

Ministry of Culture and Business Affairs
Sölvhólgata 7
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Iceland

Subject: Favourable tax rate on share option profits in research and development start-up entities

1 Summary

- (1) The EFTA Surveillance Authority (“ESA”) wishes to inform Iceland that, having assessed the favourable tax rate on share option profits for employees in research and development (“R&D”) start-up entities (“the measure”), ESA considers that the measure constitutes State aid within the meaning of Article 61(1) of the EEA Agreement and decides not to raise objections¹ to the measure, as it is compatible with the functioning of the EEA Agreement, pursuant to its Article 61(3)(c).
- (2) ESA has based its decision on the following considerations.

2 Procedure

- (3) The Icelandic authorities notified the measure on 16 January 2024.²

3 Description of the measure

3.1 Definitions

- (4) A share option gives an option holder the right to buy shares in an entity from an option provider for a predetermined price. If the option holder is an employee or board member of the entity, or is an individual service provider to the entity, the option is referred to as an employee share option.
- (5) An option is considered exercised when the option price is paid and the underlying shares are transferred to the option holder. If shares purchased under an option agreement are sold to a price higher than the sum of the purchase price and any option premium, the difference is called option profits.
- (6) Employees, board members and individual service providers are collectively referred to as employees in the following.

3.2 Objective of the measure

- (7) Start-up entities may find it difficult to recruit and retain key employees, as such entities may struggle to finance competitive wages, compared to larger and more well-established companies. This is in part due to the fact that start-up entities in general do not have the same access to capital as older and more well-established

¹ Reference is made to Article 4(3) of the Part II of Protocol 3 to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice.

² Document No 1429749.

companies. Also, employees are often risk-averse and may consider a start-up entity an uncertain employer.

- (8) Shortage of skilled employees in start-up entities impacts innovation, productivity, job creation and growth by restricting these entities in exploring their productive potential of innovation and ideas. This may result in profitable projects not being realised.
- (9) The objective of the measure is to correct these market failures for R&D start-up entities, by enhancing such entities' ability to recruit and retain key employees through a more favourable taxation of share option profits for employees, board members and individual service providers in such entities.
- (10) With employee share options, start-up entities can further encourage employees to work towards the entities' goals by sharing the risks and results of their work, which also can lead to a higher degree of innovation.

3.3 Functioning of the measure

- (11) In Iceland, income tax is regulated by the Income Tax Act No 90/2003 ("the Income Tax Act"). Income tax on wages is in three tax brackets, ranging from 31.48% to 46.28%. Income from capital gains is taxed at 22%.
- (12) According to the Income Tax Act, option profits are taxed as wage income, i.e. with a tax rate of 31.48% to 46.28%. The option profits become taxable when the employee sells the shares.
- (13) The measure introduces a more favourable taxation on option profits obtained by employees in R&D start-up entities, by taxing those option profits as capital gains instead of taxing them as wages. The option profits will still become taxable at the time the option holder sells the shares.

3.4 National legal basis, granting authority and duration

- (14) The national legal basis of the measure is Article 10(a) of the Income tax Act. The necessary amendments of the act have been adopted by the Icelandic Parliament and will enter into force from the adoption date of the present decision.
- (15) The granting authority is the Icelandic Ministry of Finance and Economic Affairs. The duration of the measure is for the tax years 2024 to 2033 inclusive.

3.5 Eligible costs

- (16) The eligible costs of the measure are defined to be option profits, i.e. any positive difference between the purchase price of the underlying shares in an option agreement and the market value of the same shares when the option is exercised.

3.6 Eligibility criteria

3.6.1 Employees, board members and individual service providers

- (17) To be eligible for using the capital gain tax rate of 22% on option profits, the option holder must have been an employee, board member or individual service provider in the entity at the time the option agreement was entered into.

- (18) For an individual service provider, the total value of the services provided to the entity shall not exceed ISK 2 million over a 12-month period, and the price assumptions of the option value shall be clearly stated in the option agreement.

3.6.2 Start-up entity

- (19) The entity must be a start-up entity, which under the measure is defined as an entity with less than 25 employees (not including board members and individual service providers), an annual turnover less than ISK 650 million and/or a balance sheet value below ISK 650 million. If an entity is part of a group of companies, the group as a whole must be considered on the basis of the consolidated financial statements.

3.6.3 R&D entity, activity and project

- (20) The start-up entity must be a R&D entity, which under the measure is defined as an entity where more than 10% of the turnover is spent on approved research and development activities and where the entity is established for that purpose.
- (21) R&D is defined under the measure as a limited and targeted process/activity that is intended to acquire new knowledge or new skills that are considered to be of benefit to the entity due to the development of a new or better product, service or production method.
- (22) Before entering into an eligible option agreement, the start-up R&D entity must have received a confirmation from Rannís³ that the project is considered to be a relevant research or development project. To qualify for this: i) the innovative idea and the business plan must be well defined, ii) it must be demonstrated with data that at least 1 million ISK is spent on research and development during a 12-month period, and iii) the relevant employees must have training, education or experience in the product or service field on which the innovative idea is based.
- (23) The labour contribution of the option holder must solely be related to the performance of the relevant project throughout the option period.

3.6.4 Option purchase price not lower than market price

- (24) To be eligible for using the capital gain tax rate, the purchase price under the option agreement cannot be less than the market price of the underlying shares at the time of conclusion of the option agreement or, in the absence of a market price, the share price corresponding to the entity's book value of equity according to the last approved annual accounts prior to the conclusion.

3.6.5 Option duration between 18 months and eight years

- (25) To be eligible for using the capital gain tax rate, at least 18 months must elapse between the conclusion of the option agreement and the exercise of the option.
- (26) An eligible option agreement cannot have a duration exceeding eight years.

3.6.6 Option being non-transferable

- (27) In order to be eligible, an option agreement must be non-transferable.

³ The Icelandic Centre for Research. More information on <https://en.rannis.is/activities/>

3.7 Number of beneficiaries, aid instrument and budget

- (28) The Icelandic authorities estimate that employees, in approximately 51-100 entities will be eligible for aid under the measure.
- (29) The aid instrument comes in the form of a tax rate reduction.
- (30) The Icelandic authorities do not expect the overall revenue loss to exceed EUR 500 000 per year.

3.8 Cumulation

- (31) The Icelandic authorities have confirmed that the eligible costs of the measure will not overlap with eligible costs of other existing State aid measures.
- (32) If a future Icelandic State aid measure will have overlapping eligible costs with the measure at stake, the Icelandic authorities have committed that they will make sure that the same eligible costs are not covered twice for any beneficiaries.

3.9 Control mechanisms and transparency

- (33) The Icelandic authorities have confirmed that at the end of each year, the entities shall send information on issued share options and exercised options, together with other relevant key information, to the tax authorities.
- (34) Further, the requirement of obtaining an approval by Rannís secures that only entities with verified R&D projects fall under the measure.
- (35) The Icelandic authorities have confirmed that the measure will adhere to the general transparency requirements.

4 Presence of State aid

4.1 Introduction

- (36) 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."
- (37) The qualification of a measure as aid within the meaning of this provision requires the following cumulative conditions to be met: (i) the measure must be granted by the State or through State resources; (ii) it must confer an advantage on an undertaking; (iii) favour certain undertakings (selectivity); and (iv) threaten to distort competition and affect trade.

4.2 Presence of State resources

- (38) The measure must be granted by the State or through State resources.
- (39) The measure involves State resources, as the measure results in less revenue to the State from income tax on option profits. Further, the measure is imputable to the State as it is introduced through a legislative act.

4.3 Advantage on an undertaking

- (40) The measure must confer on undertakings an advantage that relieves them of charges that are normally borne from their budget.
- (41) The favourable income taxation directly concerns only employees, board members and individual service providers, who are all private individuals. As they are not undertakings, Article 61(1) of the EEA Agreement does not apply to them.
- (42) However, as stated in ESA Decision No 267/21/COL,⁴ for a similar Norwegian aid measure, the favourable income taxation confers an indirect advantage on the employers, i.e. the undertakings, as the value of their remuneration in the form of options increases for their employees.⁵ For the measure at hand, at least some of the eligible entities engage in economic activity, providing services and or goods on different markets, and consequently constitute undertakings. Therefore, the measure confers an advantage on undertakings that relieves them of charges that are normally borne from their budget.

4.4 Selectivity

- (43) The measure must be selective in that it favours “certain undertakings or the production of certain goods”.
- (44) The tax advantage benefits only start-up undertakings of a certain size that carry out R&D activities. Accordingly, certain types of undertakings are excluded, based on their size or the type of activity they carry out. Therefore, the measure is selective.

4.5 Effect on trade and distortion of competition

- (45) The measure must be liable to distort competition and to affect trade between the Contracting Parties to the EEA Agreement.
- (46) The measure will strengthen the position of the eligible undertakings compared with that of its competitors. Further, at least some of the eligible undertakings are active in markets that are open for EEA-wide competition and trade. Therefore, the measure is liable to distort or threaten to distort competition and affect trade between the Contracting Parties.

4.6 Conclusion

- (47) In the light of the above assessment, ESA concludes that the measure constitutes State aid within the meaning of Article 61(1) of the EEA Agreement.

5 Aid scheme

- (48) ESA notes that the legal basis of the measure is an act which does not require further implementing measures for the granting of the aid, and which identifies the beneficiaries in a general and abstract manner.⁶ The aid is therefore granted on the basis of an aid scheme.

⁴ ESA [Decision No 267/21/COL](#), *Employee share options 2022–2031*, OJ C 131, 24.3.2022, p. 11, and EEA Supplement No 19, 24.3.2022, p. 1.

⁵ *Ibid*, paragraph 47.

⁶ Article 1(d) of Part II of Protocol 3 to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (“Protocol 3”).

6 Lawfulness of the aid

- (49) Pursuant to Article 1(3) of Part I of Protocol 3 to the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice (“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.”
- (50) The Icelandic authorities have notified the measure and have yet to grant aid under the scheme. They have therefore complied with the obligations under Article 1(3) of Part I of Protocol 3.

7 Compatibility of the aid

7.1 Introduction

- (51) In derogation from the general prohibition of State aid laid down in Article 61(1) of the EEA Agreement, aid may be declared compatible if it can benefit from one of the derogations enumerated in the Agreement. The Icelandic authorities invoke Article 61(3)(c) of the EEA Agreement as the basis for the assessment of the compatibility of the aid measure.
- (52) Article 61(3)(c) of the EEA Agreement provides that ESA may declare compatible: “(i) aid to facilitate the development of certain economic activities or of certain economic areas, (ii) where such aid does not adversely affect trading conditions to an extent contrary to the common interest”.⁷
- (53) Under the first condition, ESA examines how the aid facilitates the development of certain economic activities or areas. Under the second condition, ESA weighs up the positive effects of the aid for the development of said activities or areas and the negative effects of the aid in terms of distortions of competition and adverse effects on trade.
- (54) For most cases, these conditions are outlined in ESA’s State aid guidelines. However, in this case there are no existing State aid guidelines applicable. ESA will therefore assess the measure directly under Article 61(3)(c) of the EEA Agreement.

7.2 Development of certain economic activities or areas

7.2.1 *Economic activities or areas supported*

- (55) Under Article 61(3)(c) of the EEA Agreement, to be considered compatible, the measure must contribute to the development of certain economic activities or areas.
- (56) The measure aims at enhancing start-up entities’ ability to recruit and retain key employees. By introducing favourable taxation on option profits, the measure addresses the difficulties that start-up entities face in financing competitive wages, due to shortage of capital and low liquidity, see section 3.2. above. The measure therefore contributes to developing the economic activities of start-up entities. Further, the measure facilitates R&D activity through allowing R&D start-up entities to explore their productive potential of innovation and ideas.

⁷ Judgment of 22 September 2020, *Austria v Commission (Hinkley Point C)*, C-594/18 P, EU:C:2020:742, paragraphs 18–20.

- (57) In view of the above, ESA considers that the measure constitutes aid to facilitate the development of certain economic activities, as required by Article 61(3)(c) of the EEA Agreement.

7.2.2 *Incentive effect*

- (58) State aid is only compatible with the functioning of the EEA Agreement if it has an incentive effect, and so effectively facilitates the development of certain economic activities. To establish whether the measure has an incentive effect, it must be demonstrated that it changes the behaviour of the undertakings concerned in such a way that it engages in an activity which it would not carry out without the aid or which it would carry out in a restricted or different manner.
- (59) Since the measure seeks to enhance R&D start-up entities' ability to recruit and retain key employees, it may help these entities carry out projects that absent the measure would not be undertaken, see section 3.2 above. Further, granting options to employees as part of the remuneration incentivises them to work on increasing the value of the underlying shares.
- (60) In view of the above, ESA considers that in the absence of the measure, R&D start-up entities would not to the same extent explore their potential for producing profitable projects, and consequently the development of their economic activities would not be facilitated to the same extent. This view is also mirrored in ESA Decision No 267/21/COL for the similar Norwegian scheme.⁸ Therefore, ESA considers the measure to have an incentive effect.

7.2.3 *Compliance with relevant EEA law*

- (61) If a State aid measure, the conditions attached to it (including its financing method when the financing method forms an integral part of the State aid measure), or the activity it finances entail a breach of relevant EEA law, the aid cannot be declared compatible with the functioning of the EEA Agreement.⁹
- (62) ESA has no indications that the measure, the conditions attached to it, or the activity it finances entail a breach of relevant EEA law.

7.3 Whether the aid adversely affects trading conditions to an extent contrary to the common interest

7.3.1 *Introduction*

- (63) ESA shall not only identify positive effects of the planned aid for the development of the abovementioned economic activities, but also possible negative effects that the aid may have in terms of distortions of competition and adverse effects on trade. These positive and negative effects must then be weighed up.

7.3.2 *Markets affected by the aid*

- (64) The market directly affected by the measure is the Icelandic labour market. Further, the measure affects the economic activities of R&D start-up entities.

⁸ ESA [Decision No 267/21/COL](#), *Employee share options 2022–2031*, paragraph 65.

⁹ Judgments of 19 September 2000, *Germany v Commission*, C-156/98, EU:C:2000:467, paragraph 78; 22 December 2008, *Régie Networks*, C-333/07, EU:C:2008:764, paragraphs 94–116; 22 September 2020, *Austria v Commission (Hinkley Point C)*, C-594/18 P, EU:C:2020:742, paragraph 44; 14 October 2010, *Nuova Agricast*, C-390/06, EU:C:2008:224, paragraphs 51–51.

7.3.3 Positive effects of the aid

- (65) The aid contributes to the development of the economic activities of start-up entities, see paragraphs (56) and (57) above.
- (66) Further, the measure has the potential to promote competition in the labour market and help to improve the efficient matching of labour resources to productive economic activities, by increasing the ability of R&D start-up entities to offer competitive remuneration to employees. Since the eligible entities have to be small in size (see paragraph 3.6.2 above), this might increase competition, since it will give entities without market power greater potential to develop, market and commercialise their products and services, and may also lead to growth in overall economic productivity.

7.3.4 Limited negative effects of the aid

7.3.4.1 Introduction

- (67) Article 61(3)(c) of the EEA Agreement requires an assessment of any negative effects on competition and on trade. The aid must not adversely affect trading conditions to an extent contrary to the common interest.

7.3.4.2 Necessity of the aid

- (68) A State aid measure is necessary if it is targeted towards situations where aid can bring about a material improvement that the market cannot deliver itself.
- (69) According to the Icelandic authorities, shortage of capital and liquidity make it difficult for start-up entities to offer competitive wages. Further, employment in start-up entities is associated with higher risk than employment in larger, more well-established companies.
- (70) Moreover, it may, for outsiders, be difficult to assess risk and expected returns on investing or taking employment in start-up entities. This way, asymmetric information in both the capital and labour market presents challenges for start-up entities in recruiting and retaining key employees.
- (71) In the European Commission Decision SA.47144 (2016/N),¹⁰ in a similar case concerning Sweden, the European Commission concluded that Swedish authorities had demonstrated “the existence of a market failure in the form of asymmetric information that prevents an efficient matching of labour resources to economic needs of small business”.¹¹
- (72) The same type of market failure was addressed in ESA Decision No 267/21/COL¹² and in the previous version of the same similar Norwegian scheme, approved by ESA Decision No 225/17/COL.¹³ In those decisions ESA concluded that the Norwegian authorities had sufficiently demonstrated a market failure, in the form of

¹⁰ European Commission [Decision SA.47144 \(2016/N\)](#), *Tax reduction of employee share options*, OJ C/254/2017 of 4.8.2017, p. 10.

¹¹ *Ibid*, paragraph 43.

¹² ESA [Decision No 267/21/COL](#), *Employee share options 2022–2031*, paragraph 77.

¹³ ESA [Decision No 225/17/COL](#), *Employee share option tax scheme*, OJ C 88, 22.3.2018, p. 10, and EEA Supplement No 13, 8.3.2018, p. 3, paragraph 70.

asymmetric information that prevents an efficient matching of labour resources and access to capital to economic needs of small business.

- (73) Against this background, ESA considers that the measure addresses a market failure and therefore is needed to allow start-up entities to offer competitive remuneration to employees compared to larger, more well-established companies. By addressing the market failure, the measure enables economically profitable projects that absent the measure would not have been realised because they would not be profitable for the entity.

7.3.4.3 Appropriateness of the aid

- (74) EEA EFTA States can make different choices concerning policy instruments and State aid control does not impose a single way to intervene in the economy. However, State aid under Article 61(1) of the EEA Agreement can only be justified by the appropriateness of the particular instrument chosen to contribute to the development of the targeted economic activities or areas.
- (75) ESA normally considers that a measure is an appropriate instrument where the EEA EFTA State can demonstrate that alternative policy options would not be equally suitable to contribute to the development of economic activities or areas, and where it can demonstrate that alternative, less distortive, aid instruments would not deliver equally efficient outcomes.
- (76) The measure is designed to enhance start-up entities' ability to recruit and retain employees, board members and individual service providers. In ESA Decision No 267/21/COL, ESA concluded that a similar measure was appropriate to remedy the market failure preventing efficient matching of labour resources to economic needs of start-up entities.¹⁴
- (77) In that decision, ESA took the view that fiscal measures such as liquidity constraints and general regulatory measures were not as efficient and targeted as the notified measure. Furthermore, that the measure, like the scheme at hand, had additional advantages compared to other instruments, such as increasing the incentive for eligible undertakings to use options as a form of remuneration, which would motivate employees to create share value.¹⁵ Further, in the European Commission Decision SA.47144 (2016/N), the European Commission has concluded that the similar Swedish measure was an appropriate instrument.¹⁶
- (78) ESA takes the view that the Icelandic market conditions and liquidity constraints for start-ups are similar to those in Norway and Sweden, and that the same considerations concerning appropriateness apply also for the scheme at hand.
- (79) In view of the above, ESA considers that State aid granted through the measure is an appropriate instrument to facilitate the development of the economic activities of start-up entities.

¹⁴ ESA [Decision No 267/21/COL](#), *Employee share options 2022–2031*, paragraph 83.

¹⁵ *Ibid*, paragraph 81.

¹⁶ European Commission [Decision SA.47144 \(2016/N\)](#), *Tax reduction of employee share options*, paragraph 51.

7.3.4.4 Proportionality of the aid

- (80) State aid is proportionate if the aid amount per beneficiary is limited to the minimum needed to incentivise the additional investment or activity in the area concerned.
- (81) The measure contains some safeguards to limit the aid granted to employers.
- (82) First, the tax advantage from the measure materialises only after i) the employee exercises the option, which normally only happens when the share price exceeds the agreed exercise price, and ii) the employee sells the shares.
- (83) Second, the number of options awarded is the result of bargaining between employers and their (prospective) employees. While the latter may prefer higher remuneration, employers have incentives to minimise costs. This helps reduce the aid to the minimum necessary.
- (84) Third, the number of options awarded will be limited, as the agreed exercise price cannot be set below the market value of the underlying shares at the time of the granting of the option.
- (85) Finally, the measure has eligibility criteria for the employers to ensure the aid is targeted at a well-defined restricted set of entities which typically face difficulties in recruitment and retention of key employees, see section 3.2 above. Larger and more well-established companies not eligible under the measure do not suffer from the market challenges to the same degree. They would normally be able to compete successfully in the labour market by offering competitive remuneration without options.
- (86) ESA also notes that the aid granted under the measure is not related to any costs that can be eligible for other State aid. The qualifying criteria and control mechanisms effectively preclude any abuse or cumulation with other aid schemes for the same eligible costs.
- (87) Therefore, ESA considers the measure to be proportionate, ensuring that any aid is limited to the minimum necessary to remedy the market failure.

7.3.4.5 Conclusion on limited negative effects

- (88) In light of the above arguments, and of the fact that the aid is granted as a relatively small relief from tax liabilities, ESA concludes that any negative effects of the aid on competition and on trade are limited.

7.3.5 *Balancing positive and negative effects of the aid*

- (89) For the aid to be compatible with the functioning of the EEA Agreement, the limited negative effects of the measure, in terms of distortion of competition and adverse impact on trade between Contracting Parties, must be outweighed by positive effects, in terms of contribution to the facilitation of the development of economic activities or areas. It must be verified that the aid does not adversely affect trading conditions to an extent contrary to the common interest.
- (90) On the negative side of the balance, ESA notes that the measure is liable to strengthen the position of start-up entities in Iceland, as opposed to their competitors. However, as concluded above, ESA considers that the distortion of competition and the effect on trade between Contracting Parties will be limited.

- (91) On the positive side of the balance, ESA considers that by increasing the ability of start-up entities to offer competitive remuneration to their staff, competition may increase, as those entities will have greater potential to develop, market and commercialise their products and services. This may lead to growth in overall economic productivity.
- (92) Based on the above considerations, ESA concludes that the positive effects of the measure outweigh possible distortions of competition and adverse impact on trade. Therefore, the aid does not unduly affect trading conditions to an extent contrary to the common interest.

7.4 Transparency

- (93) According to the general transparency requirement, only aid granted in a transparent manner can be approved on the basis of Article 61(3)(c) of the EEA Agreement. The Icelandic authorities have committed to publishing information about the aid granted in accordance with the general transparency requirement.

8 Conclusion

- (94) On the basis of the foregoing assessment, ESA considers that the favourable tax rate on option profits for employees, board members and individual service providers in R&D start-up entities constitutes State aid with the meaning of Article 61(1) of the EEA Agreement. Since ESA has no doubts that the aid is compatible with the functioning of the EEA Agreement, pursuant to its Article 61(3)(c), it has no objections to the implementation of measure.
- (95) The Icelandic authorities have confirmed that the notification does not contain any business secrets or other confidential information that should not be published.

For the EFTA Surveillance Authority,

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