets, regardless of whether the assets have been realised or not. Furthermore, according to Article 18 paragraph 2 ITA the shareholders will be taxed on capital gains on the shares as if the company had been liquidated in Iceland. Unless relocation is connected to mergers, neither the company nor the shareholders are given the right to delay the payment.

As regards companies that transfer assets from Iceland to another EEA State, Iceland explained in its letter of 4 July 2014 that such companies are *"treated in the same manner as if the assets have been sold. The difference between the market price of assets and its book value for tax purposes will be taxed after deduction of carry-forward losses. The same applies regarding settlement of profit or losses when assets are moved from a fixed place of business in Iceland to its headquarters abroad. Transfer of assets will be treated as shareholders withdrawal and will be taxed as dividends."*

The Authority notes that taxpayers are not given the option to defer the payment of tax in Iceland when assets and obligations are moved out of the Icelandic fiscal jurisdiction. If, on the contrary, the company divides in Iceland, transfers its registered seat within the Icelandic territory or (re)locates the assets to an Icelandic branch of the company, any profit will not be deemed earned or become subject to taxation, until – or alternatively, if – the moment when this company actually realises the relevant assets. It may even be the case that in certain circumstances they are never realised or sold. In this case, in the domestic example, no tax would ever be levied. Similarly, shareholders of companies remaining in Iceland will not be subject to taxation on any latent profit or gains within the company until the company distributes dividends or the shareholders dispose of their shares.

The result is that Iceland treats the above cross-border movements/transactions of a company as a taxable event, whereas comparable domestic movements or transactions have no tax consequences. The cross-border transactions, therefore, lead to earlier taxation compared to purely domestic transactions.

The Authority considers that the difference in treatment, providing for immediate taxation of companies and shareholders for unrealised capital gains upon the cross-border movement/transaction of the companies to another EEA State when there is no such taxation in respect of equivalent domestic movements/transactions, constitutes a restriction on the right of establishment and the free movement of capital enshrined in Articles 31 and 40 EEA.[17]

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[17] See e.g. Cases C-371/10 *National Grid Indus*, cited above; C-38/10 *Commission v Portugal* ECLI:EU:C:2012:521; C-378/10 *Vale* ECLI:EU:C:2012:440; C-261/11 *Commission v Denmark* ECLI:EU:C:2013:480, E-15/11 *Arcade Drilling*, cited above; C-164/12 *DMC Beteiligungsgesellschaft mbH*, cited above; and Case E-14/13 *ESA v Iceland,* cited above.

4.1.3 Possible Justifications

In the *Commission v. Portugal* case, the Court of Justice of the European Union ("the CJEU") stated that differences in treatment could only be justified by an objective difference of situation (between the domestic and foreign situations).[18] Even in such circumstances, the measure undertaken would have to be assessed as to its proportionality on the facts.[19]

As regards the proportionality, it should be noted, at the outset, that – at any rate in the case of assets of a company assigned directly to economic activities that are intended to produce a profit – it may be considered proportionate for an EEA State, for the purpose of safeguarding the exercise of its powers of taxation, to determine the amount of the tax due on the unrealised capital gains that have been generated in its territory pertaining to the assets transferred outside its territory, at the time when its powers of taxation in respect of the assets concerned cease to exist, namely, at the time of the transfer of the assets outside the territory of that EEA State.[20]

As regards the recovery of such a tax, the CJEU has held that it was appropriate to give the taxable person the choice between, on the one hand, immediate payment of that tax, and, on the other hand, deferred payment of that tax, together with, if appropriate, interest in accordance with the applicable national legislation.[21] In that context, the CJEU has further held that account may also be taken of the risk of non-recovery of the tax, which increases with the passage of time, which may be taken into account by the EEA State in question, in its national legislation applicable to deferred payment of tax liabilities.[22]

The Icelandic measures are thus not in line with the principle of proportionality, since they do not foresee any possibility of deferred tax collection. The same result could be achieved by less restrictive measures. Iceland could determine the unrealized capital gains which it considers it has the right to tax, without that implying the immediate collection of tax. Iceland could, for example, prescribe rules whereby the deferred tax would become payable (after the cross-border transfer) in instalments.

In this respect, the Authority observes that the CJEU, in the *DMC* case,[23] held that recovery of tax on unrealised capital gains spread over five annual instalments, instead of immediate recovery, was considered to be a proportionate measure to attain the objective of preserving the balanced allocation of the power to impose taxes between EEA States.[24] It should, however, be noted that the Court took into consideration that no interest was levied by the legislation at issue and thus concluded that the provision did not go beyond what is necessary to attain the objective of the preservation of the balanced allocation of the power to impose taxes between Member States.[25]

In light of the above, the Authority considers that Iceland is in breach of Articles 31 and 40 EEA.

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[18] C-38/10 *Commission v Portugal,* cited above, paragraph 29.
[19] C-38/10 *Commission v Portugal,* cited above, paragraph 34.
[20] C-64/11 *Commission* v *Spain*, ECLI:EU:C:2013:264, paragraph 31, and Case C- 164/12 *DMC*, cited above, paragraph 60 and the case-law cited.
[21] Case C-657/13 *Verder LabTec* ECLI:EU:C:2015:331, paragraph 49; Case C-591/13 *Commission v Germany* ECLI:EU:C:2015:230, paragraph 67, and C-261/11 *Commission v Denmark,* cited above, paragraph 37.
[22] Case C-657/13 *Verder LabTec*, cited above, paragraph 50.
[23] Case C- 164/12 *DMC*, cited above.
[24] Case C- 164/12 *DMC*, cited above, paragraph 62-64.
[25] Case C- 164/12 *DMC*, cited above, paragraphs 63-64.

4.2 The requirement of a guarantee

4.2.1 The existence of a restriction

Article 51 ITA was amended with Act No 142/2013, which entered into force on 1 January 2014. Those amendments changed the legal situation for companies merging cross-border to the effect that companies and their shareholders will not automatically be subject to immediate taxation at the time of merger, but a tax deferral for up to five years will, according to the new Article 51(5) ITA, be granted upon request.

The above-mentioned exit tax amendments in Iceland entail that, when it comes to cross-border mergers, the taxpayer may exercise his option to defer payment of the tax if there is in place an agreement between Iceland and the other State for the avoidance of double taxation or any other such agreement to gather the necessary information. If, however, the amount exceeds 50 million ISK, he will, without exemption, be obliged to provide a guarantee for the full payment of the tax and interests, in accordance with Article 51(7) ITA. A guarantee would however not be necessary if the merger would take place within Iceland.

The Authority considers that this difference in treatment relating to the taxation of capital gains is liable to deter a company incorporated under Icelandic law from exercising its freedom of establishment protected by Article 31 EEA.[26]

4.2.2 Possible Justifications

In its letter of 31 March 2014, the Icelandic Government submitted that case law does not give any clear guidelines as regards how an assessment on the risk of non-recovery of tax is to be conducted. It is the Icelandic Government's opinion that the case law in the field of exit taxation is in general very unclear and constantly evolving. Therefore, the Government claims that it is difficult for the EEA States to formulate their national exit tax rules in a way that is in compliance with EEA law without making constant amendments in order to take notice of new case law from the CJEU and the EFTA Court.

Thus, it is the Icelandic Government's opinion that the requirement of a guarantee when the deferred tax amount exceeds 50 million ISK is in line with the freedom of establishment. In this context, the Icelandic Government maintains that the risk assessment forms an integral part of the provision where a guarantee is required if the deferred tax amount is higher than 50 million ISK. The Icelandic Government also claims that the Icelandic rules on the provision of a guarantee for tax deferrals are in fact very liberal in the sense that a guarantee is never required if the total amount of deferred tax is below the 50 million ISK limit.

The Authority does not contest that EEA States may, in some instances, take into account the risk of non-recovery of tax through measures such as the provision of a bank guarantee.[27] The Icelandic obligation would, however, seem to be disproportionate in this instance, since

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[26] See Cases C-371/10 *National Grid Indus,* cited above, paragraph 37; C-9/02 *de Lasteyrie du Saillant* ECLI:EU:C:2004:138, paragraph 46; C-470/04 *N* ECLI:EU:C:2006 :525, paragraph 35; C-380/11 *DI. VI. Finanziara di Diego della Valle & C.* ECLI:EU:C:2012:552, paragraph 36; and E-15/11 *Arcade Drilling,* cited above, paragraph 63.

[27] See e.g. Cases C- 371/10 *National Grid Indus*, cited above, paragraph 74 and E-15/11 *Arcade Drilling*, cited above, paragraph 105.

it applies to all cases where the total amount of deferred tax is over the 50 million ISK limit, regardless of the circumstances.

As to Iceland's argument that case law does not give any clear guidelines as regards when EEA States may request a guarantee for the payment of exit tax, the Authority would like to point out that in the *Arcade Drilling* case,[28] the EFTA Court stated that "*the national authorities may take certain measures in order to secure the eventual payment of the amount of tax, provided that there is a genuine and proven risk of non-recovery.*" It was further stated that a bank guarantee might even be unnecessary if the risk of non-recovery is covered by the personal liability of shareholders for outstanding tax debts of the company.[29]

Furthermore, in Case C-164/12 *DMC,*[30] the CJEU observed the restrictive effect of such guarantees, which have to be provided by the taxpayer, and stated that "*such a requirement cannot, as a matter of principle, be imposed without prior assessment of the risk of non-recovery.*"[31]

In light of the above, it is clear that such a requirement can only be applied if there is a genuine and serious risk of non-recovery of the tax claim and, as a result, the circumstances of each case must be assessed individually. Thus, Iceland cannot apply a guarantee requirement to all situations when the amount exceeds 50 million ISK. While there may be public interest objectives (such as the the prevention of tax avoidance, effective fiscal supervision and the balanced allocation of taxing rights) in requiring a guarantee in certain cases, a blanket requirement does not comply with the principle of proportionality, since it will not be justified in every case.

Thus, the Authority notes that EEA States must assess the risk of non-recovery prior to requesting the taxpayer to provide a guarantee in instances where the taxpayer opts for a deferred tax payment.

In light of the above, it is the Authority's conclusion that Article 51(7) ITA, as amended with Act No 142/2013, governing the requirement for the provision of a guarantee in all situations when the amount exceeds 50 million ISK, is in breach of Article 31 EEA.

For the sake of completeness, it should be observed that the obligation prescribed by Article 51(5) ITA to pay interest during the deferral period does not form part of the present case. The Authority has therefore not concluded on the question of whether or not this obligation is in line with EEA law.

FOR THESE REASONS,

THE EFTA SURVEILLANCE AUTHORITY,

pursuant to the first paragraph of Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, and after having given Iceland the opportunity of submitting its observations,

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[28] Case E-15/11 *Arcade Drilling*, cited above, paras 101-105.
[29] See Case E-15/11 *Arcade Drilling*, cited above, paragraph 105.
[30] Case C- 164/12 *DMC Beteiligungsgesellschaft mbH*, cited above, paras. 65-69.
[31] Case C- 164/12 *DMC,* cited above, paragraph 67.

EFTA SURVEILLANCE AUTHORITY

HEREBY DELIVERS THE FOLLOWING REASONED OPINION

that:

(1) by maintaining in force a tax system, such as the one foreseen in the Act on Income Tax, which requires immediate taxation when companies transfer their registered seat from Iceland to another EEA State, divide cross-border or transfer assets for use outside Iceland, Iceland has failed to fulfil its obligations arising from Articles 31 and 40 of the EEA Agreement.

(2) by maintaining in force a tax system, such as the one laid down in Article 51(7) of the Act on Income Tax, which, without any prior assessment of the risk of non-recovery, requires guarantees in cases of cross-border mergers when the amount of the deferred tax exceeds 50 million ISK, Iceland has failed to fulfil its obligations arising from Article 31 of the EEA Agreement.

Pursuant to the second paragraph of Article 31 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice, the EFTA Surveillance Authority requires Iceland to take the measures necessary to comply with this reasoned opinion within *two months* of its receipt.

Done at Brussels, 11 November 2015

For the EFTA Surveillance Authority

Frank Büchel
College Member

Markus Schneider
Acting Director