Forms of entities - Partnerships in Iceland

National Report to the Nordic Tax Research Council – Economic Part

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1. Introduction

There are two tax registries in Iceland, i.e. the registry for individuals and the registry for legal entities. The Directorate of Internal Revenue is responsible for the operation of both registries.

The registry for individuals contains all individuals older than 16 years of age, where all individuals who are self-employed are included. Their total number has increased considerably in recent years and was in 2013 268,451[2]. Thereof the number of self-employed was 15,581 but those are individuals who have some sort of business in their own name and ID number[3]. Only a part of those show a business profit and pay income tax accordingly.

In the tax registry for legal entities are companies who can either be taxable or non-taxable. In 2013, the total number of companies in the first group was 38,123 and in the latter group 15,811. In total there were 53,934 legal entities in the tax registry in 2013 and their number has been increasing for the last years. Not all businesses are profitable, but in 2013 about 42.2% of the companies paid income tax. Some forms of entities in the tax registry offer a choice regarding the tax structure when establishing a company, whether to be taxed independently or to be a transparent tax entity. This applies for example to those who establish general partnership, limited partnership and partnership limited by shares. In the year 2013 there were 573 partnerships registered as transparent tax entities compared to 3,234 partnerships as independent tax entities.

The most common forms of legal entities are public limited company, private limited company, self-employed entity, general partnership, limited partnership and partnership limited by shares, where the most popular one is private limited company. Owner‘s responsibility and tax structure varies between the forms, as well as regulations on accounting and registration.

What follows is a short description of the most common forms of entities in Iceland and their structure. The emphasis will be on general partnership, limited partnership and partnership limited by shares. Second, there is a description on the development of the corporate,

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[2] Estimated population was 321,857 at year end 2013.

[3] Those who have declared imputed salaries as a part of their yearly tax return.

partnership and personal income tax rates. Third, statistics on total number of partnership forms including independent tax entities and transparent tax entities are introduced along with figures on the tax base and sector analysis. Fourth, an overview on different taxation between various forms of entities and the pros and cons of choosing a certain legal form for a business. Finally the main conclusions are summed up.

2. Forms of entities

2.1 Self-employed entity

A self-employed entity is a business form where one party owns and runs a business in his own name and ID number where the owner‘s responsibility on the company‘s commitments is direct and unlimited. Direct responsibility means that creditors can access the owners‘ total assets if debts are not paid. Self-employed entities pay personal income tax and the amount depends on the income earned with three brackets ranging from 37.3 to 46.24%. The owner has to return an operating account along with the yearly tax return which details the entities‘ income and expenditure including the owner‘s minimum imputed wage. No taxes are paid when the profit is paid out. There is no need to register a self-employed entity in a company registry unless the business is to be given a specific name, that is other than the owner‘s name.

2.2 Public Limited Company

The owners of public limited companies need to be at least two and their indirect responsibility is limited to their contribution of equity to the company. The equity needs to be at least 4 million ISK. Public limited companies are independent tax entities and pay 20% corporate income tax. Dividends paid out to owners are subject to capital income tax which is presently 20%, but there are special regulations that limit dividend payments. Public limited companies are listed in the company registry operated by the Directorate of Internal Revenue.

2.3 Private Limited Company

A private limited company can have one or more equity owners and their responsibility is limited to their equity share in the company. The minimum equity is 500,000 ISK. Private limited companies are independent tax entities like the public ones and pay 20% corporate income tax. Dividends paid out to owners bear 20% capital income tax but there are special limited rules on dividend payments. They are also listed in the company registry. Private limited companies, being the most popular business form in Iceland, do not have as strict legal framework as public limited companies and are therefore better suited for smaller businesses where the intention is not to attract public investors.

2.4 General Partnership

General partnerships need to have at least two owners that can either be an individual or a legal entity. All owners bear direct, undivided and unlimited liability of the company‘s commitments. General partnerships can choose to be independent tax entities and if that is the case they bear 36% partnership tax. They can also be transparent tax entities, but then the owners are taxed by their share in the partnership and the tax percentage is the same as for a self-employed entity (37.3-46.24%). If the owner is a legal entity then the 20% corporate income tax applies. No additional tax is levied on the partnership‘s profit when paid out. All general partnerships are registered in the company registry.

2.5 Limited Partnership

Limited partnerships have one or more partners with direct, undivided and unlimited liability for the partnerships‘ liabilities and one or more partners with limited liability that is limited to their share of the equity. Those partners therefore don‘t bear more liability than they put in the company just as shareholders in limited companies. Limited partnerships can be independent or transparent tax entities with either 36% partnership tax or taxed by their share in the partnership with steps from 37.3 to 46.24% personal income tax (if the partner is an individual), or 20% corporate income tax (if the partner is a legal entity). As with general partnerships, no additional tax is levied on the partnership‘s profit when paid out. All limited partnerships are registered in the company registry.

2.6 Partnership Limited by Shares

Partnership limited by shares are, like limited partnerships, required to have one or more owners with direct, undivided and unlimited liability on the company‘s commitments and one or more owners with limited liability based on each and everyones share of the equity. Minimum equity is 4 million ISK. Partnerships limited by shares can be independent tax entities where the corporate income tax is 20% or transparent tax entities where the partners are taxed by their share in the partnership (37.3-46.24% / 20%). Dividend is paid out in accordance with regulations. Presently, the capital income tax is 20%. **A**ll partnerships limited by shares are registered in the company registry.

	General Partnership	Limited Partnership	Partnership Limited by Shares	Private Limited Company	Public Limited Company	Self-employed entity
Owners	At least 2	At least 2	At least 2	At least 1	At least 2	1
Responsibility	Unlimited and undivided	At least 1 with unlimited and undivided responsibility and at least 1 with limited responsibility	At least 1 with unlimited and undivided responsibility and at least 1 with limited responsibility	Limited with shares	Limited with shares	Unlimited and undivided
Minimum equity	Partners' decision	Partners' decision	4,000,000	500,000	4,000,000	--
Income Tax, if independent	36%	36%	20%	20%	20%	--
Independent taxable party	Partners' choice	Partners' choice	Partners' choice	Yes	Yes	No
Income Tax, if transparent	37.2-46.24% / 20%*	37.2-46.24% / 20%*	37.2-46.24% / 20%*	--	--	37.2-46.24%
Tax on dividend payment	0%	0%	20%**	20%	20%	0%

*37.2-46.24% if owned by an individual and 20% if owned by a legal entity.
**If independent tax entity

Table 1. Overview of forms of entities

3. The development of corporate, partnership and personal income tax rates

Figure 1 shows the development in the corporate income tax rate and the partnership income tax from 1990 to 2015 as well as capital income tax rate from 1997. There has been a large change in both corporate and partnership income tax rates since 1990. Both tax rates gradually decreased until 2008 with the goal to improve the competitiveness of Icelandic companies and to attract foreign investment. After the financial crisis hit Iceland in 2008 the tax rates have increased a little again with more drastic increase in the tax rate for partnership mainly due to the increase of the capital income tax rate from 10% to 20%. The corporate income tax rate was raised from 15% to 18% in 2010 and again in 2011 to 20%. The partnership income tax rate was also raised from 24% to 33% in 2010 and to 36% in 2011.

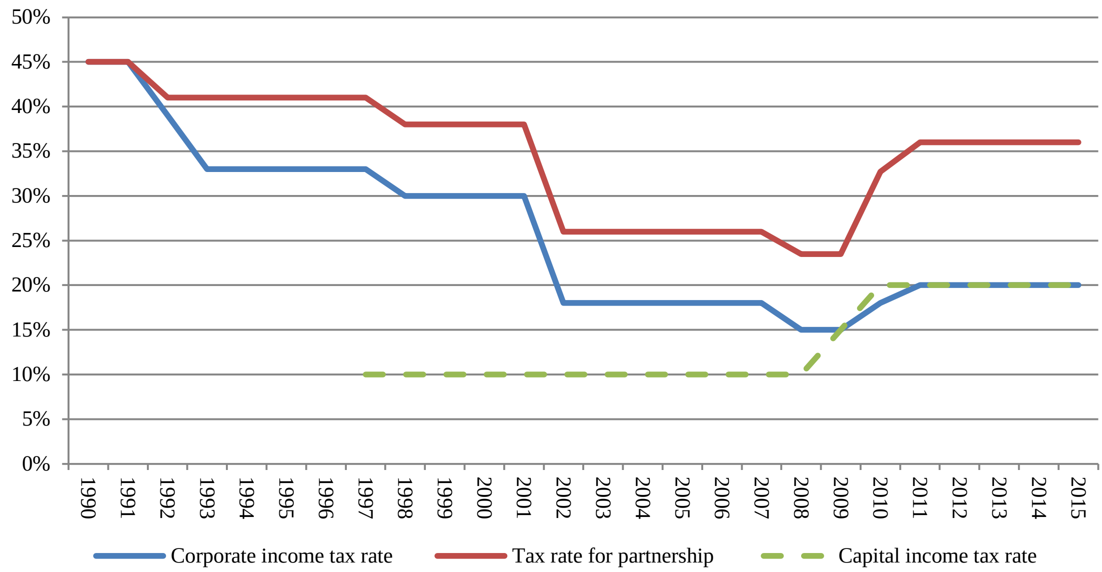

Figure 1. Corporate, partnership and capital income tax rates

For transparent taxable entities owned by individuals, figure 2 shows the development in their tax rates (personal income tax). From 1993 to 2005 the income tax rate decreased but at the same time a special income tax was introduced on revenues above a certain threshold. In 2006 the special income tax was abolished all together for three years but became effective again for the last six months of 2009. As a consequence of the financial crisis a personal income tax with three brackets was introduced in 2010 in order to collect more revenues. In 2014 the rates were altered a little between the brackets increasing the last bracket and decreasing the other two. Presently, the personal income tax is levied by three brackets, i.e. 37.3% income tax on revenues up to ISK 309,140 per month, 39.74% on revenues between ISK 309,140 and ISK 836,404 per month and 46.24% on revenues above ISK 836,404 per month.

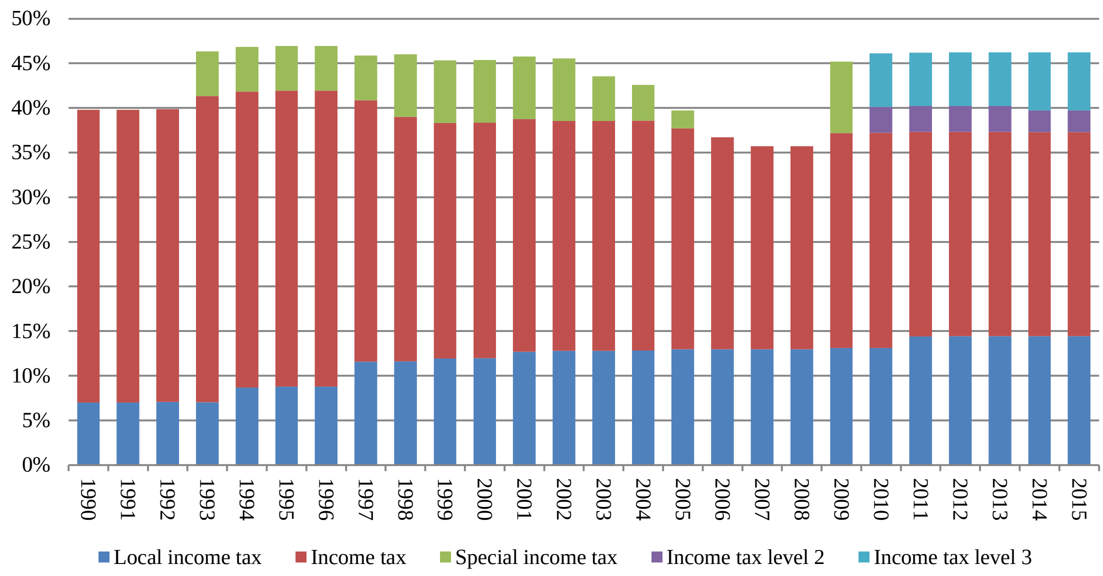

Figure 2. Personal income tax rates

4. Statistics

The data is collected from the tax registry of legal entities for the years 2006-2013. All legal entities are registered there, both the independent and transparent tax entities. Information on transparent tax entities is, however, difficult to obtain. It was for example not possible to obtain information on the tax base and the returns. These types of partnerships fill in their tax assessments within the owners‘ private ones and often do not fill out extra forms with all appropriate information to be able to know for certain the relevant data. It was also impossible to publish data showing its share of returns in proportion of the tax bases for partnerships with independent tax entities. Companies in the partnership forms are very few in Iceland thus one or two companies can confuse the whole picture. Nevertheless, the published data should give a fairly broad picture on the structure of the forms of entities.

4.1 Number

As mentioned before the partnership forms can be divided into either independent or transparent tax entities. The former one is more common with e.g. 1,509 general partnerships with independent tax entities and 487 with transparent tax entities in 2013. With 1,996 general partnerships in total, it becomes the most popular partnership form in Iceland. The number of general partnerships has been relatively stable over the past years with a little decrease since 2006.

	General Partnership	Limited Partnership	Partnership Limited by Shares	Self-employment	Private Limited Company	Public Limited Company	Total
Independent tax entity	1,509	1,712	14	--	33,604	733	37,572
Transparent tax entity	487	48	39	15,581	--	--	16,155
Total	1,996	1,760	53	15,581	33,604	733	53,727

Table 2. Total number of companies in 2013

The number of limited partnerships has increased dramatically since 2009 or by 219%. That is mainly a result of a change in the legislation for limited companies in 2009 (called 20/50 rule). According to the law dividend up to 20% of equity could be taxed as capital income. Half of dividend payment exceeding 20% of equity was taxed as salaries and half as capital income. This change in the legislation affected private limited companies significantly. Before it was not as popular to establish a company within the limited partnership form because at least one owner has an unlimited responsibility of the company‘s commitments. With the new legislation that changed, establishment of limited partnership increased a lot and many private limited companies were changed to a partnership form. The reason being that in partnerships there are no taxes on dividend payments thus the profit goes directly to the owners. As a result partnerships‘ tax burden was less than the tax burden of limited companies. In 2013 the legislation was abolished. One issue that came up regarding the rule is that some avoided taking on the responsibility issue by establishing a private limited company as well and by making it a co-owner of the limited partnership and bearer of the unlimited responsibility. As a result the original owner(s) then only had a limited responsibility. Whereas the owner of a private limited company has a limited responsibiliy, none is fully responsible for the commitments of the limited partnership. Now limited companies only need to pay capital income tax on all dividend payments as they did before the change in the law. The number of limited partnerships was 1,712 in 2013 where 97% were independent tax entities and 3% were transparent tax entities.

The number of partnerships limited by shares has been increasing over the past nine years but is still few in comparison with the other group forms. In 2013 they were in total 53 including 39 with transparent tax entities, after being almost none existent before 2006.

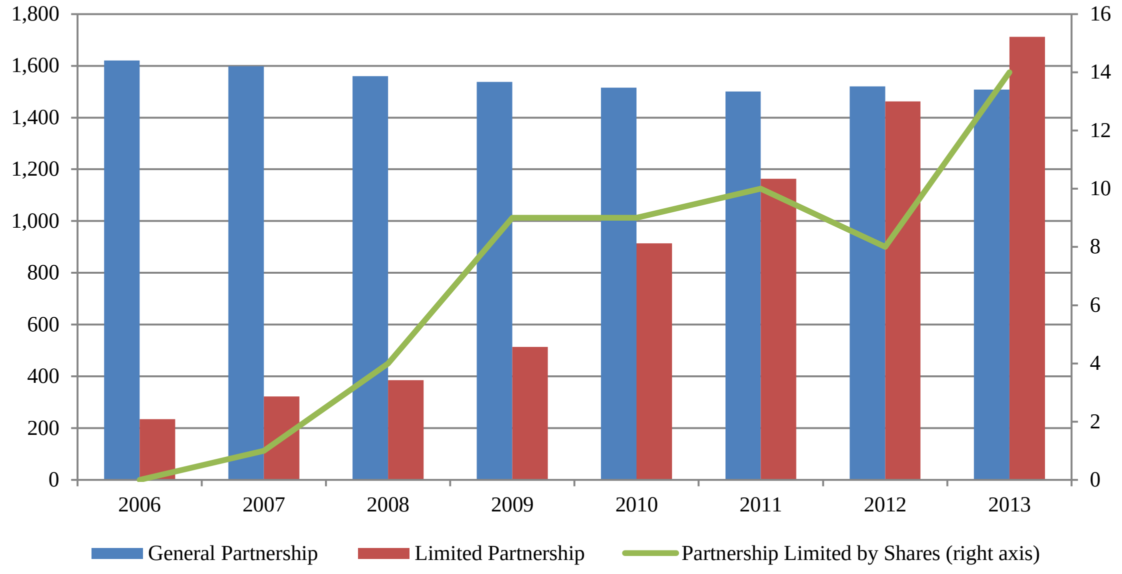

Figure 3. Number of independent tax entities

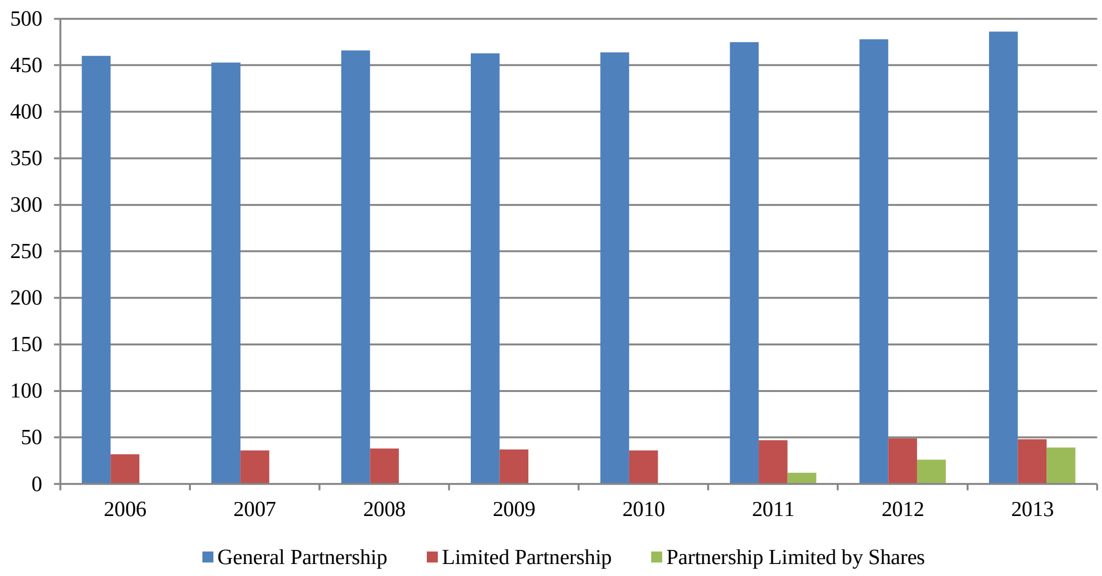

Figure 4. Number of transparent tax entities

The most common business form in Iceland is a private limited company with 33,604 companies in 2013. It has increased by 28% since 2006 but only by 0.7% from 2012-2013. At the turn of the century it became popular to establish private limited companies. The corporate income tax rate was much lower than the personal income tax rate and the capital income tax rate (which came into effect in 1997) was also very low or 10%. As a result the number of companies in this form increased dramatically at the expense of self-employed entities. The ratio between partnership forms (independent and transparent tax entities) and liability companies (private and public) has been increasing after the financial crisis both because the latter ones increased at a slower pace and because limited partnerships increased sharply at that time as discussed earlier due to the 20/50 tax rule. In 2013 the ratio was 11.1% compared to 10.4% the year before after being down to 7.8% in 2009.

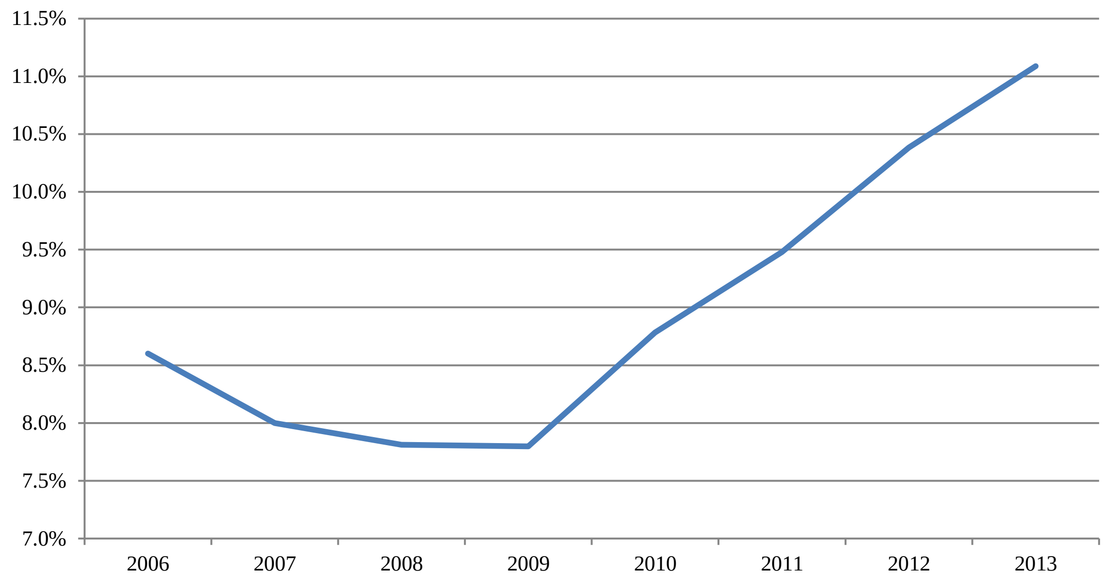

Figure 5. Ratio between the partnership forms and the liability companies

4.2 Sector analysis

The number of partnership forms divided by sectors is presented in figure 6. Most partnerships, both in general and limited partnership forms, are in the sector of professional, scientific and technical activities with total of 716 partnerships. Included there are e.g. lawyer services, accountants, architects and engineering businesses and advertising agencies. The second biggest sector for these forms is human health and social work activities followed by constructions. However, almost all partnerships limited by shares are in financial and insurance activities or 42 out of 53.

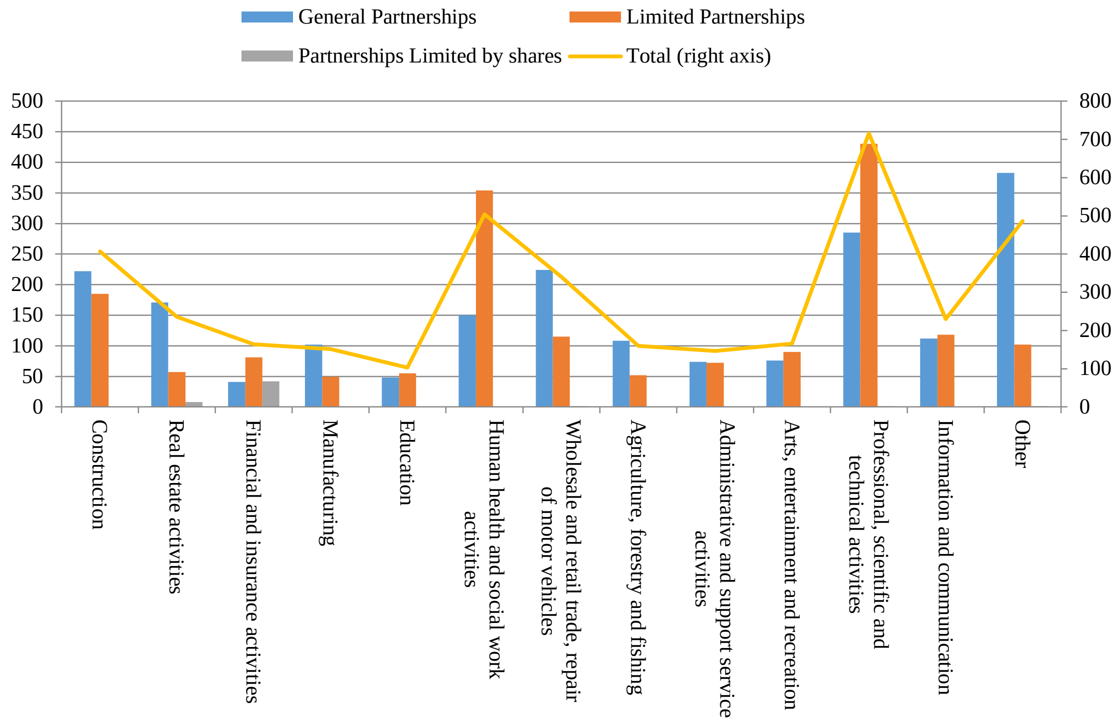

Figure 6. Sector analysis

4.3 Tax base for independent tax entities

The total tax base for partnerships in the form of independent tax entities has been increasing for the last three years mainly because of a sharp increase in the tax base of limited partnership forms. However, the tax base for partnerships limited by shares has been almost zero for all the years in question which is a result of a low profit and high losses carried forward. After the financial crisis the tax base for all forms were weaker except for limited partnerships but it has been improving again for the last few years. The tax rate for all forms also increased in 2010 and 2011 which helped the tax base to recover after the crisis.

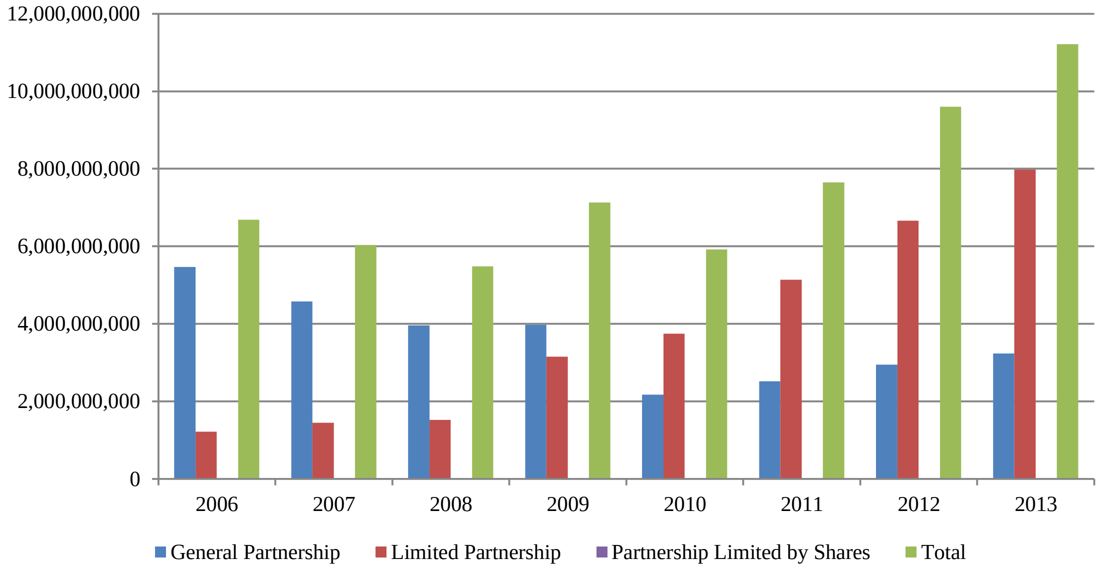

Figure 7. Tax base of partnerships with independent tax entities

In total the proportion of partnerships‘ tax base and the tax base of limited companies was 4.9% in 2013. The ratio has increased since the financial crisis because at that time and the years there after losses increased in the annual accounts, especially for public limited companies, and therefore there was no income tax base for some of the companies. Many companies also became bankrupt or have ceased to operate thus the number of public limited companies is less now than before 2008. In recent years the main increase has also been in establishment of limited partnerships in expense of private limited companies which increases the tax base for the partnerships.

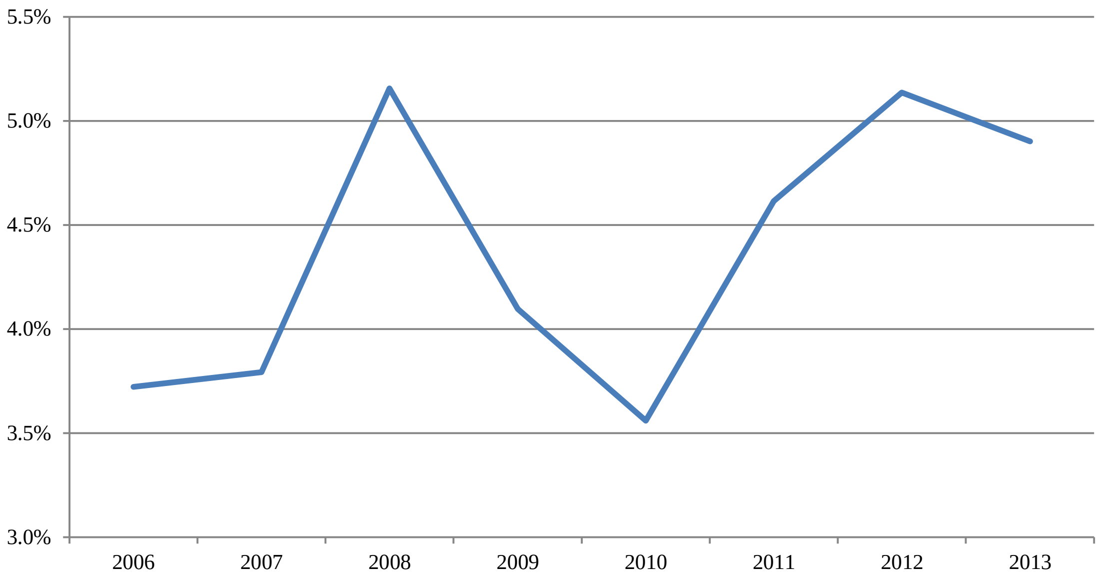

Figure 8. Ratio between the tax base of partnerships and limited companies

5. Choosing the right form of entity

The right form of entity for a company can be difficult to choose and it is necessary to take account of other things than the difference in taxation between the forms, e.g. things like the difference in responsibility and what the overall activity of the company is going to be.

Minimum imputed wages for self-employed, partnerships and limited companies are published each year by the Directorate of Internal Revenue. Principals should allocate to themselves the appropriate minimum wage in all three types of business, upon which they pay personal income tax, social security contribution and premium to the pension funds. Minimum imputed wages are not supposed to be lower than if it were salaries received working for an unrelated person. The same applies to minimum imputed wage for work of spouses, own children under 16 years old, inlaws or close relatives.

In some cases it is possible to choose from being a self-employed or a wage-earner. A self-employed person is taxed as an individual. The tax base is the owner's total revenue both professional operating income and other private revenues which are not related to the business less operating expenses. It is permitted to withdraw some business expenses from the revenues, for example minimum imputed wage. As a self-employed person is taxed with the same tax rates as a wage-earner there is no difference in the tax payments for a self-employed person with a profit of ISK 1 million and an individual with salaries of ISK 1 million. The same is also relevant for a partnership with a transparent tax entity. Thus there are no tax incentives between these forms. However a partnership with an independent tax entity pays less tax of the profit whereas the tax rate is lower, or 36% instead of 37.3-46.24%.

	Wage-earner	Self-employed	Transparent Partnership	Independent Partnership
Salaries	1,000,000	--	--	--
Taxes	400,491	--	--	--
Profit	--	1,000,000	1,000,000	1,000,000
Taxes	--	400,491	400,491	360,000
After tax	**599,509**	**599,509**	**599,509**	**640,000**

Table 3. Taxation on a wage-earner and a self-employed person[4]

After the financial crisis in 2008, the Icelandic Government requested the International Monetary Fund (IMF) to conduct a review of the tax system. The outcome of the review was published in two reports, in June 2010 and May 2011.[5] According to the IMF the allocation of capital and labor income should be the same for self-employed, partnerships and private corporations, so that the form of business does not depend on tax considerations. At least, the

[4] Minimum imputed wages are not shown specificly in this example for the self-employed person and for the owners of the partnerships. It has already been taken into account in the profit. Also if there would be a deficit on the company no taxes would be paid except personal income tax on the minimum imputed wage.

[5] *Improving the Equity and Revenue Productivity of the Icelandic Tax System*; IMF, June 2010 and *Advancing Tax Reform and the Taxation of Natural Resources*; IMF, May 2011.

method should be unified for partnerships and corporations, since self-employed have the option of adopting one of these forms if they have significant capital assets.[6]

There can be a tax incentive between a transparent partnership and a limited company even though it is not between the latter one and a partnership with independent tax entity. As discussed before the tax rate for a partnership form with independent tax entity is 36%. For a partnership with profit of ISK 100 the tax payment is therefore ISK 36. There is no tax payment on the profit paid out. Thus the owner can take the after tax amount out of the company without paying additional taxes. For limited companies the income tax rate is 20%. If the profit is ISK 100 the income tax paid is ISK 20. If the owner takes the after tax amount (ISK 80) out of the company, a payment of 20% capital income tax is needed or ISK 16. The total tax paid is therefore ISK 36, the same amount as owner of a partnership has to pay[7]. Hence, there are no tax incentives between partnership forms with an independent tax entity and liability companies. The difference lies in other parts e.g. the responsibility and minimum equity needed. The favourable tax regime for corporate profits and partnership income relative to labour income has however created incentives to move from self-employed over to private limited and partnership companies with independent tax entity. Also for a partnership with transparent tax entity the income tax rate is between 37.3-46.24% depending on the amount of the profit. Thus that kind of a form pays higher taxes than partnership with independent tax entity and limited company.

	Independent Partnership	Limited company	Transparent Partnership
Profit	100	100	100
Taxes	36	20	37.3
Dividend	64	80	62.7
Taxes	0	16	0
Total taxes paid	**36**	**36**	**37.3**

Table 4. Taxation on partnerships and a limited company

5.1 Pros and cons

All business forms of entities have their pros and cons. Some are more convenient for smaller companies, others for larger ones. Choosing a form can also depend on the debt structure of the company and its financing.

A general partnership can be a good form if there is no or very little debt in the company and the business has a low risk. The starting cost can be low whereas the startup capital is decided solely by the owners and there are less compulsory legal rules and restrictions than for limited companies. General partnerships do not need to pay capital income tax of the profit allocation and is therefore more flexible form than public and private limited companies. However the

6 *Advancing Tax Reform and the Taxation of Natural Resources*; IMF, May 2011, page 22.

7 36% (=0.20+(1-0.20)*0.20).

owners´ risk is very high since they are responsible for the company with all their assets. Hence, this form could be good if the owners‘ cooperation is good and filled with trust and the business is a low risk and profitable.

Limited partnership is similar to a general partnership except there is only one owner needed to take responsibility of the business with all its assets. The startup capital is again decided by the owners with no minimum. The profit of the company can go directly to the owners without paying capital income tax. It can be quite risky to be the one who bears full responsibility of the company‘s commitments, therefore the owners need to work well together, the business cannot have high risk or it has to have low debts and it needs to be profitable.

The only difference between general and limited partnerships with independent tax entities vs. transparent tax entities is the income tax rate which is higher for the latter one. That explains why there are very few partnerships which are transparent compared to the independent tax entities. Nonetheless some could find it easier to hand in one individual tax assessment and do not want to do a seperate one for the company. It could also be the case that two people start a partnership together to be able to advertise its business as a group and have a logo for the company but nevertheless want to be on their own as if they were self-employed.

Partnership limited by shares is not very common form. It is a mix of a limited partnership and a limited company. The startup capital is high, the rules are more complex then in other partnership forms and it is not possible to take all the profit out of the company without paying taxes. However, it could be convenient to establish a company under this form if it is a company engaged in e.g. research and development. One of the owners could be responsible for the commitments and would also bring in the knowledge (e.g. biotechnologist) and the other (shareholder) brings in the finance. Still the ownership could be 50/50.

Responsibility for the company‘s commitments is low in private limited companies. The only risk is to loose the amount of capital put into the company. It is also easier to sell this kind of a company compared to a partnership. However this form is less flexible than the partnership forms. The owners might not be able to take as much as they want out of the company and they always need to register it as dividends or salaries.

In a public limited company the owner‘s responsibiliy is low and only depends on the amount of money put into the company by buying shares in it. It is easier to sell this form than the partnership form. Also a public limited company can get new funding by increasing its stocks. Nonetheless, the rules are very strict for public limited companies and there is much surveillance for companies listed in the stock market. The startup capital is also high and the owners cannot allocate the profit as they want. A confirmation on whether the company can pay any dividend is needed from a stockholder‘s meeting.

Self-employed entity can be suitable if the company has a low risk. The owner is independent in its decisions, there is no startup capital and it is not necessary to list it in a company registry. It is also possible to use operating cost to lower operating revenues and there is no capital income tax paid on the allocation of the profit. Nonetheless this form is quite risky for the owner because his responsibiliy is both unlimited and undivided. Hence the owner is responsible, with all his assets, for the business. The income taxes are high and it can be more difficult to sell the business.

5.2 Financing

All types of partnership forms and limited companies can normally get a loan from a bank if the owners provide some equity themselves. The bank also has to approve the business model and be convinced that the business can pay the loan back. Nonetheless if the owner cannot provide equity it can be possible to provide collateral in their houses or some insurance for the loan. The most common type which banks lend to is private limited company. It is also possible to get a venture capital from the NSA ventures, a fund which emphasises on start-up companies with high growth potential. However, it only invests in limited companies or partnerships limited by shares with the most common setup being again private limited company. If the fund has invested in a company it might be possible to get a loan from them as well.

6. Conclusion

There is no special political focus on any business form of entity including partnership forms in Iceland. In 2010 new law came into force which grants support to innovation companies with the goal to strengthen research and development and to improve the competitive conditions for innovation companies by offering them tax deduction due to cost on innovation projects. The law does however only apply to partnerships with independent tax entities and limited companies, not partnerships which are transparent tax entities. The main conclusions from this article on the partnership forms in Iceland are following:

- It is more popular to establish a partnership with independent tax entity than partnership which is a transparent tax entity.
- The most popular partnership form in Iceland is general partnership followed by the increasing numbers of limited partnerships.
- As a result of a special rule called 20/50 rule which was in force in 2009-2013, the number of limited partnerships increased significantly.
- The data on partnerships which are transparent tax entities are difficult to obtain e.g. the tax base and return therefore they are not included in this report.
- There are no tax incentives between a wage-earner and a self-employed person with the same amount of salaries and profit.
- There are no tax incentives between partnerships with independent tax entities and limited companies, however there is more tax burden on partnerships which are transparent tax entities.
- There are other parts than taxation which can affect what kind of a form is chosen for a company, e.g. responsibility on the company‘s commitments, minimum equity needed and the overall activity the company will be engaged in.