JUDGMENT OF THE COURT
2 December 2013

(Failure by a Contracting Party to fulfil its obligations – Articles 31 and 40 EEA – Different taxation on domestic and cross border mergers within the EEA)

In Case E-14/13,

EFTA Surveillance Authority, represented by Xavier Lewis, Director, and Gjermund Mathisen and Auður Ýr Steinarsdóttir, Officers, Department of Legal & Executive Affairs, acting as Agents,

applicant,

v

Iceland, represented by Anna KatrínVilhjálmsdóttir, First Secretary, Ministry for Foreign Affairs, acting as Agent,

defendant,

APPLICATION for a declaration that, by maintaining in force a difference in treatment between domestic mergers and cross-border mergers pursuant to Article 51 paragraph 1 of the Icelandic Act No 90/2003 on Income Tax (*lög nr. 90/2003 um tekjuskatt*), Iceland has failed to fulfil its obligations arising from Articles 31 and 40 of the Agreement on the European Economic Area.

THE COURT,

composed of: Carl Baudenbacher, President, Per Christiansen (Judge-Rapporteur) and Páll Hreinsson, Judges,

Registrar: Gunnar Selvik,

having regard to the written pleadings of the parties,

having decided to dispense with the oral procedure,

gives the following

Judgment

I The application

1 By application lodged at the Court Registry on 3 July 2013, the EFTA Surveillance Authority ("ESA") brought an action under 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 ("SCA"). In the application, ESA addresses an alleged failure by Iceland to fulfil its obligations under Articles 31 and 40 EEA by imposing an immediate tax on assets and shares of companies that merge cross-border with companies established in other EEA States and on shareholders of such companies, whereas similar transactions within the Icelandic territory, do not attract any immediate tax consequences. According to ESA, the different treatment between mergers within the Icelandic territory and cross-border mergers is not justified and is therefore incompatible with Articles 31 and 40 EEA.

II Legal background

EEA law

2 Article 31 EEA reads:

> *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 take up and pursue activities as self-employed persons and 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.*
>
> …

3 Article 34 EEA reads:

> *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.*

> *‘Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.*

4 Article 40 EEA reads:

> *Within the framework of the provisions of this 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 XII contains the provisions necessary to implement this Article.*

5 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty (OJ 1988 L 178, p. 5), referred to at point 1 of Annex XII to the EEA Agreement, implements Article 40 EEA. Article 1(1) of the Directive obliges the EEA States to abolish restrictions on movements of capital taking place between persons resident in the EEA States. The Article refers to a non-exhaustive Nomenclature in Annex I to the Directive, in which capital movements are classified. Point a) under Heading III of the Nomenclature classifies operations in shares and other securities of a participating nature as capital movements.

National law

6 Under Icelandic law, a cross-border company merger, where the shareholders of the merging company are only paid with shares in the acquiring company as a payment for the liquidated company (merger with exchange of shares), will lead to immediate taxation on the capital gains for shareholders according to Article 18 paragraph 2 of Act No 90/2003 on Income Tax (*lög nr. 90/2003 um Tekjuskatt*) (“ITA”), if the market price of the shares is higher than the purchase price. The difference between the purchase price and the market price will be taxed as dividends. The same principles applies to a company that is being dissolved without going into liquidation and transfers all its assets and liabilities to a foreign company holding all the securities or shares representing its capital (merger without the exchange of shares).

7 However, pursuant to Article 51 paragraph 1 ITA, domestic mergers, with or without the exchange of shares, are to be exempted from tax in Iceland.

8 In its binding opinion No 1/08 of 4 February 2008, the Directorate of Internal Revenue (*Ríkisskattstjóri*) concluded that the tax exemption in Article 51 paragraph 1 ITA is not to be applied in cross-border mergers.

III Facts and pre-litigation procedure

9 On 22 March 2010, ESA informed the Icelandic Government that it, on its own initiative, had opened a case regarding the immediate taxation of cross-border mergers, and invited Iceland to provide further information on the matter.

10 By letter of 26 April 2010, Iceland provided the requested information, and the matter was discussed at a meeting in Iceland on 3 and 4 June 2010. Following the meeting, ESA invited Iceland to keep it up-to-date on any development on the issue.

11 On 6 August 2010, ESA received a complaint against Iceland for levying immediate tax on companies exiting Iceland when merging cross-border. By letter of 11 August 2010, ESA informed the Icelandic Government of the complaint, and invited Iceland to provide information. Iceland replied to the request by letter of 13 September 2010.

12 By letter of 28 April 2011, ESA invited Iceland to provide further information. Iceland replied by letter of 26 May 2011. The immediate tax imposed on cross-border mergers was discussed in a meeting between ESA and Iceland on 7 and 8 June 2011. In a follow-up letter dated 24 June 2011, Iceland was invited to provide further information. Iceland provided information by letter of 14 July 2011.

13 On 8 February 2012, ESA issued a letter of formal notice to Iceland for failing to comply with its obligations pursuant to Articles 31, 34 and 40 EEA. Iceland replied to the letter of formal notice by letter of 7 May 2012, acknowledging that legislative amendments concerning the immediate taxation of cross-border mergers were needed, and that such amendments would be part of the legislative agenda for the autumn of 2012. The case was discussed further at a meeting in Iceland on 7 June 2012.

14 By email of 25 September 2012, confirmed in a letter of 18 October 2012, Iceland informed ESA that the amendments to the Icelandic tax rules on cross-border mergers were not on the parliamentary agenda for the autumn of 2012.

15 On 28 November 2012, ESA delivered its reasoned opinion to Iceland, concluding that, by maintaining into force a difference in treatment between domestic mergers and cross-border mergers as a result of the application of Article 51 paragraph 1 ITA, Iceland has failed to fulfil its obligation arising from Articles 31, 34 und 40 EEA. Pursuant to the second paragraph of Article 31 SCA, ESA requested Iceland to take the measures necessary to comply with the reasoned opinion within two months following notification thereof, that is no later than 28 January 2013.

16 By letter of 23 January 2013, Iceland replied to ESA’s reasoned opinion, explaining that a bill amending the current exit tax rules was currently being

prepared and the amendments were expected to be approved by the end of March 2013.

17 On 28 February, the Ministry of Finance and Economic Affairs submitted a proposal to the Parliament for amendments to the ITA and the Act on the Withholding of Public Levies at Source No 45/1987 (*Iög nr. 45/1987 um staðgreiðslu opinberra gjalda*). According to the proposal, the intention was to include amendments to the rules on exit taxation of cross-border mergers in Article 51 ITA. However, as Iceland informed ESA by letter of 2 April 2013, the issue turned out to be more complex than expected. Therefore, the proposal for amendments to those rules would not be ready until the autumn of 2013, and would not enter into force until 1 January 2014.

IV Procedure before the Court and forms of order sought

18 ESA lodged the present application at the Court Registry on 28 June 2013. On 23 September 2013, Iceland submitted its statement of defence. The reply from ESA was registered at the Court on 26 September 2013. By e-mail of 8 October 2013, Iceland waived its rights to submit a rejoinder.

19 The applicant, ESA, requests the Court to:

> *1. Declare that by maintaining into force a difference in treatment between domestic mergers and cross-border mergers as a result of the application of Article 51 paragraph 1 of Act No 90/2003 on Income Tax (lög nr. 90/2003 um tekjuskatt), Iceland has failed to fulfil its obligations arising from Articles 31 and 40 of the Agreement on the European Economic Area.*
>
> *2. Order Iceland to bear the costs of these proceedings.*

20 The defendant, Iceland, does not dispute the declaration sought by ESA. Iceland acknowledges that legislative steps will need to be taken in order to address ESA's concerns. A draft bill is expected to be presented to the Parliament during its current legislative session.

21 Due to the circumstances of the case, Iceland requests the Court to:

> *Order each party to bear its own costs of the proceedings.*

22 After having received the express consent of the parties, the Court, acting on a report from the Judge-Rapporteur, decided pursuant to Article 41(2) of the Rules of Procedure ("RoP") to dispense with the oral procedure.

V Findings of the Court

23 Article 31 EEA prohibits all restrictions on the freedom of establishment within the European Economic Area, whereas Article 40 EEA prohibits all restrictions

on the free movement of capital in the area. National measures liable to hinder, or make less attractive the exercise of those fundamental freedoms, are an encroachment upon the freedoms requiring justification (see Case E-2/06 *ESA* v *Norway* [2007] EFTA Ct. Rep. 164, paragraph 64, and the case law cited).

24 Article 31 EEA is aimed at ensuring that foreign nationals are treated in the same way as nationals of that State. It also prohibits the EEA State of origin from hindering the establishment in another EEA State of a company which is incorporated under its legislation (see Case E-15/11 *Arcade Drilling* [2012] EFTA Ct. Rep. 676, paragraph 59, and the case law cited).

25 It is settled case law that even though direct taxation falls within the EEA States' competence, the EEA State must nonetheless exercise that competence consistently with EEA law (see Case E-1/04 *Fokus Bank* [2004] EFTA Ct. Rep. 11, paragraph 20, and the case law cited).

26 In the field of taxation, the prohibition on discrimination, whether it has its basis in Articles 4, 31 or 40 EEA, requires that, for tax purposes, comparable situations must not be treated differently and that different situations must not be treated in the same way unless such treatment is objectively justified (see *Arcade Drilling*, cited above, paragraph 60, and the case law cited).

27 The Court recalls that 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 (see Case E-9/11 *ESA* v *Norway* [2012] EFTA Ct. Rep. 442, paragraph 79).

28 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 the company merges cross-border, 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 (see *ESA* v *Norway*, cited above, paragraphs 79 to 82, and the case law cited).

29 It is undisputed that the difference in treatment between domestic and cross-border mergers with regard to the tax exemption in Article 51 paragraph 1 ITA represents a restriction on the right to establishment and the free movement of capital pursuant to Articles 31 and 40 EEA. It is also undisputed that the measure cannot be justified.

30 The question of whether an EFTA State has failed to fulfil its obligations must be determined by reference to the situation in that State as it stood at the end of the period laid down in the reasoned opinion (see, *inter alia*, Case E-11/13 *ESA* v

Iceland, judgment of 15 November 2013, not yet reported, paragraph 21, and the case law cited).

31 It is not disputed that at the time the period prescribed in the reasoned opinion expired, Iceland had not adopted the measures necessary to rectify these shortcomings.

32 It must therefore be held that, by maintaining in force a difference in treatment between domestic and cross-border mergers as a result of the application of Article 51 paragraph 1 of Act No 90/2003 on Income Tax (*lög nr. 90/2003 um tekjuskatt*), Iceland has failed to fulfil its obligations arising from Articles 31 and 40 EEA.

VI Costs

33 Under Article 66(2) RoP, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the EFTA Surveillance Authority has requested that Iceland be ordered to pay the costs and the latter has been unsuccessful and since none of the exceptions in Article 66(3) apply, Iceland must therefore be ordered to pay the costs.

On those grounds,

THE COURT

hereby:

1. **Declares that, by maintaining in force a difference in treatment between domestic and cross-border mergers pursuant to Article 51 paragraph 1 of the Icelandic Act No 90/2003 on Income Tax (*lög nr. 90/2003 um tekjuskatt*), Iceland has failed to fulfil its obligations arising from Articles 31 and 40 of the Agreement on the European Economic Area.**

2. **Orders Iceland to bear the costs of the proceedings.**

Carl Baudenbacher Per Christiansen Páll Hreinsson

Delivered in open court in Luxembourg on 2 December 2013.

Gunnar Selvik
Registrar

Carl Baudenbacher
President