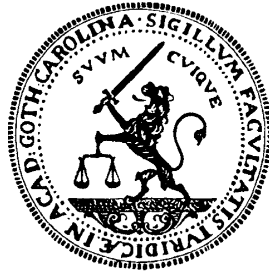

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Harmful Taxation, From an Icelandic Perspective

Master thesis
20 points

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European Tax Law

Spring 2002

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Summary

Iceland has now become a player in the global tax competition. Many questions have thus arisen regarding the international taxation environment. Tax reductions were in fact more than in any other country in the year 2001, where among other measures, the corporate tax rate in Iceland was lowered from 30% to 18%. It has been maintained, that Icelandic Authorities are completely independent in matters of taxation, without any regard to the European Economic Area.

Iceland's membership of the EEA ensures access to the EU´s single market. As Europe has moved increasingly to a Single Market, companies have had to organize their operation on a European scale. The competence of the area of direct taxes does not fall under the jurisdiction of the European Union, even if the indirect taxes, such as VAT (Value Added Tax) and excise taxes are within the power sphere of the European Union. However, in Art. 56 EC, it is stipulated that the EU should abolish any obstacles that hinder free flow of capital between MS. In order to meet these objectives, there have been adopted directives by the Council., for example the Parent-Subsidiarity Directive. The EC Directives on taxes are not included in the EEA Treaty.

The power of taxation ensures the sovereignty of the state, providing the necessary public funds for the state to function. The question therefore arises: How is the national power of taxation limited by the fundamental freedoms and non-discrimination clauses of the EC Treaty?

The main interest of this thesis is establishing the status of Iceland as a tax competitor. Generally speaking the concept "tax competition" can involve a good or a bad form of tax competition, depending on the underlying aim of the country in question.

Tax law does not make up part of the EEA Treaty - in principle. However, there are consequences that arise on the basis of the fundamental freedoms and competition, including State aid - this also applies with regard to the autonomy of tax law of the EEA Member States. The nature of these consequences and the EU-EEA environment form the structure of this thesis.

In my opinion the Code of Conduct does affect Iceland. The implication of this statement is not the Code is applicable by itself as an instrument to control the tax legislation in Iceland. Quite the opposite, the Code of Conduct is not applicable in any way in Iceland, but the restraints that it puts on taxation policy on the Member States, must have the effect of strengthening Iceland's position as a serious tax competitor. The conclusion is that a corporate-friendly tax rate, a membership in the Internal Market, without the pressure of the Code of Conduct rules and the Monetary Union gives Iceland a good position in European tax competition. Finally it must

be concluded, that the measures that the Icelandic Government has taken so far, fall under the definition of “good” tax competition and not harmful tax competition.

Abbreviations

EFTA	European Free Trade Association
GDP	gross national product
ISK	Icelandic kronas, the currency of Iceland
MNE	Multi national entities
MS	Member State
KPMG	a Swiss non-operating association

1. Introduction

1.1 Purpose and outline

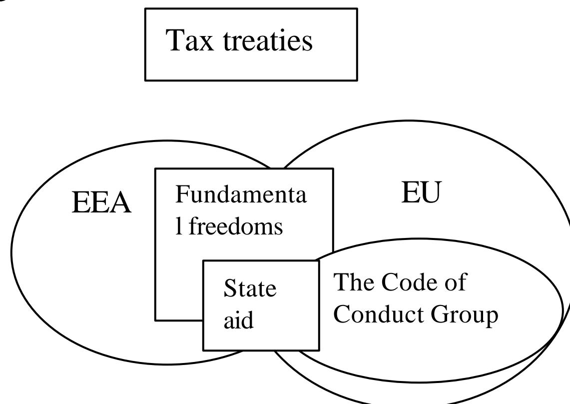
Globalization and the technological revolution have created many new challenges for tax authorities. Among these challenges is harmful tax competition, a concept that embraces tax practices which erode national tax bases, distort trade, investment and the shift of tax burden to labor.[1]

As will be discussed later, Iceland has become a player in the global tax competition, which raises several questions regarding this environment: What are the constraints and the possibilities of tax competition – what does it in fact entail? Is Iceland is completely free to design its´ tax system, without any regard to the European Union? What the scope of the EEA Agreement? Is tax competition acceptable in the EU? Does the Code of Conduct have any influence on Iceland?

The title of this paper can be a little misleading. However, the Icelandic perspective is the red thread through the paper and taxation and harmful tax competition are discussed from that perspective.

The following figure shows the problem at hand – the assignment is making it all fit together.

Figure 1.



Hopefully, this paper will give a clearer picture of the issue. The starting point is an analysis of Iceland regarding the recent developments in matters of taxation. A chapter on tax competition is next in line. A rather detailed discussion on the EEA Agreement follows in chapter three, followed by an outline of the institutions of the European Union. Finally we come to the subject of tax law in the European Economic Area, followed by a limited

[1] Katsushima, Harmful Tax Competition, Editorial, Intertax, Volume 27, issue 11, Kluwer Law International 1999, p. 396.

discussion on the Code of Conduct. The final chapter responds to previous discussion, followed by a summary.

It is far from easy to locate the exact place for Iceland in the context of European taxation as such, thereby establishing what, if any, of the acquis communautaire is applicable and/or binding.

1.2 Limitations

Iceland is a member of EFTA and linked to the European Community by the EEA Agreement. Iceland is also a member of the OECD, but despite a very interesting discussion on harmful tax competition in the OECD countries, this paper is not the forum for that discussion. I admit, that it could be seen as a fault, not using the opportunity to compare and analyze the measures made on the one hand the EU and the other the OECD in regards on harmful tax competition, but my evaluation was that this would expand the subject at hand too much and take it out of the EEA perspective, which is the main focus of the following discussion.

It is however relevant to mention in this context, the following comment made by a high official within the OECD; "Only the less talented pay taxes anymore"[2]. This comment shows that harmful tax competition is not only European, but a global issue. The OECD Report on harmful tax practices is mentioned only in comparison in chapter 7 on the Code of Conduct.

This paper is limited to the issue of direct taxation, hardly mentioning the subject of indirect taxation at all.

Furthermore are bilateral or multilateral tax treaties outside the scope of this paper as well, even though some of the judgments of the European Court of Justice may touch upon the subject alongside other issues.

Finally, the obvious must be stated, that the following discussion is very limited and does not do justice to the vast and extensive subjects at hand.

[2] So commented by Tommy Persson in class in International skatterett at the University of Lund, in spring 2001

2. Iceland – background and recent changes

2.1. General introduction

Iceland's situation is in many ways unusual compared to most other Western European countries. The Icelandic nations' most radical cultural and economic changes occurred in the 40s when British and later American forces occupied the country, after a stable period for centuries. The influence, by far more by the Americans, was enormous.

The structure and economy of the society had for centuries undergone rather modest changes compared to other nations on the Western hemisphere, as the industrial revolution had had a very limited effect on the economy of this isolated nation. Followed by the vast amount of foreign currency and cultural influence large structure changes happened to the society. People moved in vast quantities from the countryside to the capital, Reykjavík, and many received for the first time a regular salary, paid in money, for their work.

After the Second World War, Iceland received higher amount of financial assistance, the Marshall help, than any other nation in the world. In addition to the high amount of currency that had flowed into the Icelandic economy in relation to the British, and more further the American forces, this had a revolutionary effect on the nation, which has in no other period witnessed such fast and radical changes.

Due to this fact Iceland has without doubt received considerable influence from the American culture - rather than European influence, in the latter half of the 20th century. Certain political mainstreams have followed. The Conservative Party is for example by far the largest party in the country, usually with support from about 40% of registered voters. Socialists and Social democrats hold only a fraction of the support that similar parties have in most other Western-European countries. A liberal view of the officials' role in the society is therefore more apparent in Iceland than its neighboring countries.

Furthermore, Iceland has no official army and does not have to sponsor the country's defense. Contrary to paying a percentage of its' income to defenses; it has received a generous sum of money from the American forces.

The Icelandic Prime Minister has stated, that he opposes EU membership and furthermore there are indications, that membership will not be agreed upon, as the fishery industry is too important for the economy to limit Iceland's sovereignty in this important area.

2.2. Taxation in Iceland

Partly because of the facts stated above, and partly because of the aim of attracting capital, Iceland has become among those European countries, which have the lowest income tax on business. Even more tax reductions have occurred in Iceland last year. They were in fact more than in any other country,[3] as established an annual research on business taxation, made by the KPMG International Tax and Legal Center in January 2002.[4]

In 2001, the corporate tax rate in Iceland was lowered from 30% to 18%, as of 1 January 2002.[5] Other changes were made as well, such as a reduction of the corporate net wealth tax, from 1.2 per cent to 0.6 per cent at the end of 2002. Furthermore, The corporate net wealth surtax is to be abolished at the end of 2002, as well as inflation accounting. Corporations were to be authorized to keep their books and draw up their accounts in foreign currency as of the same tax and finally, the social security tax was to increase by 0.77 per cent as of 1 January 2003. In addition to this, there is a reason to believe that the corporate tax rate will be lowered even more in the near future.[6]

In the last few years, reforms have been enacted in the field of holding company taxation. An important reform is the advance ruling system, which can create guidelines concerning the computation of taxable income, in relation to certain head office activities carried out in Iceland.[7]

As mentioned in the introduction, these changes have the effect of entering Iceland into the area of tax competition.

The method of lowering the corporate tax brings to mind the actions of the Irish Government, where the business taxation rate is substantially lower than the aforementioned development in Iceland. In chapter 9, the situation in Ireland and recent changes and changes and problems connected with Irish taxing policy are shortly discussed.

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[3] http://www.kpmg.is , the research was done in 68 countries, among those the 30 OECD countries, to many countries in South America, as well as countries in Asia and in the South Pacific.

[4] KPMG, an international company, specializing in accounting and taxation matters

[4] Quote the law in question – nb.

[6] In The Economist, 14. April 2001, Mr. David Oddsson, Iceland´s Prime Minister, announced his goal to lower the corporate tax rate from 30% to 15%.

[7] Valdimarsson, G., Iceland A Location for International Holding Companies?, European taxation, June 2001, p. 227-228.

3. Tax competition

Tax competition is highly relevant for Iceland, with the recent changes of the corporate tax rate that were discussed here before. This chapter is meant to find out what the concept tax competition comprises.

Regarding the subject ahead, tax competition, to my knowledge, has not been a big issue within EFTA and in fact until the nineties, the phenomenon tax competition between sovereign states within the European Community or globally, was not a matter of special concern or subject to an international or Community regulation. Not until recently has tax competition become a real concern of the Community.[8]

3.1. Introduction

Commissioner Mario Monti **made the following statement** when he was introducing the Commission's proposal to set up a new permanent Taxation Policy Group:

> **T**axation is an integral part of our lives. It is, of course, the source of revenue from which the state provides its citizens with public infrastructure and social benefits. Beyond this, tax policies affect a number of social and economic objectives. They have a vital role to play in the European Union in creating the smoothly functioning Single Market that is essential for our future prosperity. And they must also be viewed in the context of the Community's shared objectives of promoting employment, stimulating enterprise and protecting the environment.
> ... While fully supporting the principle that Community action is only needed where measures cannot best be taken at a national level, the Commission believes that closer and better coordination is vital. This is also necessary to prevent the rapid liberalization of trade and investment flows from further eroding the effective sovereignty of MS in favor of the markets.
> ...We must also continue to pay attention to the threat of fiscal erosion, an underlying concern that came up time and again during the work of the High Level Group. Unfair or harmful competition for tax revenues can erode certain tax bases, resulting both in a loss of revenue and in the distortion of tax syst**ems.**

These words capture the important elements behind historical developments in the area of taxation within the European Union, among them measures

[8] Santon, A. C., Point J of the Code of Conduct or the Primacy of Politics over Administration, European taxation, September 2000

taken by the Commission and other Community institutions, to counter harmful tax competition.

3.2. Tax competition – does it exist?

An important starting point is to keep in mind, that the fiscal systems as a whole are in competition, but not the isolated tax systems of competing states, i.e. the pattern of revenue and expenditure.[9]

In a working paper from the European Parliament; Tax Co-ordination in the European Union, European Parliament, a research was done on changes in certain direct tax rates, in the years 1986-1997.

One of the conclusions was, that it was clear that tax competition had not had the long-term effect of reducing tax bases, either within the EU or the OECD. Surprisingly, the percentage of GDP taken in tax had shown a steady tendency to rise. However, the increase in overall taxation over the last few years was only marginal compared to the previous twenty, and some EU countries even experienced a modest fall. In the working paper, the possible conclusion was addressed, that tax competition has effectively "capped" the tendency for taxes to rise in relatively high tax countries, and produced a convergence within the EU. This conclusion goes against the aforementioned speech made by Mario Monti in 1997.

Another conclusion in the working paper, was that the figures did not show any recent tendency for direct taxes or social security contributions to rise more markedly than taxes overall. However, there was over the period 1984-94 there a shift to taxes on labor from taxes on other production factors in the EU as a whole, though this was not the case in all MS. It is a fact, that falling rates of corporate taxes tend to confirm an average shift of the tax burden from the "mobile" to the "immobile" tax base.

On the other hand, differing tax structures make for sharp variations in these effects and as an example some countries like Denmark and the UK rely less on direct social charges than countries like France. Many factors, among them differing tax structures, may well explain why tax competition classified as "harmful" by one MS is not considered to be so by another."[10]

In a study of Chennels and Griffith[11] on tax competition between countries, the conclusion was that no findings supported the hypotheses that small countries set lower taxes than large countries or that a difference in tax rates

[9] Tax co-ordination, in the European Union, European Parliament, working paper, Directorate- p. 74
[10] Tax Co-ordination... p. 73
[11] Chennels, L., Griffith, R., Taxing Profits in a Changing World. Institute of Fiscal Studies, London. A study from 1997, calculating effective and implicit tax rates for the period 1979-1994.

between small and large countries depended on mobility of capital. Other surveys conclude that there is evidence for international tax competition.[12]

3.3. "Good" or harmful tax competition

The concept "tax competition" is generally speaking referred to as the improvement of a country's national economy as compared to foreign jurisdictions by lowering internal tax burden to increase the competitiveness of domestic business or to attract foreign direct investments.

Tax competition can be both good and bad – i.e. harmful – depending on the underlying aim of the country in question. Good tax competition can force governments to maintain low levels of expenditure. This kind of tax competition is meant to achieve fairness and neutrality in the tax systems, leading to desirable changes in the tax structure, such as broadening of the taxable base and lowering of tax rates.

Where the goal, on the other hand, is primarily to attract foreign direct investments, this can result in a harmful tax competition. An example of such harmful tax competition is a reduction of a corporate tax rate applicable on income earned by foreign investors or a reduction of withholding tax rates on outbound income distributions. The most dangerous economic implication of harmful tax competition is the ultimate erosion of the taxable base.[13] There exists no general, comprehensive and universally accepted definition of harmful tax competition.[14]

One of the examples of unfair tax competition are tax incentives that are designed to attract "footloose" investment, with the possible effect of distorting economic behavior of consumers, workers or investors to prejudice the fair working of the Single Market. The erosion of tax bases is also an obvious possibility.[15]

3.4. Harmful tax competition – when is it harmful?

Competition between tax systems as a whole, can include the overall level of taxation, the balance between direct, indirect and the general structure of rates, as well as competition based on special arrangements for particular

[12] Schjelderup, G., International Tax Competition: Is it Harmful, and if so, What are they Policy Implications? The Globalisation Project, Norwegian Ministry of Foreign Affairs, April 2002, p. 18.
[13] Pinto, C., EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken?, Intertax, Volume 26, Issue 12, 1998, p. 386-387.
[14] Pinto, C., EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken, Intertax, Volume 26, Issue 12, Kluwer Law International 1998, p. 394.
[15] Tax co-ordination, p. 73

activities or areas, or administrative features that have the effect of distorting competition.

Whether competition between tax systems can be considered “fair/good” or “unfair/harmful” is really a political question and the fact has to be taken into account that all MS are democracies, which should be able to make choices like relatively low tax levels or particular tax structures, even if the result brings about a competitive advantage.

A very important fact is that the tax systems in isolation are not in competition, but fiscal systems as a whole – that is, the pattern of both revenue and expenditure. A good example is, that low corporate tax rates may attract investment; but poor infrastructure and a poorly-educated workforce may repel it.

If we take an example of two countries, A and B, that both have a general level of taxation equal to 50% of their GDPs. Country A finances this through high rates of indirect taxation, with relatively low rates of corporate tax: country B in the reverse way. Tax competition exerts a downward pressure on indirect tax rates in country A, and on corporate rates in country B. This would result in:

A. Downward pressure on the overall tax level in both countries
B. Convergence of tax structures.[16]

3.5. Special tax arrangements

Special tax arrangements, rather than tax systems as a whole, are generally what harmful or unfair tax competition refers to.

In the aforementioned working paper from the European Parliament; Tax Co-ordination in the European Union, special tax arrangements are analyzed as being of two kinds:

1. Tax arrangements, which distort competition as an incidental consequence of their main purpose. The Commission has for example highlighted the differences in the corporate tax base, which result in a large number of marginal effective corporate tax rates. These can vary by around 200%, depending on among other industrial sector, mode of finance and category of investor and can strongly influence the choice of tax jurisdiction in which companies invest.

2. Tax arrangements being the primary purpose of which is to affect competition. The most obvious example of the second category is regional/State aid, which is distributed via preferential tax

[16] Tax Co-ordination in the European Union, European Parliament, working paper, Directorate- p. 74.

arrangements. There is a continuing debate over State aids – this subject will be touched upon later in this paper, with regards to taxation. Preferential treatment for one geographical area is obviously "unfair" to others. On the other hand, this is usually the precise point of the policy. The creation of the euro area and the need to limit the danger of "asymmetric shocks" within it will possibly heighten this dilemma in the future[17]. Furthermore it can also be argued that zero rates of withholding tax on interest paid to non-residents are specifically intended to attract savings. The Commission has referred to this as a factor both in the erosion of MS´s tax bases and the misallocation of investment. However, in this case the competition is not merely within the EU, but global.

3.6. Approximation of national tax law

The approximation of national tax law where the European Community has legislative competences is also to be considered in this regard.[18] Member States still have veto in the area of direct taxes and thus it has never been possible to establish international tax neutrality by harmonizing direct taxes. A fundamental change has however occurred, as growing international tax competition has the possibility to restrict the scope of fiscal action of a single country. The Commission has therefore, since 1996, aimed at further approximation of the tax systems of the MS. In a report from 1996[19], the Commission distinguished between "loyal" and "harmful" tax measures. The harmful or unfair tax competition have been identified by the OECD Committee on Fiscal Affairs in their Guidelines[20] and by the European ministers of finance in the Code of Conduct for business.[21]

Despite the "benign" report of the European Parliament regarding tax co-ordination in the EU, there seems to be a common consent among the MS that an action at the Community level is needed to fight against harmful tax competition. The reasons are the following:

a. the erosion of national tax bases through unfair tax competition represents a threat to the tax revenues of the MS.
b. The competition can reduce fiscal revenue, which can lead to a shift in the balance towards the labor force that leads to negative effects on labor costs.
c. Harmful taxation hinders the smooth functioning of the Single Market, as it undermines its basis of fair competition.

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[17] "Adjusting to Asymmetric Shocks", Economic Affairs Series, Working Paper ECON 104 European Parliament, DGIV, September 1998.

[18] Schön, W., Tax Competition in Europe – the legal perspective, EC Tax Review 2000-2, p. 97

[19] Taxation in the European Union - Report on the Development of Tax Systems, COM (96) 546 final from 22nd of October 1996.

[20] OECD, Harmful Tax Competition – An Emerging Global Issue (1998)

[21] Schön, W., Tax Competition in Europe – the legal perspective, p. 96-97

The European Union was the first governmental body to formulate measures against harmful tax practices, as the EU released its Code of Conduct in 1997. The Code provides five broad criteria for determining a harmful tax regime. In addition, the Member States have made a commitment not to introduce new tax measures that are considered to be harmful and to review and abolish existing harmful law and practices. A timetable was set to eliminate harmful tax competition among the EU states.[22] The Code of Conduct will be discussed further on, in chapter six.

[22] Katsushima, Harmful Tax Competition, Editorial, Intertax, Volume 27, issue 11, p. 396.

4. The EEA Agreement

This chapter explains shortly the history of the EEA Agreement and the institutions that were created in the Agreement. A discussion on methods to solve inevitable disputes is then followed by the subject of the nature of the Agreement and changes of the MS and how they reflect on the Agreement. The Nature of EFTA vs. the EU is next in line. For the sake of equilibrium, there is a short chapter on the history and institutions of the European Union. In conclusion there is a table showing the common institutional structure of the European Economic Area. This discussion is vital to the subject at hand, for placing the area of taxation in it's context.

4.1. EFTA, creation of the EEA & Institutions

The European Free Trade Association (EFTA) is an international organization comprising four states, Iceland, Liechtenstein, Norway and Switzerland.

The EFTA Treaty was originally made and signed by Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom, as an association of countries similar to the EEC. Finland and Iceland also joined EFTA, but the founding countries except Norway and Switzerland gradually joined the EEC.

Three of the four member states (Iceland, Liechtenstein and Norway) have structured their relations with the European Union (EU) in the form of the Agreement on the European Economic Area (EEA). They participate in the Single Market through the agreement.[23] The Icelandic Implementation was through the EEA Act from 1993.[24]

The idea of a European Economic Area dates back to a joint EFTA-EEC ministerial meeting in Luxembourg in 1984. Between 1984 and 1989 the removal of obstacles to trade was undertaken on a case- by-case basis. In 1989, Jacques Delors, who was the chairman of the European Commission at that time, launched a plan to expand the internal market to the EFTA states, to form a European Economic Area EEA. The negotiations were difficult as the law had to be homogenous and adapted or both the EEC and the EFTA states without diminishing legal protection within the Community.[25]

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[23] http://www.efta.int

[24] *The EEA Act 1993 (Lög um evrópska efnahagssvæðið). For the Icelandic administration, the adaptation of national legislation to the EU's single market legislation, accumulated over a period of thirty years, was indeed an ambitious undertaking. Tens of thousands of pages of legal text were identified, translated, published and implemented over a relatively short period.*

[25] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, EC TAX Review, 2001 – 1, p. 26-27.

The EEA Agreement was entered into in May 1992, for the purpose of including the Member States of the EFTA, in the common market.[26] It was to have comprised the EC and (then) the seven EFTA States, but Switzerland failed to ratify the EEA Agreement. Under the EEA Agreement, which entered into force on January 1994, these States are subject to the existing body of Community law (the acquis communitaire) relating to the internal market and competition and all future rules in this areas. The EFTA States are not represented in the EC institutions.[27] All the annexes and acts referred to in the EEA Agreement are integral parts of the Agreement, which means that EC secondary legislation that is relevant for areas covered by the EEA, is part of the Agreement.[28]

The ECJ denied the first chosen structure for interpretation and application of the Treaty, in accordance with Art. 164 of the EEC Treaty, in its opinion of 14th of December 1991.

4.1.3. Institutions & bodies[29]

The aim of the EEA Agreement is to guarantee the free movement of persons, goods, services and capital and to provide equal conditions of competition and abolish discrimination. A large part of the EEA Agreement is identical to the relevant parts governing the fundamental freedoms as in the Treaty of Rome of 1957. The novel idea and an important part of the Agreement is, that its common rules are continuously updated by new EC legislation.

This is made functional by a **EEA Joint Committee**, that incorporates a number of EEA-relevant pieces of legislation each month into the EEA Agreement. The Joint Committee is responsible for the ongoing management of the EEA Agreement. It provides the forum for exchange discussions and decision-making. Decisions to incorporate Community legislation into the EEA Agreement are taken by consensus. The Joint Committee is made up of ambassadors of the EFTA EEA states and representatives of the European Commission and EU member states. Five Subcommittees assist the Joint Committee.

The **EEA Council**, which is composed of the foreign ministers of the EU and EFTA & EEA countries, provides political impetus for the development of the Agreement and guidelines for the Joint Committee. Ministers meet at least twice a year to evaluate the functioning of the EEA Agreement and to discuss issues of mutual interest.

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[26] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation, p. 110

[27] Steiner, J & Woods, L., Textbook on EC Law, P. 11

[28] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation, p. 111

[29] This chapter is based on the EFTA website; http://www.efta.int

The **Joint Parliamentary Committee** (JPC) comprises members from the national parliaments of the EFTA & EEA states and members from the European Parliament. The Committee contributes through dialogue and debate to a better understanding between the Community and the EFTA states in the fields covered by the Agreement and expresses its views in reports and resolutions. The President of the EEA Council may appear before the Committee in order to be heard by it. In practice, representatives of the EEA Council, the EEA Joint Committee and the EFTA Surveillance Authority appear regularly before the Committee for exchanges of views. The JPC has a pure EFTA counterpart in the form of a committee of parliamentarians from the four EFTA states.

The **EEA Consultative Committee** consists of an equal number of members of the EFTA Consultative Committee and of members of the Economic and Social Committee of the EC (representing social partners/economic and social interest groups in the European Union). The EEA Consultative Committee works to strengthen contacts between the social partners on both sides and to co-operate in an organized and regular manner to enhance awareness and provide input on the economic and social aspects of the EEA. The EEA Consultative Committee expresses its views in the form of reports and resolutions. The EFTA social partners also meet in the EFTA Consultative Committee.

Of the EFTA institutions established under the EEA Agreement, the **Standing Committee** of the EFTA States fulfils the role of coordinating body in preparing for meetings of the EEA Joint Committee. It is made up of representatives from Norway, Iceland and Liechtenstein and observers from Switzerland and the EFTA Surveillance Authority. It serves as a forum in which the EFTA & EEA countries consult one another and arrive at a position before meeting with the EU side in the Joint Committee. Its structure mirrors that of the EEA Joint Committee, with five subcommittees and a large number of working groups.

Constitutional problems that arose by allowing EU institutions to take decisions applicable to the EFTA countries required the establishment of two other important bodies in the EFTA pillar. A two-pillar system of supervision of the Agreement was devised: the EU Member States are supervised by the EC Commission and the EFTA States party to the EEA by the EFTA Surveillance Authority.

The former is the **EFTA Court**, based in Luxembourg. The EFTA Court corresponds to the Court of Justice of the European Communities in matters relating to the EFTA EEA states. The Court deals with infringement actions brought by the ESA. Furthermore the court hears appeals concerning decisions taken by the ESA and gives advisory opinions to courts in the EFTA States on the interpretation of EEA rules.

The latter is the **EFTA Surveillance Authority**, based in Brussels, ensures that the EFTA & EEA states fulfill their obligations under the EEA

Agreement. As well as general surveillance of compliance, the Surveillance Authority has wider powers in relation to competition, State aid and public procurement, reflecting the extended competencies of the European Commission in these fields within the Community.

From the institutional viewpoint, the EEA is well equipped, as can be seen above. [30] However it is relevant that the institutions within EFTA have always been rather weak, and the application of the agreement has been different and less forceful than enforcement of the Treaty of Rome. [31]

4.2. Disputes and repercussions

The jurisdiction of the EFTA Court mainly corresponds to the jurisdiction of the Court of Justice of the European Communities over EC States[32], but the EFTA Court has a more limited competence than the EC Court. The EFTA Court deals with infringement actions, that are brought by the ESA[33], against an EFTA State, regarding the implementation, application or interpretation of an EEA rule, for the settlement of disputes between two or more EFTA States, for appeals concerning decisions taken by the EFTA Surveillance Authority and for giving advisory opinions to courts in EFTA States on the interpretation of EEA rules.

Furthermore, one MS may bring a case before the EFTA Court against another MS.[34]

Citizens of the EFTA States and the MS themselves can bring cases against the ESA for illegality or impropriety of its decisions, or for failure to make obligatory decisions. There are no sanctions against MS who refuse to comply with decisions of the EFTA Court. The EFTA Court can also give opinions to domestic Courts, but such opinions are not binding on the domestic courts, even if domestic Courts still rely on the opinions of the EFTA Court in many cases.[35]

As the intention is to maintain a homogenous interpretation of Community law and that part of EEA law which is identical to it, the Joint Committee is charged with keeping the development of the case-law of the Court of Justice and the EFTA Court under constant review, to preserve the homogenous interpretation of the Agreement.[36] If a difference in case law of

[30] Kaptayn P.J.G., & VerLoren van Themaat, P., Introduction to the Law of the European Communities, p. 1333

[31] Björn Friðfinnsson, Permanent Secretary of the Ministry of Justice and Ecclesiastical Affairs, http://www.ees.is

[32] The EFTA website; http://efta.int

[33] Art. 31 of the Agreement between the EFTA States on the establishment of a surveillance authority and a Court of Justice, signed in Oporto 2 May 1992.

[34] Art. 32 of the Agreement – see footnote 34.

[35] Leegard, T., Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p 111.

[36] Art. 105(2) EEA.

the two courts arises, the Joint Committee, in order preserve homogenous interpretation is to act according to a special procedure. If the Joint Committee has not resolved the dispute within two months, the parties may place the matter before the Court of Justice for a ruling on the interpretation of the relevant rules. This applies however only if the dispute concerns provisions of the EEA Agreement which are identical in substance to those of the EC or ECSC Treaties and legislation adopted hereunder. If the Joint Committee has not resolved the dispute within six months or if the Contracting Parties have not referred the matter to the Court of Justice, safeguard measures may be taken or provisional suspension of the disputed provision may follow.[37]

It should also be mentioned, that there have been changes in Icelandic Tax Law, due to the actions of the EFTA Surveillance Authority, without involvement of the Court.[1] One amendment worth mentioning is a stipulation in the Icelandic tax law that enabled private persons to deduct a certain amount of Icelandic kronas from their taxable income, if they had bought shares in Icelandic companies with certain conditions. These provisions were changed to include purchase of shares in companies in the European Economic Area, as changed with Law nr. 86/2000, amending Act 75/1981, on income- and property tax.

4.3. The nature of the EEA Agreement

The EEA Agreement has in many ways a special character for a multinational treaty. For example, the institutional structure is advanced, but the quality of a dynamic agreement is somewhat unusual, because there are no legislative powers conferred on the EEA institutions. Supremacy of EEA law is another quality, the instruments of implementation consistent with EC law. The Principle of uniformity is yet another element, imposing a duty of a uniform interpretation in future case-law development in areas that are corresponding to the EC treaties.

4.3.1. Dynamic

A very important objective of the EEA Agreement is the objective of establishing a dynamic and homogeneous European Economic Area, as stated in the preamble of the Agreement. As explained before, EC secondary legislation that has been recognized as relevant for the areas that are covered by the EEA is part of the agreement itself. In principle, the EEA Agreement is a traditional multinational treaty.

[37] Kaptayn P.J.G., & VerLoren van Themaat, P., Introduction to the Law of the European Communities, p. 1333

4.3.2 Uniform

Article 6 of the EEA Agreement imposes the duty of a uniform interpretation in future case-law development in areas that are corresponding to the EC treaties[38]. Art. 6 is the following:

> Without prejudice to future developments of case-law, the provisions of this Agreement, in so far as they are identical in substance to corresponding rules of the Treaty establishing the European Economic Community and the Treaty establishing the European Coal and Steel Community and to acts adopted in application of these two Treaties, shall, in their implementation and application, be interpreted in conformity with the relevant rulings of the Court of Justice of the European Communities given prior to the date of signature in this Agreement.

This provision makes the relevant jurisprudence of the ECJ up to the date of signing, binding on the interpretation and application of the EEA agreement by the ECJ, the EFTA Court and domestic courts in EEA MS.[39] There has been a debate whether the jurisprudence since the date of signing is binding as well and in practice. Furthermore, Art. 3 of the ESA/EFTA Court Treaty, adds that the jurisprudence of the ECJ has to be taken into account when it concerns provisions that are essentially equal to those of the EC Treaty, after the signature of the Treaty.[40]

The EFTA Court has treated jurisprudence of the ECJ as relevant in its judgments despite a later date than is specificly mentioned in Art. 6., as can be seen in the case of Islandsbanki[41],[42] where a judgment of the ECJ from 1995 was quoted.[43]

Furthermore, in the case Erla María Sveinbjörnsdóttir[44], the EFTA Court held that the nature of the EEA Agreement was an international treaty sui

[38] Björgvinsson, D.Þ., Afmælisrit Gauks Jörundssonar, p. 187-188

[39] Leegaard, Thor, Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 112

[40] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p. 32-33

[41] EFTA Court of Justice, Case E-1/00, State Debt Management Agency v. Islandsbanki FBA hf.

[42] Leegaard, Thor, Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 112

[43] "In addition, as the Court of Justice of the European Communities has previously held, the borrowing of money from a bank in another Contracting Party falls within the scope of capital movement within the meaning of the Directive (see insofar Case C-484/93 *Svensson and Gustavsson* [1995] ECR I-3955)."

[44] EFTA Court of Justice, Case E 9/97, Erla María Sveinbjörnsdóttir v. Government of Iceland, 10 December 1998. It was established in the judgment that i*t was a principle of the EEA Agreement that an EFTA State was obliged to provide for compensation for loss and*

generic, containing a distinct legal order of its own. The conclusion of the Court was that the agreement went further than normal international treaties, but had less profound effects than EC law.[45]

In a new judgment from the EFTA Court[46] the Karlsson case, the Court says among other that it follows from Art. 7 EEA[47] and Protocol 35 to the EEA Agreement that EEA law does not entail a transfer of legislative powers. Furthermore the Court says:

> At the same time it is inherent in the general objective of the EEA Agreement of establishing a dynamic and homogenous market, in the ensuing emphasis on the judicial defense and enforcement of rights of individuals, as well as in the public international law principle of effectiveness, that national courts will consider any relevant element of EEA law, whether implemented or not, when interpreting national law. .. " The Court goes on in another quotation: "The absence of recognition of direct effect for EEA rules does not preclude the existence of an obligation on the State to provide for compensation for loss and damage caused to individuals and economic operators as a result of breaches of obligations under the EEA Agreement for which that State can be held responsible.

The Court acknowledged state liability, despite its words that there was not direct effect for EEA rules.

4.3.3. Supremacy

Art. 7 of the EEA Agreement requires that the EFTA Member States implement the Agreement and subsidiary legislation in domestic law, in a way that is consistent with equivalent instruments in EC Law, even if the form and method of implementation is in discretion of the MS. When parliament decides in subsequent legislation to override the EEA Agreement, the national courts must follow that decisions rather than the Agreement. Special provisions in the relevant acts implementing the Agreement, in Iceland, secure the EEA Act from 1993 the supremacy of EEA law.[48]

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damage caused to individuals as a result of breaches of the obligations under the EEA Agreement, for which the State could be held responsible.

[45] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 111

[46] The Karlsson case from May 30th 2002, Case E-4/01.

[47] Art. 7 of the EEA Agreement requires that the EFTA MS implement the Agreement and subsidiary legislation in domestic law in a way that is consistent with equivalent instruments of EC law.

[48] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 113

4.4. Changes of the agreement? Diminishing importance?

The changes that have been made on the European Union since 1991, when the EEA Agreement was made, have without doubt diminished the importance of the EEA Agreement. Among the changes is diminished influence of the EFTA states on the legal development, partly with increased power of the European Parliament. With enlargement to the east, it is likely that the possibilities for the EFTA states to influence the direction and the work of the European Union will diminish even further, simply because there will be more Member States.

On the other hand, the enlargement of the European Union also means enlargement of the EEA Area, which can bring about more business opportunities for the EFTA countries, but also new problems.

The issue of enlargement of the European Union has many implications. An enlarged EU also means an enlarged Internal Market benefit that will affect all members of the EEA, comprising close to half a billion people with the world's largest Internal Market. Article 128 of the EEA Agreement stipulates that a State becoming a member of the EU shall become a member of the EEA.[49]

Even if the practical importance of the EEA Agreement has undoubtedly diminished as a result of the accession of Austria, Finland and Sweden to the European Union, the EEA phase facilitated the accession negotiations.

4.5. The nature of the EFTA vs. the EU

What is the difference between EEA and EU membership? There are four main criteria that describe the difference:

1. the EEA Agreement does not extend to all sectors (agriculture and fisheries being major areas not fully covered by the Agreement).

2. the EEA is not a customs union and has no common external tariff, although it provides for fundamentally improved free trade. Border controls amongst the EFTA EEA and EU states are greatly facilitated.

3. the EEA Agreement does not include a common commercial policy, but the EFTA states have in many cases concluded trade agreements parallel to those of the EU with third countries.

[49] Björn Friðfinnsson, Permanent Secretary of the Ministry of Justice and Ecclesiastical Affairs, lectures on the web-site http://www.ees.is

4. The EEA entails no transfer of legislative power from the parliaments of contracting parties to the EEA institutions, which necessitates for decisions adopted by the EEA Joint Committee to be transposed into national legislation.

A membership in EFTA is thus much more limited than a membership in the European Union. It is important that with the exception of the actions related to economic and taxation policies, all relevant Community legislation in the field of the Internal Market has been integrated into the Agreement.[50],[51]

4.6. Introduction of the European Union

For the sake of coherence, there will be a short introduction of the European Union, its' history and institutions. Furthermore, the introduction is intended to give a fuller picture of the structure of the European Economic Area.

4.6.1. A brief history of the development of the European Union

In 1956, an intergovernmental conference was held in Venice, participating were the ministers of Foreign Affairs of the Netherlands, Belgium, Luxembourg, Germany (Western-Germany), France and Italy. On the conference, the basis for further negotiations was set, resulting in the Treaty on the European Community of Coal and Steel from 1958, the Treaty on the Nuclear Energy from 1952 and the Treaty on the European Economic Community from 1958.

The political-economic objective of the preamble of the EEC Treaty of 1957, has since then been consolidated by a number of amendments. The Single European Act in 1986 gave the Internal Market a decisive impetus. The Maastricht Treaty from 1992 enabled a new state where the MS resolved to achieve the strengthening and convergence of their economies and to establish an economic and monetary union.[52]

The former Article N(2) in the Treaty of the European Union, provided that an intergovernmental conference should be held in 1996, resulting in the Treaty of Amsterdam, which was signed on October 2nd 1997 and entered into force on May 1999.[53]

[50] The chapter is based on lectures on the web-site http://www.ees.is, by Björn Friðfinnsson, Permanent Secretary of the Ministry of Justice and Ecclesiastical Affairs

[51] It can be mentioned, that a new Agreement between EFTA and Switzerland entered into force very recently. The Agreement establishes the same economic connection as Switzerland's connection with the European Union.

[52] Schön, W, Tax Competition in Europe – the legal perspective, p. 90.

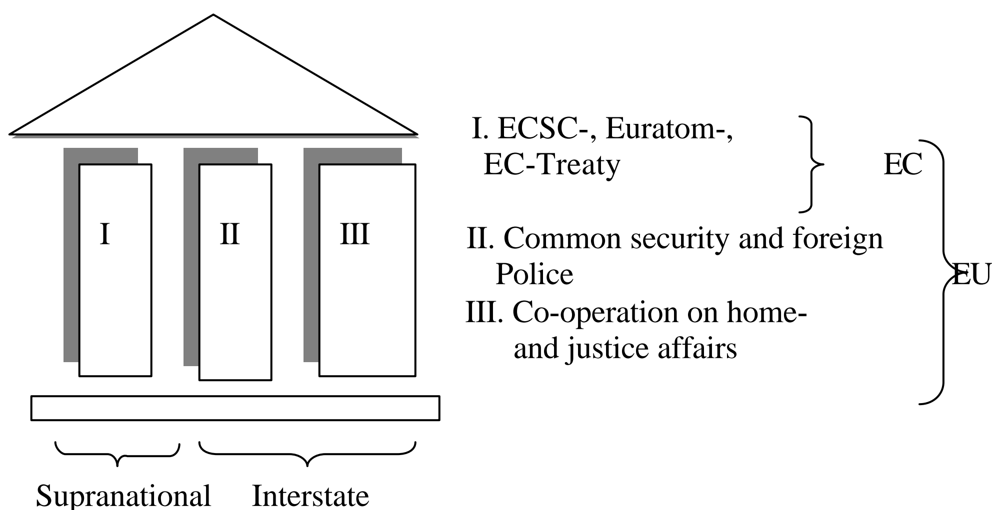
[53] Steiner, J., & Woods, L., Textbook on EC LAW, p. 7

4.6.2. Institutions of the EU[54]

It is unavoidable to outline the principal institutions of the European Union, to maintain the right context with regards to the institutional structure of the EEA Agreement.

The basis structure of the European union is commonly characterized as a three-pillar co-operation, comprising three different areas. In pillar number one are significant supranational elements and several federal features. The first pillar comprises the treaties mentioned above; the ECSC-, the Euratom and the EC-Treaty. The second pillar comprises common security and foreign policy and the third pillar comprises co-operation on home and justice affairs.[55]

Figure 2[56]



Representatives of MS, democratically elected, compose **the European Parliament**. The Parliament has played an increasingly important role in the legislative process and has decisive power over the budget. Furthermore the European Parliament has direct political control over the Commission.

The **Council of the European Union** consists of one representative of each MS, at a ministerial level. The Council is to ensure that the objectives of the Treaty are attained and has the final power of decision on most secondary legislation.

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[54] A very descriptive image of the interconnection between the EU & the EEA institutions can be found on the EFTA website; http://www.efta.int/structure/SURV/efta-srv.asp
[55] Ohlin, H., A Comparative Analysis of Two "Federal" Tax Systems, Final paper, Faculty of Law, University of Lund, 1999.
[56] Shaw, J., European Community Law, p. 3-8

The **Commission** has been described as "the guardian of the Treaties", consisting of 20 members[57] chosen on the grounds of their competence. The Commissioners are to be independent in their duties. The Commission has the power of initiative and acts as the Community watchdog, seeking out infringements of EC law. The Commission also has the task of enforcing the EC competition policy.

The **Court of Justice** consists of 15 judges, one from each MS, assisted by 8 advocates-general. The role of the ECJ is to ensure that the law is observed in the interpretation and application of the Treaty.

The **Court of First Instance** was established in 1986, consisting of 15 judges, with jurisdiction for staff cases and applications for judicial review and damages by natural and legal persons, according to Articles 230 and 232 of the EC Treaty.

It does not serve the purpose of this paper to discuss other institutions, such as the Court of Auditors or the Economic and Social Committee.

4.7. The common institutional structure of the European Economic Area.

In the chapters above, the institutions of the European Economic Area have been introduced shortly. The following table clarifies the institutional framework of the EEA Agreement[58]:

Table 1

European Communities	**European Free Trade Association**	**European Economic Area**
European Parliament	Committee of Members of Parliament of the EFTA States	EEA Joint Parliamentary Committee
EU Council	EFTA Standing Committee	EEA Council
EU Commission	EFTA Surveillance Authority	EEA Joint Committee
EU Court of Justice	EFTA Court	
Economic and Social Committee	EFTA Consultative Committee	EEA Consultative Committee

[57] Changes have been made with the Nice Treaty, to meet the proposed enlargement of the EU.
[58] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, EC TAX Review, 2001 – 1, p. 29

5. Taxation

As has been established here above, the EEA Agreement integrates parts of acquis communis into the aquis of the Member States of the Agreement, including Iceland. It is therefore important to establish the main rules and judgments that taxation in the European Union rests on, especially in the light of Art. 6 of the EEA Agreement that has been mentioned before and the fact that the EFTA Court seems in practice to adhere to the jurisprudence of the ECJ in terms of judgments that are delivered after the signature of the Agreement.

5.1. Taxation in the European Union

In the EEC Treaty of 1957 and the Amsterdam Treaty, there are specific tax provisions providing basis for Community authorities insofar as they affect the free movement of goods, as can be seen in Art. 293, addressing double taxation. This is the only Article addressing direct taxation in the EC Treaty. Despite this fact, the area of taxes has been harmonized in accordance with the treaties through the stipulations of the fundamental freedoms and State Aid.

5.1.1. Sovereignty of the MS

A state's power to tax is part of its power to the purse. This taxation power comprises legislative power, administrative power and entitlement to the tax revenue and judicial authority. The power of taxation ensures the sovereignty of the state, providing the necessary public funds for the state to function. The question therefore arises: How is the national power of taxation limited by the fundamental freedoms and non-discrimination clauses of the EC Treaty? The fundamental freedoms are considered; the free movement of workers, (Art. 39ff), freedom of establishment (Art. 43), free movement of services (Art. 49) and free movement of capital (Art. 56).[59]

5.1.2. Fundamental freedoms

The fundamental freedoms are built upon the principles of a prohibition of discrimination on grounds of nationality and the right to cross the borders of the Member States without disproportionate restrictions.[60]

Under EC law, restrictions on intra-Community trade and investment are prohibited. The principle that MS may not restrict the freedoms that are

[59] Lehner, M., Limitation of the National Power of Taxation, p. 6-7.

[60] Bergström, S., Bruzelius, A, Home-State Restrictions on the Freedom of Establishment in a Swedish Income Tax Law Perspective, p. 234.

guaranteed by the treaties is based on Art. 10 of the EC Treaty. This provision is to be applied only in the absence of a specific rule of EC law. The

The fundamental freedom provisions in the EC Treaty are directly applicable legal rules and constitute primary Community law. Thus, they do not require further specification through legal acts that are adopted by the Community organs or by national legislators.[61] The ECJ has confirmed in its rulings that the fundamental freedom provisions in the EC Treaty are directly applicable. This has the effect, that if a national tax rule is inconsistent with the fundamental freedom provisions, EC law will override these rules.[62]

The concept of the fundamental freedoms can be conceived as an umbrella concept, put in concrete terms by the non-discrimination clauses and the prohibition of restrictions in Art. 39, 45, 49, and 56, as maintained by Kingreen, Scweitzer and Hummer.[63]

5.1.3. Legal framework

The competence of the area of direct taxes does not fall under the jurisdiction of the European Union, even if the indirect taxes, such as VAT (Value Added Tax) and excise taxes are within the power sphere of the European Union according to Article 93 EC (former Art. 99 EC). However, in Art. 56 EC, it is stipulated that the EU should abolish any obstacles that hinder free flow of capital between MS. In order to meet these objectives, there have been adopted directives by the Council.[64]

Since the end of the 1960s, there has been a substantial harmonization of Community legislation in the area of indirect taxation through directives, for example the Parent-Subsidiarity Directive[65] and the merger directive[66], but this legislation can be deemed rather restrained, as the result of this limited legal basis and the effect of the principle of subsidiarity. The EC Directives on taxes are not included in the EEA Treaty, but a possible effect of the Parent-Subsidiarity Directive is discussed in chapter 8.

Furthermore there have been amendments made in the domestic law in MS. For example, rules on tax-free distributions, where foreign companies belonging to a state within the European Economic Area, in a group of companies, should not affect the possibility of group contributions between two Swedish companies. Also the rules are applicable if the recipient of group contributions is a Swedish company with residence in an EEA state,

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[61] Schuch, J., EC law requires multilateral tax treaty, p. 36
[62] Schuch, J., EC law requires multilateral tax treaty, p. 31
[63] Lehner, M., Limitation of the National Power of Taxation, p. 7
[64] Ohlin, H., A comparative analysis of two "federal" tax systems, p. 14.
[65] Council Directive 90/435/EEC of 23rd of July 1990. Other directive is for example: Directive 77/799/EEG, Mutual Assistance.
[66] Council Directive 90/434/EEC of 23rd of July 1990.

as the result of the application of provisions in a tax treaty on the conditions that it carries out activities in Sweden through a permanent establishment[67].

5.1.4. Judgments

The European Court of Justice has had great influence on the development of community law in the area of direct taxation. It is necessary to introduce briefly some of the judgments, where there the COJ has interpreted the internal legislation of the MS.[68]

The fact that there is not competence for the European Union in the area of direct taxation does not necessarily mean that there is no development of community law within that area. The European Court of Justice comes into the picture and the ECJ has determined in a number of cases whether national direct taxes are in harmony with the Community laws or not.[69]

The prohibition of discrimination is in Art. 12 of the EC Treaty. The non-discrimination clauses, as interpreted and administered by the European Court of Justice, have been called either "hidden harmonization" or "negative harmonization"[70]. This is by no means harmonization, but rather ECJ´s adjudication on fundamental freedoms and non-discrimination that concern provisions of the EC Treaty which can be directly invoked by citizens of the European Union. The ECJ may not declare domestic regulations void, but it may determine a conflict with Community law.[71]

The ECJ sets out in its judgments, to ascertain whether a national rule is consistent with the non-discrimination principles, which are incorporated into the EC Treaty. The Court, having affirmed that the provisions of the fundamental freedoms are directly applicable, examines whether two situations are comparable, by comparing taxpayers who are subject to specific rules, to other taxpayers in similar situation where the rule in question is not applied or another rule is applicable.[72] Discrimination arises when different rules are applied to comparable situations or when the same rule is applied to different situation. Discrimination only arises when two comparable situations are regulated by the same sovereign power and therefore a treatment granted to a taxpayer in one state cannot be compared to the treatment of other taxpayers in another state.[73]

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[67] Bergström, S., Bruzelius, A, Home-State Restrictions on the Freedom of Establishment in a Swedish Income Tax Law Perspective, p. 233.

[68] It has been discussed in this connection, whether the COJ has in fact exceeded its´ jurisdiction in matters of taxation. This will however not be a topic here and the point of departure is thus that the COJ is performing its duties according to the treaties.

[69] Ohlin, H., A comparative analysis of two "federal" tax systems

[70] Weatherhill and Beaumont, EC Law (2nd edition) , p. 254.

[71] Lehner, M., Limitation of the National Power of Taxation, p. 7.

[72] See the Wielockx judgment in chapter 4.2.

[73] Schuch, J., EC law requires multilateral tax treaty, p. 31-36

In this chapter, 8 judgments will therefore be mentioned shortly as they are all of great importance in this context, as explained here above.

1. In the case of Avoir fiscal[74], (which was the first case concerning income taxation), a tax credit (avoir fiscal) was available to French companies, but not to foreign companies. The ECJ found that this was a discrimination against the foreign companies according to Art. 52 (now Art. 43) of the EC Treaty. This judgment clarified, that the principle of non-discrimination was MS´s internal income tax regulations, despite the fact that they did not fall within the scope the competence of the Union.[75]

2. In the case of Bachmann,[76] the conclusion of the European Court of Justice was, that covert discrimination, where a national tax rule was working to the particular detriment of a non-resident, in taxation matters can be justified by the public interest in fiscal coherence. The COJ held, that the Belgian rules which discriminated indirectly against foreign workers, by refusing tax deduction of life insurance premiums and pensions contributions, when paid to insurers who were not established in Belgium, were justified on public interest grounds because of the need to preserve the cohesion of the MS´s tax system. Therefore tax deduction of premiums was justified only if the MS in question could be sure to collect the tax on the subsequent insurance benefits.

3. In the case of Futura,[77] - there was a dual approach, based on discrimination in relation to tax burden and a restriction-based analysis. A restriction-based analysis stands for a term, that has been increasingly used by the COJ on the four-freedom Articles, that a non-discriminatory rule, that restricts one of the freedoms, may be caught by the Treaty, unless it is justified grounds related to the public interest such as fiscal supervision, or public health or environmental protection.[78]

4. In the case of Schumacker,[79] a Belgian national who was a resident in Belgium but employed in Germany, he was taxed without without taking account of his personal situation. Mr. Schumacker then applied to German tax authorities for a taxation under a different category, where his family situation would be taken into account, but was denied. The appeal went to the Bundesfinanzhof, where the COJ was asked for opinion. The COJ maintained that Art. 48 prevented Germany from different taxation due to nationality. The Article did

[74] Avoir fiscal, ECJ 28 Janurary 1986, case C-270/83
[75] Ohlin, H., A comparative analysis of two “federal” tax systems, p. 18-19
[76] Bachmann v. Belgian State, C-204/90 [1992] ECR I-249
[77] Futura Participations and Singer v. Administration des Contributions, C-250/95
[78] Farmer, P., EC law and national rules on direct taxation: a phoney war?, EC Tax review, 1998-1, P. 13-xx
[79] Schumacker Case C-279/93 [1995] ECR I-225.

not in principle prevent a MS from taxing the income of a non-resident more heavily than that of a resident, but in a situation where the non-resident received no significant income in the resident state, thereby precluding the resident state from taking account of the taxpayers personal circumstances, constituted discrimination. The discrimination was due to the fact that neither state could take his personal that the right of persons exercising their Community freedoms to national treatment does not necessarily place them in the same position as and family circumstances into account. This ruling acknowledges national taxpayers. There is an obvious distinction between personal relief, which is the responsibility of the resident state, and source-related employment and business relief, which must be granted on the same terms to residents and non-residents under the non-discrimination rule. This brings us to the Wielockx case.

5. In the case of Wielockx,[80] where a Belgian national, resident in Belgium, wanted to appropriate a part of his business profit to a pension reserve, as allowed by the Netherlands rules of taxation for self-employed persons. Mr. Wielockx was a partner in a physiotherapy practice in the Netherlands, who was not permitted to set up a pension reserve, as a non-resident taxpayer. He argued that this was against Art. 52 of the Treaty. The COJ followed the same line of reasoning as in Schumacker, rejected the arguments of the Netherlands Government based on the Bachmann judgment. The Netherlands Government argued that if a non-resident could set up a pension reserve in the Netherlands, the pension would not be taxed there, since such income should be taxed in the state of residence according the a double-taxation Convention between the countries. The COJ did not accept this argument based on the principle of fiscal coherence, and referred to the OECD Convention where fiscal cohesion was secured by a bilateral convention.

6. In the case of Commission v. France,[81] the French legislation restricted shareholders´ tax credits on dividends from French companies to persons with residence or registered office in France. The Commission contended that France had infringed Art. 52 of the Treaty, by not granting the credits to French branches or agencies of insurance companies of other MS, on the same terms as to the French companies. The French government argued among other that there would be a distortion as foreign companies might place their French shares in the hands of a permanent establishment rather than in subsidiaries, as neither French domestic law nor double tax agreements granted tax credits to foreign companies with major holdings in French companies. The COJ replied that the absence of harmonization did not preclude the application of Art. 52 and said that the risk of tax avoidance was not of importance in this context,

[80] Wielockx v. Inspecteur der Directe Belastingen, C-80/94 [1995] ECR I-2493
[81] Commission v. France, 270/83 [1986] ECR 273.

as Art. 52 of the EEC Treaty did not permit derogation from the fundamental principle of freedom of establishment.

7. In the case of Asscher,[82] a stipulation in the Netherlands provided that taxpayers who were non-resident and obtained less than 90% of their worldwide income in the Netherlands, should pay tax at a higher rate on part of their income. Mr. Asscher, who was a Netherlands national, was a director of his own a private limited company in the Netherlands and also a manager of a Belgian company and carried his work out in Belgium. In 1986, Mr. Asscher moved to Belgium, without changing his activities and was only taxable on his Netherlands income in the Netherlands, but the rest of his income was taxable in Belgium, where, under the double taxation Convention between the two countries, Belgium could take the Netherlands income into account for progressive taxation. Mr. Asscher maintained that this constituted indirect discrimination on grounds of nationality contrary to Arts. 7 and 48 of the EC Treaty. The ECJ found that there was a difference in treatment between residents and non-residents as Mr. Asscher did in fact get progressive taxation under the double taxation Convention and was in fact discriminated. The Court considered whether this could be justified. The Netherlands Government the argument that the different treatment was necessary to ensure the cohesion of the tax system under the principle laid down in Bachmann.. The COJ replied, that a higher tax rate did not prove any social security protection, referring to Council Regulation 1408/71. The arguments were thus rejected.[83]

8. In the case of Safir,[84] the case was about assurances taken in companies, that were situated in other countries. The Swedish rules treated assurances in Swedish companies differently than those signed in foreign companies. The ECJ held, that this was a restriction and a violation of Art. 59 (now Art. 49) EC, as the rules impaired frr movement of services. The Court further stated, that even if direct taxes did not at the moment fall under the competence of the Community, the MS still had an obligation to respect EC law when designing their national tax systems.[85]

The legislative sovereignty in taxation, between the Community and the MS is by far the largest issue dominating taxation policy in the European Union. As has been discussed above, the fundamental freedoms set limits to MS action and thus restrict the tax competition between the players on the Internal Market. The European Court of Justice has been the dominating

[82] Asscher v. Staatssecretaris van Financieén, C-107/94 [1996] ECRI-3089
[83] Farmer, P., EC law and national rules on direct taxation: a phoney war?, p.13-26
[84] Safir v. skattemyndigheden, Case C-118/96
[85] Ohlin, H., A comparative analysis of two ”federal” tax systems, p. 19

instrument of the institutions of the European Union to establish the limitations of the MS, as it has the obligation to ensure the Community's principles are upheld. Taxation should not and is not sheltered from this fundamental consideration, as can be seen by the judgments above.

5.1.5. The EU and State aid

A sharp and important weapon against distortion of competition is to be found in former Articles 92-94, now Articles 87-89 EC on State aids. These Articles form a special set of rules for aids granted by MS or paid in any way by means of state resources, which distort or threaten to distort competition, by favoring certain undertakings or production of certain goods. State aids are declared to be incompatible in principle with the common market to the extent to which they affect trade between MS – they form an essential complement of the free movement provisions. [86]

The Commission published, in November 1998, a notice on the application of the State aid rules to measures relating to direct business taxation[87]. This notice has the aim to link the provisions of the Treaty and related rules on State aid to fight against harmful tax competition and it also has the wider objective of clarifying and reinforcing the application of State aid rules to reduce distortions of competition in the Single Market.

In Article 87(1) the basic test for State aids is laid down. It covers aid given to public undertakings that come within Article 86, as well as to private companies. In paragraph 1, the general principle is established, that State aid is incompatible with the common market. The reasons for State aid is not relevant nor the form, in the view of the ECJ and the Commission. [88] In Art. 87(2), certain exceptions are provided, where aid will be deemed to be compatible with the common market. In Art. 87(3), there are discretionary exceptions, developed by the Commission but subject to judicial review. Aid can thus be designed to restructure an undertaking, to rescue an undertaking or to help with operating costs. The Community Guidelines on State aid for Rescuing and Restructuring Firms in Difficulty[89] are aimed at those.

The Commission makes the assessment that fiscal aid is considered to be State aid, with the cumulative meeting of four criteria:

1. "The measure must confer an advantage of recipients, relieving them of charges that they would normally have to bear by their budgets.

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[86] Kapteyn P.J.G., & VerLoren van Themaat, P., Introduction to the Law of the European Communities, p. 811 - 812.

[87] 98/C 384/03

[88] Case 173/73, Italy v. Commission
Case 2—241/94, France v. Commission

[89] Community Guidelines on State aid for Rescuing and Restructuring Firms in Difficulty [1994] OJ C-368/12.

2. The advantage must be granted by the state or through state resources
3. the measure must affect competition and trade between Member States.
4. the measure must be specific or selective, favoring "certain undertakings or the production of certain goods".[90]

The various prohibitions of discrimination of the Treaty which aim to ensure equal competitive conditions, such as the declaration of incompatibility of State aids with the common market correspond to the principle of equity.[91]

The State aid rules limit the autonomy of the MS & EEA States, as provided for by Art. 87 et seq. of the EC Treaty and Articles 61-64 in the EEA, in order to ensure the same rules for actors on the internal market.

5.2. The Code of Conduct

It is impossible to discuss taxation in the European Union, without touching up on the issue of the EU Code of Conduct. The Code was designed to counter harmful tax competition, in the form of a political commitment of the MS of the European Union The Code of Conduct in relation to harmful taxation from an Icelandic perspective will be discussed in the final chapter.

5.2.1. Introduction

The European Commission prepared a white paper on "Taxation in the European Union[92], which was discussed in on an informal ECOFIN Council meeting Verona in 1996. The discussions were maintained, leading to an unanimous adoption of a Code of Conduct for Business Taxation, by the ECOFIN Council[93]. In the preamble, it is stated that the Code is to concern tax measures that affect, or may affect, in a significant way, the location of business activity in the Community.[94]

The Code of Conduct represented a new strategy in the field of corporate taxation, after many reports[95] and several attempts by the Commission to introduce legislation that had all failed. The Code took the form of a political agreement under which MS undertook to end tax practices that might damage fair competition within the Single Market. Application of the

[90] Editorial – How State aid affects tax competition, EC Tax Review 1999/4 p. 209-210,
[91] Kapteyn P.J.G., & VerLoren van Themaat, P., Introduction to the Law of the European Communities, p. 132.
[92] Taxation in the European Union, European Commission, March 20th 1996, s. (96) 487 final,
[93] Conclusions of the ECOFIN-Council meeting on 1 December 1997 concerning tax policy, OJ, C 2/1 1998.
[94] Landmark agreement ….
[95] most recently the Ruding Report, from 1992

Code led to the creation of the Primarolo Group, which reported at the end of 1999, having examined 271 tax measures, notified those under the terms of the Code, and identified 66 that affected "in significant way the location of business activity in the Community". The Group's mandate has now been extended to monitor the "roll-back"[96] of these measures, and to ensure that a "standstill" on new measures is maintained.[97]

However, in the opinion of Prof. Maarten J. Ellis, the tax systems of Europe have not converged, but grown further apart since the birth of the Code of Conduct. Furthermore the use of tax measures to attract business and investment has increased, simultaneously as the uncertainty about the outcome of the discussion on the Code of Conduct has had negative effect of new investment decisions. Prof. Ellis believes that a new Commissioner has brought a change of direction towards removing impediments instead of removing harmful competition.[98]

5.2.2 Political commitment - scope

The Code of Conduct was adopted by the Council as a resolution, not as a legally binding instrument. Therefore, the Code is merely a political commitment of the MS to comply with their agreement and its provisions may not be enforced through legal remedies by the EU institutions or the MS.[99]

This means that observance cannot be assured through local court or the European Court of Justice. Observance relies foremost on peer pressure. The Commission may however hold a powerful instrument as it has the exclusive power to, with the State aid provisions of the EC Treaty.[100] There is some overlapping in the scope of the Code of Conduct vs. State aid rules, although it is clear, that the Code has much wider scope, as all tax measures that are covered by the State aid rules are covered by the Code of Conduct as well.[101]

The scope of the Code of Conduct is wider than that of the OECD Report,[102] because it covers business taxation as a whole and not merely taxation on income from mobile activities, although the OECD Report is geographically more extended. Indirect taxation and direct taxation on individuals are excluded from both documents. The Code of Conduct points out that

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[96] 1 January is the final deadline for the rollback of harmful tax regimes.
[97] Tax Co-ordination in the European Union, European Parliament, working paper, Directorate-General for Research, Economic Affairs Series Econ 125 En. p. ix.
[98] Ellis, M., The Code of Conduct in 2000: Cracking the Code or Coating the Crack?, European Taxation, September 2000, p. 415.
[99] Pinto, C., EU and OECD to Fight Harmful Tax Competition; Has the Right Path Been Undertaken? International Tax Review, Intertax, Volume 26, Issue 12 1998, p. 389
[100] Nijkamp, H., Landmark Agreement on EU Tax Package, EC Tax Review, 2001/3, p. 153
[101] Svalborn, O., Ireland and the Evolution of Tax Competition, p. 14.
[102] See www.oecd.org, Development (OECD) Report "Harmful Tax Competition: An Emerging Global Issue"

measures that are potentially harmful are those providing for an effective tax burden, which is significantly lower than what is applicable under the standard system of a certain country, including zero taxation.[103]

The following table shows the major criteria for identifying harmful tax practices, as compared by the EU Code of Conduct and the OECD Report.

Table 2.[104]

	Criterion to identify harmful tax practices	EU Code of Conduct	OECD Report
i)	No or only nominal taxes	O	X
ii)	Deviation of a tax measure from the "benchmark" tax system	X	X
iii)	Ring-fencing from the domestic economy	X	X
iv)	No substantial economic presence	X	X
v)	Computation of taxable income according to principles other than internationally accepted ones	X	X
vi)	Lack of transparency (administrative practices)	X	X
vii)	Lack of effective change of information (banking secrecy legislation)	-	X
viii)	Other economic indicators	O	X
	X = explicitly indicated O = Implied -= Not indicated		

The criteria of the Code of Conduct are designed to single out the most damaging mechanisms; the working method is based on transparency, openness, dialogue and critical analysis. No new preferential or harmful tax regimes have been crated since the work on the Code of Conduct began.[105]

5.3. The EEA Agreement and taxes

The EEA Agreement was not meant to include any cooperation in the field of taxation and in Norway the position has been that the agreement does not apply to direct tax measures.[106] The same can be said about the position in

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[103] Pinto, C., EU and OECD to Fight Harmful Tax Competition; Has the Right Path Been Undertaken? , p. 392

[104] Pinto, C., EU and OECD to Fight Harmful Tax Competition; Has the Right Path Been Undertaken? p. 392

[105] Parly, F., The Code of Conduct and the Fight against Harmful Tax Competition, p. 407-408.

[106] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, Eureopan Taxation, p. 114

Iceland. Is it really so, that Iceland is completely free to create its own taxation policy and rules?

As a starting point it must be mentioned that certain secondary legislation containing tax provisions was included in the EEA Agreement from the beginning, such as Council Regulation 1612/68, on the free movement of workers[107], which contains a provision in Art. 7 stating that foreign workers shall be granted same tax treatment as resident workers. The 1990 tax directives on Merger and the Parent-Subsidiary Directive are not a part of the EEA agreements.[108]

5.3.1. The Fundamental freedoms - EEA

The fundamental freedoms can have consequences for the tax law of the partners of the EEA Agreement. The Articles covering the fundamental freedoms and the State aid rules are mostly identical to the corresponding Articles of the EC Treaty, except for certain differences in the rules applying to the free movement of goods and capital.[109] The principle of conformity in Art. 6 of the EEA Agreement also suggest that the jurisprudence of the ECJ concerning direct taxation should apply under the Agreement.

The EEA countries are however not totally without resources as the principles apply also in regard to taxes. In this respect any kind of discrimination on grounds of nationality is forbidden (Art. 4). The same goes for freedom of establishment (Art. 31.) and the free movement of workers (Art. 28.). Furthermore freedom to provide services (Art. 36) and free movement of capital (Art. 40) are to be found in the EEA agreement.

Articles 10 and 11 of the EEA Agreement also prohibit customs and the quantitative restrictions on imports having equivalent effect. Finally, Art. 14 of the EEA Agreement states that no Contracting Party shall impose, directly or indirectly, on the products of other Contracting Parties, any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.

It is obvious that different rules of taxation between the EU and the EFTA states, caused by further harmonization can impede the flow of goods within the European Economic Area.[110]

Art. 31 of the EEA Treaty corresponds with Art. 43 of the EC Treaty, that has direct effect since the transitional period has passed.[111] Freedom of

[107] Council Regulation 1612/68/EEC 15 October 1998 on freedom of movement of workers within the Community

[108] Leegaard, T., Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 114

[109] Leegaard, T.,, Impact of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 113

[110]Stefánsson, S. M., Evrópusambandið og Evrópska Efnahagssvæðið p. 355-356,

Establishment within the EEA concerns persons with an EU or EFTA state nationality and companies established in accordance with the law of such a state. The freedom of establishment is similar with the free movement of workers and self-employed persons and the freedom to provide services, giving residents of an EU/EFTA state right of establishment without restrictions due to the difference in treatment on basis of nationality, place of establishment, laws on the basis of which a companies has been established or similar criterions.[112]

An important case is derived from the EFTA Court from December 10th 1998 in the Herbert Rainford-Towning case[113]. In this case a national provision was at issue that demanded that the director of a legal person should reside in Liechtenstein, as well as the legal person, and the application of a certain facility depended on this action. This provision was found to be against Art. 31. of the EEA Treaty because of indirect discrimination. The possible justification of unequal treatment with an appeal to government policy as mentioned in Art. 33 of the EEA Treaty was not accepted.

5.3.2 Direct effect?

The prohibition of Art. 56 of the EC Treaty has direct effect. It is not clear as of now, to what extent the EEA provisions have and equal effect compared to the EC provisions. Art. 40 of the EEA Treaty corresponds to the old Art. 67 of the EEC Treaty, stating that within the framework of the EEA Treaty, there are no restrictions on the free movement of capital belonging to persons residing or established in the EEA states. [114]

It seems clear that Art. 31 has direct effect and the same scope as Art. 43 of the EC Treaty, stating that restrictions on the freedom of establishment of nationals of an EEA state on the territory of another EEA state are prohibited. The freedom of establishment also entails the freedom to choose a place of establishment, as stated in the case of Daily Mail[115] that the freedom of establishment also included the freedom of departure. Furthermore, the freedom of establishment entails the freedom to choose between the use of a permanent establishment and a subsidiary in a MS, as maintained in ECJ´s judgments Avoir fiscal[116] and Commerzbank[117], where

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[111] The principle of the transitional period was established in the Reyners case; – ECJ 2/74

[112] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p. 33

[113] The EFTA Court, Herbert Rainford-Towning, Case E 3/98, 10 December 1998

[114] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p. 31-33

[115] Daily Mail, ECJ 27 September 1988

[116] Avoir fiscal, ECJ 28 Janurary 1986, case C-270/83

[117] Commerzbank, ECJ 13 July 1993, case C-330/91

it was established that Art. 52 also included the freedom to choose the best applicable legal form.[118]

The provisions on equal treatment thus prohibit discrimination on the basis of nationality, giving corporations the right to perform their activities in another EEA state by means of an agency, branch or a subsidiary on the same conditions as the nationals in that state.

A Treaty provision has direct effect when three conditions are fulfilled; The provision must be clear, unconditional and there must be no discretionary freedom left to the judge. In the case Van Gend & Loos[119], the ECJ stated that the Community constituted a separate legal order, including direct effect of the EEC Treaty provisions, when there is a dualistic system. EEA legislation seems to have direct effect and primacy over internal law of MS.[120] The cases from the EFTA Court; Sveinbjörnsdóttir[121] it was held that the nature of the EEA Agreement was an international treaty sui generic, containing a distinct legal order of its own and the Karlsson,case,[122] where the court refers to the absence of recognition of direct affect for EEA rules, but still recognize state liability, do not provide absolute answers to the question of direct effect.

Art. 67 did not have direct effect, so Art. 40 has in principle, no direct effect either, in the opinion of Hans Van den Hurk and Albert Theunissen. This Article is however clear and unconditional and attributes rights to individuals, thereby fulfilling the criteria for direct effect.[123] Van Gerwen holds that the common view is that EEA legislation has direct effect and primacy over internal law of Member States.[124] The question of direct effect is much debated at the moment and remains unresolved.

5.4. The EEA-Agreement and State aid

Instrument against distortion of competition in the EEA Agreement is to be found in Art. 61 of the EEA Treaty, which corresponds to Articles 87-89 EC on State aids (former Articles 92-94), see chapter xxx, A fairly recent case

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[118] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p.

[119] Van Gend & Loos, Case 26/62
[120] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p. 31
[121] See footnote 43
[122] See footnote 44
[123] Van den Hurk, H., Theounissen, Al, Several institutional and fiscal aspects of the European Economic Area, p. 31-33
[124] van Gerwen, W., “The Genesis of EEA law and the Principles of Primacy and Direct Effect” in Struyck and Looijestijn, The European Economic Area EC-EFTA, European Monographs (Kluwer, Deventer-Boston 1994, p. 33-56.

from the EFTA Court will be discussed and recent ESA involvement in Iceland regarding State aid.

5.4.1. Norway v. EFTA surveillance authority

In the case Norway v. EFTA Surveillance Authority[125], the issue was a differentiated employers social security contribution, which was found to be incompatible with the prohibition in Art. 61 of the EEA Agreement. At the relevant time, Norway had a social security system, where the contributions varied from zero to over 14%, depending on residency i various parts of Norway. This system was designed to benefit business in certain disadvantaged areas. The Norwegian Government claimed that the system was a part of the general tax system in Norway and that it was sufficiently general in nature as not to involve State aid.[126]

The Court first noted that, as a general rule, a tax system of an EEA/EFTA State was not covered by the EEA Agreement. Then the Court said that in certain cases, however, such a system might have consequences that would bring it within the scope of applications of Art. 61(1) EEA. The ECJ stated furthermore, that it was established case law of the ECJ that the fiscal nature of a measure did not shield it from the application of Art. 92 EC (now Art. 87 EC), nor did Art. 92 EC distinguish between the measures of State intervention by reference to their causes and aims but rather defined them in relation to their effects. The Court said that in referring to "any aid granted by EC Member States, EFTA States or through State resources in any form whatsoever, Art. 61(1) was directed at all aid financed form of public resources and that such measures, favoring certain undertakings or the production of certain goods, might thus fall within the scope of Art. 61(1) EEA".

Although Art. 61 of the EEA Treaty concerns State aid, here the general discussions on the scope of the EEA Treaty is important.[127]

ESA guidelines on the application of State aid rules to tax measures in member states, that were adopted on June 30th 1999, are identical to the guidelines set out by the Commission.[128]

5.4.2. Recent ESA involvement in Iceland

There are two recent cases of ESA involvement in Iceland worth mentioning, comprising State aid. The former, involving Air Iceland, has already been resolved, but the latter has just started its process. These cases

[125] EFTA Court 20. May 1999, case E-6/1998 The Government of Norway v. ESA
[126] Leegaard, T., Impart of the European Economic Area Agreement on Direct Taxation: A Norwegian Perspective, p. 113.
[127] Van den Hurk, Andersen, Theunissen, Several institutional and fiscal aspects of the European Economic Area, p. 34
[128] Leegaard, T.,, European Economic Area, p. 114.

are relevant in the discussion of harmful taxation from an Icelandic Perspective as they touch upon the independence of the Icelandic authorities in matters of national importance.

The former case concerns a proposed aid to Air Iceland (Flugfélag Íslands), amounting to ISK 31,5 million (approx. 380.000 euros), as a compensation for the operation of air services between Reykjavík and Höfn (a town in the Eastern part of Iceland) for a limited period of time. A contract comprising the aforementioned aid was entered into by the Icelandic authorities following the announcement of Air Iceland to cancel scheduled air services between the two places mentioned above, as the services on that route were no longer commercially viable. The duration of the contract is limited until a new air carrier will be selected under a formal tender procedure. The EFTA Surveillance Authority decided not to raise objections to the proposed aid, as stated in a press release 22nd of May, 2002. The reasons for the decision were among other that the Icelandic Government demonstrated full compliance with the tender formalities as laid down in Art. 4 of Regulation No 2408/92, as well as showing that the measures did not go beyond what is necessary.[129]

In the latter case, the Icelandic Minister for Finance, acting for the Government of Iceland, was authorized, for the purpose of promoting the development of high-tech industry in drug development in Iceland, to provide a guarantee of collection in respect of a bond issue by the parent company of Íslensk erfðagreining ehf., deCODE Genetics Inc, in an amount of up to USD 200 million, to finance new activities of the company. According to Art. 1(3) of Protocol 3 of the Surveillance and Court Agreement, a notification was made. A possible justification of the compatibility of the aid measure is to be found in Art. 61(3)(c) of the EEA Agreement.[130] A notification on State aid according to Art. 1(3) of the Protocol of the Surveillance and Court Agreement, was only sent on the 27th of May 2002, so the ESA´s decision has not been made. The Icelandic state considers the aid measure a legitimate State aid for Research and Development within the meaning of Art. 61 of the EEA Agreement.

5.5. New issues – gray areas

There are a number of areas of Norwegian domestic tax law, where a differentiation is made on the basis of residence and could be in conflict with the fundamental freedoms[131].[132] In the area of taxation, there are always new issues and gray areas, to be determined by the lawmakers and/or

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[129] Air Iceland, ESA decision no. 83/02/COL, 24 May 2002

[130] Gunnarsson, E., Nordic State aid meeting in Reykjavík, 13. May 2002

[131] Leegaard, T.,, European Economic Area, p. 114

[132] *One such example is personal allowances that are granted as a deduction from the net taxable income of taxpayers, provided they are resident in Norway. In the Icelandic law on income- and property tax, there is also deduction based on residence. The same therefore applies, that conflict with the fundamental freedoms is possible.*

the Courts. Two such issues to be mentioned are on one hand the Baars-case, which regards free movement of capital and on the other, the Parent-Subsidiary Directive. These issues are put forward as questions, but no solutions are provided.

5.5.1. The Baars-case

In the case of Baars,[133] an entrepreneur Mr. Baars, who was a resident in the Netherlands and owned a substantial part of shares in a company (Ballyard) established in Ireland. Mr. Baars filed his declaration of capital wealth tax where he stated that value of his shares in Ballyard and claimed the exemption of company capital in the capital wealth tax. The tax inspector in charge of the declaration refused the exemption, not because the participation did not meet the condition of a substantial participation according to the Dutch tax law, but on the grounds that the company, Ballyard, was not established in the Netherlands and therefore did not meet the condition of Art. 7, para. 3(c) of the Act on capital wealth tax 1964. Mr. Baars turned to the national court in Hague, arguing among other that the restriction of the exemption to shares to companies established in the Netherlands, was contrary to Art. 52 (now Art. 43) and to Art. 73B (now Art. 58) of the EEC Treaty. Two questions were posed to the ECJ, in essence asking whether Articles 6 and 52 of the EC Treaty were opposed to the denial of the exemption of capital, based on the agreement that the company in question was not established in the Netherlands. The ECJ came to the conclusion that the denial was contrary to Art. 43 (formerly Art. 52) of the EEC Treaty. The judgment has the effect, that when an entrepreneur falls within the scope of Art. 43, the Netherlands have to apply the exemption also to capital invested in companies established outside the Netherlands.

The question arises whether this conclusion would be different, if the capital was invested in shares in an EFTA state? Art. 31 of the EEA Treaty is phrased the same as Art. 43 of the EC Treaty, and both Articles have direct effect and the obvious conclusion is that capital invested in companies in EFTA countries, has to be facilitated.[134]

5.5.2. The Parent-Subsidiary Directive

As has already been discussed, the Parent-Subsidiary Directive is not included in the EEA Treaty and no cooperation has been realized on that issue of taxation.

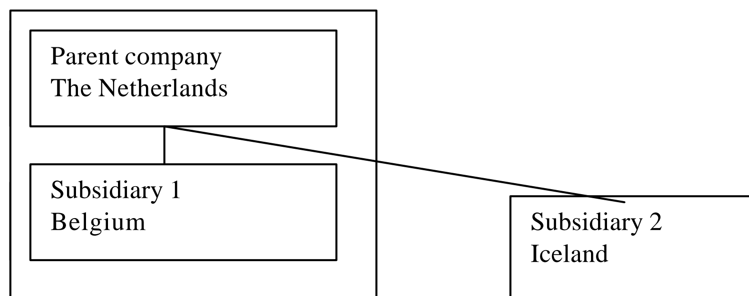
A fictious example of a European concern with a holding company in the Netherlands and a subsidiary in Belgium and Iceland is created by Hans van

[133] C. Baars v. Inspecteur der Belastingen Particulieren Odernemingen Gorinchem, 13. April 2000, case C-251/98
[134] Van den Hurk, H., Theunissen, A., Several institutional and fiscal aspects of the European Economic Area, p. 35–36.

den Hurk and Albert Theunissen, in their Article; Several institutional and fiscal aspects of the European Economic Area. This example is highly relevant in this discussion on Iceland as a player in tax competition and it will therefore be presented carefully, as a piece in our puzzle.

On the basis of the Parent-Subsidiary Directive, it is allowed to distribute profits to a holding company within the European Union, without impediment of discrimination. This would have the effect, that the state where the subsidiary was established, could not levy withholding taxes on the distributed profit of the subsidiaries, unless it had been permitted to the parent company to deduct the part of the tax levied of the subsidiary with regard to this profit and to deduct the withholding tax levied with the subsidiary.

Figure 2,[135]



When a subsidiary is established in an EEA country, this does not have to be the case, as it is possible that state where the holding company is established levies taxes in this case or that the state where the subsidiary is established levies withholding taxes. In both examples, there is a difference in treatment compared to an internal EU situation.

The Netherlands grants exemption when the conditions in the Directive are met. If the subsidiary in Iceland is a capital investment, then the Article regarding exemption of the Act on corporate income tax 1969[136] is applicable. If the subsidiary in Iceland was established in Ireland, then the Netherlands would have applied the exemption on a different exemption grounds in the same Act. The difference entails a less advantageous treatment of the EFTA company in comparison with the EU company, constituting a violation of the fundamental freedoms?

The authors of this example, Hans van den Hurk and Albert Theunissen see only one justification of this fictious infringement and that is if the ECJ or the EFTA Court would find, that the EEA Treaty was a pure trade agreement, not nearly as far reaching as the EU Treaty. The authors believe that this is not a likely judgment and I absolutely agree with them on that conclusion.

[135] Several institutional .... picture on p. 36
[136] Act on Dutch corporate income tax 1969

The example concerns cross-border economic activity and therefore it is safe to say that the EEA Treaty is applicable. The parent company would be impeded in its freedom to choose a place of establishment of the subsidiary. An investment in an EU state would be more advantageous than a similar investment in an EFTA state, the difference being the place of establishment, within the internal market.

6. Taxation Policy in the EU

Most of the areas relating to harmful taxation from an Icelandic perspective should now be in place. The development is fast in these times of globalization and technological revolution and each player has to try and establish what is competitor is up to. In this chapter, the latest development in the area of taxation policy within the European Union will be discussed, focusing on tax competition.

6.1 Tax co-ordination in the EU

As Europe has moved increasingly to a Single Market, companies have had to organize their operation on a European scale. However, the Community has been comparatively successful at eliminating non-tariff barriers to cross-border trade, the legal and tax structures have not caught up with the market. A European corporation should be a longer-term option for companies that operate on a pan-European scale. The removal of the unanimity requirement for some aspects of taxation would facilitate this.[137] For the present, according to Art. 95(2), fiscal provisions are excluded from the qualified majority voting procedure, giving the MS freedom to veto harmonization proposals in the Council.

There is general agreement that unanimity will be retained for tax rates, in the foreseeable future. However, the position is less clear in the case of features equivalent to tax rates, such as effective rates of tax being considerably lower than nominal headline rates, due to complexity of corporate taxation.[138]

At the Intergovernmental Conference in Nice[139], the Commission tried to seek agreement on approval of proposals on those tax matters that are deemed vital for the functioning of the Single Market, through qualified majority, but failed. The Commission has therefore been focusing on alternative ways for making a progress toward reducing cross-border tax obstacles.[140]

The European Commission thus presented a Communication on company taxation and under the Belgian presidency, during the second half of 2001, this was one of the their priorities.[141] The Communication was from the Commission to the Council, the European Parliament and the Economic and Social Committee, on the subject; Towards an Internal Market without tax

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[137] Tabaksblat, M., Chairman of Unilever, speech at a conference in Leiden on June 1998.
[138] Tax co-ordination ....
[139] In December 2000
[140] Onno Ruding, H.., The Long Way to Removing Obstacles in Company Taxation in Europe, p. 5
[141] Reynders, D., Tax policy priorities under the Belgian Presidency of the European Union during the second half of …, Editorial p. 145-14

obstacles. The starting point of the Communication is a statement, where reform of EU company taxation is said to be crucial for achieving the Lisbon-goals[142]. The so-called Lisbon-goals comprise for the European Union to become the most competitive and dynamic knowledge-based economy in the world.[143]

The European Commission's report on "Company Taxation in the Internal Market[144]comprises four alternative comprehensive models. Model I is the Home state Taxation, where taxable profits originating form affiliates of MNEs in other MS would be determined and computed according to the tax code of the home state of the parent company. Model II is the Common (Consolidated) Tax Base, where MNEs would be imposed on consolidated net profits of the units that operate within the European Union. Model III proposes a common consolidated tax base, with a single rate determined at the EU level. Model IV would substitute the existing 15 corporate tax systems by a single one to be applied by all enterprises within the EU. Models II, III and IV do in fact involve the drafting of a new tax code at the EU level whereas Model I is based on mutual recognition. [145]

In a speech by the European Commissioner Frits Bolkestein, that he calls Taxation Policy in the European Union which he delivered at the Institute of European Affairs, in Ireland 29 May 2001, he declared among other that the intermediate zone of direct taxation of mobile tax bases, in particular the taxation of companies and the taxation of financial capital might have direct effects on the Internal Market. Bolkestein said, that it should be stressed that the Commission had no intention of harmonizing company tax rates but rather that tax competition might encourage Member States to streamline their public expenditure as well as it obliged governments to offer the best possible services at the lowest possible price. Furthermore, Bolkestein said, that tax competition could become harmful when it undermined the capacity of MS to finance essential public services, when enterprises and individuals arrange their affairs so as to benefit from low-tax jurisdictions for taxation purposes and high tax jurisdictions for the purposes of receiving public services. The proposed way to tackle this was to promote a co-ordination of Member State tax policies – by encouraging and facilitating co-operation.

6.2. Arguments for/against co-ordination/tax competition.

The main arguments pro and con tax competition versus tax co-ordination are featured in the following table.

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[142] This objective was first established at the European Council in Lisbon in March 2000 and reitered by the Stockholm European Council in March 2001.
[143] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, p. 3.
[144] Released on 23 October 2001
[145] Plasschaert, S. R.F., Comprehensive Approaches to EU Company Taxation: To Which Companies Should They Apply? p. 7 -11

Table 2[146]

“Arguments for co-ordination/against competition	Arguments for competition/ against co-ordination
With the disappearance of risks based on currency fluctuations, the differences in tax systems have become clearer, and have a greater impact on capital flows. Capital allocations will be distorted if it takes place solely for tax efficiency.	Competition takes place, not between tax systems in isolation, but between revenue/expenditure systems as a whole. Countries with relatively high taxation – for example in Scandinavia – remain competitive by offering attractive social and other factors.
Tax competition will result in a “race to the bottom”, eroding Member States´ tax bases	Tax competition has not, in fact, resulted in a fall in the proportion of GDP taken in tax: rather the opposite.
There is an imbalance between the lack of co-ordination on tax on the one hand; and, on the other, the centralization of monetary policy within the € area, together with tightly constrained budgetary policy.	Since national governments within the € area have lost the ability to change interest rates, exchange rates or monetary aggregates, the only instruments left to them for stabilization policies is freedom to vary taxes.
Welfare maximation through competition only works when both capital and labor can move between competing jurisdictions. Where one factor (capital) is mobile, but another (labor) is not, the tax system will be distorted. Tax competition is increasing the tax burden on labor, which increases the rate of unemployment.	The gains from co-operation are not necessarily shared equally between participants. Lower taxes are one of the mechanisms through which relatively poor and/or small economies can compete in attracting investment (e.g. Ireland). Tax co-operation may therefore be merely an attempt by richer/larger economies to protect their revenues.
Tax competition makes it extremely difficult to pursue social and environmental objectives through the tax system: for example, income redistribution, the taxation of pollution, etc. Only co-ordination will prevent “free-loading”.	The desired mix of taxation/public expenditure may not be the same in all economies. Devolved decisions on tax are therefore more likely to correspond to citizens´ preferences. Tax competition is in accordance with the principles both of subsidiarity and democracy.
Business has to deal with fifteen different tax systems and fifteen different tax authorities within the EU, causing considerable costs and distortions.	“There is no art which one nation more swiftly learns of another than that of draining money from the pockets of the people”. (Adam Smith)

[146]Tax – cordination in Europe, p. 77

7. Analysis: Harmful taxation, from an Icelandic perspective

This final chapter concludes this discussion on harmful taxation from an Icelandic perspective. The main question posed was whether Iceland is completely independent in relation to its own tax system, without any regard to its participation in the European Economic Area. Tax law does not in principle make up part of the EEA Treaty. However, as has been shown, there are consequences that arise on the basis of the fundamental freedoms and State aid - this also applies with regard to the autonomy of tax law of the EEA Member States.

7.1. Different objectives

There is a difference of objectives of the EEA compared to those of the EU. The European Union strives for an internal market, but the EEA aims at free trade on the basis of the fundamental freedoms. The question therefore arises whether this difference allows the fundamental freedoms in the EEA, as in the EU, to restrict the autonomy of tax law? Hans van den Hurk and Albert Theunissen maintain, that this difference in objectives cannot be ignored. They believe that the scope to infringe, on the basis of the fundamental freedoms, the autonomy of tax law is less far reaching than on the basis of non-discrimination provisions in the EC Treaty.

As mentioned in the beginning, Iceland has become a player in the global tax competition by lowering the corporate tax rates. Ireland has been an active tax competitor for over twenty years, with a very beneficial effect on the economy in Ireland. A short overview follows of the development in Ireland and the measures they have taken in the area of taxation.

7.2. Ireland – a comparison

The Member **States´ interest** is that **the** citizens of the Union and businesses from other countries place capital and function in their **own?** country. Ireland is a good example on this. Through special rules in their legal system, **it is now considered** attractive for businesses within the financial sector to establish themselves in Ireland. And with a tax on companies only 10%, it was clearly indicated that Ireland was a good country to place certain businesses in.[147]

This temporary 10% tax rate for certain manufacturing companies was introduced in Ireland over 20 years ago, before the advent of the Internal

[147] EU-Boken, En handbok för företag om skatter och moms, Jan-Åke Jernhem, Jan-Olof Johansson & Ulf Svensson, p. 79.

Market, when the rate applicable to other sectors was 45%. At that time the Commission raised no objection under State aid rules but later, after the scheme had been extended, the Commission became concerned. In 1998 the Commission concluded that it did now represent State aid because it was sectoral and applied only to manufacturing activities. Not only did the scheme fall foul of the State aid regulations but also, it was subsequently found to be harmful under the Code of Conduct because it applied a lower rate of tax to certain categories of activity[148].

Ireland in response reduced its corporation tax for companies from 24% to 12,5%, effective 1. January 2003.[149] By 2003 the general statutory tax rate will be 12.5%. Instead of one sector relying on State aid under a harmful scheme the whole Irish economy will now benefit from what, by comparison with the rest of the EU is a 'low' rate of company taxation. However, 'the setting of the general statutory corporation tax is a matter for individual Member States. Although this is subject to the obligation to comply with Community law, the Commission does not consider that the 'low' general statutory corporation tax rate in Ireland infringes these.[150]

As **the Code of Conduct does not cover this low corporation tax, sin**ce the Code only covers tax measures that provide for significantly **lower,** level of taxation than the level that generally applies in the MS in question.

The new corporate tax system (to be implemented in January 2003), is thus not to be labeled harmful according to the Code of Conduct, as it covers all trading income derived by both resident and non-resident taxpayers and is therefore not "special".[151] The new 12,5% rate is thus **neither** incompatible with the Code of Conduct nor the State aid rules. [152]

The economy in Ireland has flourished in the last years, but the tax cuts among other factors have caused inflation to rise. Due to that situation, a decision was made by ECOFIN, to warn Ireland that it was not complying with the stability pact, resulting in Council Opinion[153] of February 12th 2001, a recommendation under Art. 99(4) of the Treaty was made. There are really no sanctions that the Commission can use, other than political pressure.

Given that Iceland is not participating in the monetary union the situation in Ireland where the Code of Conduct does not apply to measures inducing tax competition, but on the other hand a violation of the stability pact in

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[148] A speach by the European Commissioner Frits Bolkestein, at the Institiut of European Affairs, in Dublin Ireland, 29. May 2001.
[149] Budget 2000, http://revenue.is/wnew/corp00.htm
[150] A speach by the European Commissioner Frits Bolkestein, at the Institiut of European Affairs, in Dublin Ireland, 29. May 2001.
[151] Pinto, C., EU and OECD to Fight Harmful Tax Competition; Has the Right Path Been Undertaken? International Tax Review, Intertax, Volume 26, Issue 12, P. 393
[152] Svalborn, O., Ireland and the Evolution of Tax Competition, p. 14.
[153] Council Opinion, February 12th 2001, on the 2000 update of Ireland's stability programme, 2001-2003 (2001/C 77/07)

connection with the monetary union can cause political pressure, there could be indirect beneficial effects on Iceland its newly entered competition for attracting footloose investment.

7.3. Co-ordination

In European tax policy, it has been a general rule that national sovereignty takes precedence, as MS want to decide themselves how to structure their tax systems. Despite the emphasis on sovereignty, the European tax system is nevertheless undergoing changes and arguments for taking action in a European context are being heard more often. Coordinated European action is needed in areas such as cross-border problems, as it can reduce the competitiveness of one MS in comparison with another MS. Also coordinated action is needed to remove obstacles as differences between the tax systems of MS that can hinder the efficient operation of the Internal market.[154] A harmonized tax rate within the European Union is not a likely solution, given the development in recent years.

Member States of the EU have furthermore begun amendments on tax legislation. Close examples are the amendments on the tax legislation in Sweden where foreign companies within the EEA were enabled in some cases to be treated under the same conditions as Swedish. The reasons were among others those, that it was important that tax legislation did not put unnecessary burdens on groups of companies involved in cross-border activities and also that it was important for Sweden to appear as an attractive country for foreign investments.[155] Such measures do not only make Sweden more attractive to foreign investment, but it may also be concluded that such measures facilitate for establishment of subsidiaries in Iceland.

7.4. The Code of Conduct – does it effect Iceland?

The Code of Conduct is a political commitment, entered into by the MS, enforced by peer pressure. A spill-over effect from the Code into the internal taxation of an EEA state is highly unlikely indeed.

Her vantar eitthvad

Enlargement of the European Union is in progress. Accession negotiations have started with six countries[156] and accession negotiations have been

[154] Bos, W. J., The Changing World of European Tax Policy, European taxation, September 2000, p. 409-411
[155] Bergström, S., Bruzelius, A, Home-State Restrictions on the Freedom of Establishment in a Swedish Income Tax Law Perspective, p. 238.

[156] The Czech Republic, Cyprus, Estonia, Hungary, Poland and Slovenia.

launched with six additional candidate countries.[157] The challenge with the adoption and implementation of the taxation acquis of the European Union is much greater, as the participants in the last enlargement had been members of the European Economic Area with highly developed economies and has already taken on large parts of the acquis.[158]

The candidate countries have been reminded, that the Code of Conduct for Business Taxation, is a part of the tax acquis, even if it is not a legal obligation but a political commitment. In most candidate countries, there has been some kind of preferential company taxation, for example offshore centers or economic free zones. The candidate countries have provided information, permitting an assessment on the compatibility of their tax systems with the general principles of the Treaty, such as the freedom of establishment and non-discrimination. The candidate countries have been invited to confirm that they are prepared to only introduce new tax measures, which are in line with the Code of Conduct, similar to the "standstill" presently applied by the MS.[159]

In my opinion the Code of Conduct does thus affect Iceland. The implication of this statement is not the Code is applicable by itself as an instrument to control the tax legislation in Iceland. Quite the opposite, the Code of Conduct is not applicable in any way in Iceland, but the restraints that it puts on taxation policy on the Member States, must have the effect of strengthening Iceland's position as a serious tax competitor. The conclusion is that a corporate-friendly tax rate, a membership in the Internal Market, without the pressure of the Code of Conduct rules and the Monetary Union gives Iceland a good position in European tax competition.

7.5. Iceland – a good or harmful tax competitor

Good tax competition can have beneficial effect by forcing governments to maintain low levels of expenditure and by changing the tax structure to achieve fairness. Where the goal is primarily to attract foreign direct investments, this can result in harmful tax competition by for example reducing a corporate tax rate applicable on income earned by foreign investors, possibly leading to the ultimate erosion of the taxable base. But when the corporate tax rate is reduced on income earned by ALL investors, national or foreign, such measures do not constitute harmful taxation.

[157] Bulgaria, Latvia, Lithuania, Malta, Romania and the Slovak Republic.
[158] Birk Jacobsen, S, Enlargement of the European Union – taxation, Editorial, EC Tax Review, 2000-4. P. 216.
[159] Birk Jacobsen, S., Enlargement of the European Union – taxation, Editorial, EC Tax Review, 2000-4. P. 218-219.

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