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Recent Developments in International Taxation

Iceland

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Personal income tax

Last year, several changes were made that were directed especially towards incentivising innovation. The amendments include the following:

*Special exemption for individuals that hold shares in companies with approved R&D projects*

The exemption allows a contribution of shares to a personal holding company without the realised of taxable gain that would otherwise be subject to 22 per cent capital income tax.

*Tax deduction (50 per cent) for investments in small and innovative companies*

The tax deduction was extended to include 2022–2024, but was originally presented in 2016.

*Deferred taxation of realised stock options*

The deferral was extended to board members of companies with approved R&D projects. Before the amendment, the deferral applied generally to employees of companies in Iceland, but for board members, it now only applies in the case of companies with approved R&D projects.

Corporate income tax

*Interest deduction*

Following disputed binding rulings from the Icelandic tax authorities, which regarded domestic banks, an amendment was made to tax legislation that provides certainty for the deductibility of interest from certain hybrid financial instruments. The new provision also makes clear that certain conditional interest is deductible when paid rather than on an accrual basis.

*Withholding tax on dividends*

An amendment was made with the effect that dividends paid from a domestic limited company to another domestic limited company are not subject to withholding tax. Before the change was made, limited companies were subject to 22 per cent withholding tax, with the only exception of dividends paid between jointly taxed entities (subject to 90 per cent holding). However, limited companies are generally not subject to corporate income tax on dividend income due to a full deduction that effectively exempts the taxation of dividends (similar to participation exemption), so the withholding tax had an adverse cashflow effect.

*Debt-to-equity conversion*

A new provision was added to the Icelandic Income Tax Act that allows companies a deferral of taxation for two years upon the conversion of debt to equity. The deferral applies to gains that are realised in the case of the conversion of debt to equity at companies with approved R&D projects.

*Depreciation of certain assets*
The purpose of the amendment was to provide investment incentives for companies. First, companies are allowed 50 per cent depreciation within the years 2021–2025 of the acquisition price of assets acquired in the years 2021 and 2022. The maximum depreciation of assets differs depending on the category. Therefore, the new rule can have different consequences depending on the investment.

Second, the amendment allows for additional depreciation of 25 per cent (13.8 per cent for partnerships) for certain green assets. The provision provides a criterion that the assets must fulfill. Additional depreciation should be applied in equal deductions in 2021, 2022 and 2023.

**International tax**

*Transfer pricing*

Documentation requirements were presented in Iceland in 2014. However, to date, the tax authorities have not been able to apply penalties if companies do not comply with the requirements. The consequences could still be the added risk of the adjustment of tax bases with a 25 per cent charge calculated on any additional income tax to be paid.

The Icelandic Parliament passed an amendment that introduces fines that can be applied by the tax authorities if companies do not comply with the document requirements. The fines can be up to ISK3m.

*Cross-border joint taxation*

After several attempts, amendments have now been made to the Icelandic Income Tax Act to allow the use of the 'final losses' (based on case law from the European Union court) of European Economic Area (EEA) subsidiaries by an Icelandic parent company. Joint taxation should be applied for at the Icelandic tax authorities. The amended provision does not seem to allow for a retroactive effect. This poses questions in relation to the rights of companies that were not able to apply for joint taxation in the past despite Iceland having been obligated to provide for such joint taxation.

**Other amendments**

*The public good register (almannaheildaskrá)*

One of the changes to tax legislation in 2021 concerns the activities of legal entities for the public good. One of the main goals of the changes was to increase the tax incentive of associations for the public good, and the individuals and legal entities that sponsor such associations.

Individuals and businesses are now authorised to deduct grants and gifts to associations that fulfil requirements and are registered. Individuals can receive a deduction up to ISK 350k and companies can receive a deduction up to 1.5 per cent of gross income. Registration, and therefore the exemption from income tax, only applies to certain company forms.

*Increased proportion of film and television production costs now refundable*

In June 2022, a bill took effect that increases reimbursements for film production costs in Iceland from 25 per cent to 35 per cent if certain conditions are met. Production costs refer
to all costs incurred in Iceland that are deductible from the revenue of enterprises pursuant to the provisions of the Income Tax Act. Payments pertaining to employees and contractors are only to be included in production costs if they are verifiably taxable in Iceland.

The aim of the bill is to further support filmmaking in Iceland and promote the completion of more large projects entirely in Iceland. The projects must meet three new conditions to be eligible for a 35 per cent refund: (1) they must be at least ISK350m in size; (2) there must be at least 30 working days in Iceland; and (3) there must be at least 50 employees working directly on the project.

Case law

Interest deduction: District Court

The tax authorities had challenged the interest deduction by an Icelandic subsidiary (El kem Ísland ehf) of a Norwegian company. The Icelandic subsidiary had issued an interest-bearing bond to its parent in 2012 in relation to an offer by the Central Bank to buy foreign currency with Icelandic krona at a discount.

The tax authorities had put forward the main argument that interest from the bond did not qualify as deductible for tax purposes because the Icelandic subsidiary, in fact, did not need loan financing at the time. Therefore, the interest expense should not be deductible based on the general rule in the Income Tax Act, which states that expenses should have a direct link to generating income. The tax authorities also made reference to the general anti-avoidance rule in the Icelandic Income Tax Act. The District Court did not agree with this assessment and did not view these arguments as a basis for not allowing the deduction of the interest expense from the loan.

Controlled foreign company (CFC) rules: Court of Appeal

In June 2022, the Court of Appeal delivered a judgment in case No 286/2021, which is the first case on CFC rules brought to the Icelandic courts since the rules were introduced in 2009.

The case regarded the taxation of an Icelandic shipping company (Eim skip hf) from income generated by its CFC subsidiaries (leasing). The company based its main defence on the fact that the ownership was through an independent entity in the Faroe Islands that was subject to tax and within the EEA. The court responded by stating that the CFC subsidiaries were not registered in the Faroe Islands and the location of the intermediary did not free the company from the CFC rules applying because the rules also applied to indirectly held entities.

The company also based its defence on the statement that the income that the CFC entities generated should not be categorised as ‘capital income’ within the meaning of the CFC rules. The court stated that the company had not proved that the income should not be categorised as real economic activity and hence not capital income.

Crypto currency: Internal Revenue Board
The Internal Revenue Board passed a ruling that covered the categorisation of income from bitcoin, which has not been clearly defined in the Icelandic Income Tax Act. The Internal Revenue Board agreed with the tax authorities, which had issued guidance on the matter, that such income should be treated as the sale of tangible assets for tax purposes. In most cases, the sale of bitcoin by individuals would therefore be subject to 22 per cent capital income tax. However, the treatment might be different in some circumstances.

**VAT Icelandic branch: Internal Revenue Board**

The Internal Revenue Board confirmed in a ruling that a local branch (with a foreign head office) would not be subject to VAT registration if the sole purpose of the branch was to provide services to the head office. Therefore, the local branch was denied registration and could not reclaim input tax from local costs. The case involved a local branch that provided services in relation to services hosted by a local data centre, and has effect on other similar activities engaged in by local branches in Iceland.

**VAT refunds: Internal Revenue Board**

Icelandic VAT legislation has changed significantly in the past few years, in regard to cross-border services, and the aim has been to align VAT legislation with the Organisation for Economic Co-operation and Development (OECD) VAT guidelines and EU VAT framework. However, as Iceland is not a party of the EU VAT Directive, it has not harmonised its legislation in full with the directive. In addition, Iceland has recently had issues and disputes relating to foreign travel agencies that have tourists travelling to Iceland. These cases have raised some uncertainties on the VAT treatment of foreign service providers.

The Internal Revenue Board passed a few rulings during 2021 on the aforementioned issues and provided for a criterion that is subject to some uncertainty. As we understand, the criterion assumes that foreign service providers that resell services to customers in Iceland in their own name would be subject to VAT registration. This would apply even if the foreign service provider does not have a presence in Iceland (employee, establishment etc). However, if the foreign service provider is only an intermediary, that is, connects foreign customers with Icelandic service providers and receives a fee, the foreign service provider is not subject to VAT registration. The same would apply if the foreign service provider, which acts as an intermediary, pays invoices that are issued to the customer as out-of-pocket costs. In such cases, the intermediary could be eligible for a refund of VAT in Iceland for any costs related to its activities as an intermediary. The customer could also be eligible for a refund of VAT (partly or fully) on its costs based on the same rules, that is, on the refund of VAT to foreign enterprises. The refund is subject to several requirements.