The taxation of partnerships in Iceland

Legal part of the Icelandic National Report to the Nordic Tax Research Council - spring 2015

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Introduction

In the last years the most common type of company in Iceland has been the limited liability company or the private limited liability company. This development is mainly due to the limited liability of the owners towards creditors and third parties, the reasonable cost of establishing a private limited liability company and because the tax rules for these companies have been considered rather beneficial. In 2009 changes in the taxation of limited liability companies and their dividends[2] decreased their popularity and instead the number of limited partnerships increased significantly.[3] This change in the tax legislation for limited liability companies in 2009 was called the 20/50 rule and provided that a dividend of up to 20% of the equity was taxed as capital income in the hands of the shareholders. Half of any dividend payment exceeding 20% of a company's equity was taxed as wages and half as capital income. This change in the legislation affected limited liability companies considerably and is considered to have caused the before mentioned shift in a choice of business form from private limited liability companies to limited partnerships. The 20/50 rule has since been abolished with effect from 1 January 2014.[4]

Limited liability companies have been regulated in Iceland since 1921 and when the EEA Agreement entered into force on 1 January 1994 the legislation in this area was adapted to EU legislation.

Partnerships have however historically also been commonly used as an organisation to conduct business in. As already mentioned their popularity has increased among small and medium enterprises in the last years due to a less favourable tax regime for limited liability companies and also because the partnership form is more flexible than the limited liability company. Subsequently, the number of newly registered partnerships, especially limited partnerships, has been on the increase.

Company law aspects

Introduction - history

There are three main types of partnerships under Icelandic law where at least one of the partners has unlimited liability for the partnerships liabilities. The unlimited liability is the decisive factor that distinguishes partnerships from other types of business organisations. The most common one is the general partnership, but the number of limited partnerships and partnerships limited by shares has increased in later years.

[1] Legal Adviser, Ministry of Finance and Economic Affairs.
[2] Act No 128/2009 amending the Income Tax Act No 90/2003.
[3] The number of newly registered limited partnerships has increased by 219% since 2009.
[4] Act No 142/2013 amending the Income Tax Act No 90/2003.

General partnership (*sameignarfélag*)

General partnerships are regulated by Act no 50/2007 on General Partnerships which entered into force on 1 January 2008.[5] Before the entry into force of this Act there was no general legal act on general partnerships in force in Iceland and the law in this area consisted of a few legal provisions but mostly judicial practice. Partners in a general partnership which conduct a business jointly have unlimited liability for the partnership's obligations.[6] Usually, the partners enter into a partnership agreement when establishing the partnership and register the general partnership with the Public Register of Enterprises where the partnership agreement is filed. A partnership needs to have at least two partners and the partners can be an individual or a legal entity.[7] The partners can however not be a married couple. There is no minimum capital required by law as that is left up to the partners to agree upon. The reason why it wasn't considered necessary to set a minimum capital requirement in the General Partnership Act is the unlimited liability of the partners. To dissolve the general partnership all partners need to agree on the dissolution, a winding-up committee should be established, a notification posted to alert all creditors and finally the Public Register of Enterprises should be notified of the dissolution. Partnership agreements can also provide for more detailed rules on the dissolution of the partnership.

Limited partnership (*samlagsfélag*)

In a limited partnership there is at least one partner that has unlimited liability for the partnership's obligations but other partners bear limited liability, which is then limited to their financial contribution to the partnership. There are a few legal provisions covering this type of partnership which can be found in the Act on Commercial Registries, Firms and Proxy No 42/1903 but no general act on limited partnerships is in place. A limited partnership is established by a partnership agreement and should be registered with the Public Register of Enterprises where the partnership agreement is filed. There is no minimum capital required by law as that is left up to the partners to agree upon. A limited partnership needs to have at least two partners but the partners can be an individual or a legal entity. The partners can however not be a married couple. To dissolve the limited partnership all partners need to agree on the dissolution.

Partnership limited by shares (*samlagshlutafélag*)

A partnership limited by shares is a partnership entered into between one or more jointly and severally liable partners, known as managing partners, and one or more shareholders, who are only liable to lose their investment amount. The managing partner can also be a shareholder. Partnerships limited by shares are governed by the Act on Limited Liability Companies No 2/1995[8] but specific provisions therein only apply to partnerships limited by shares. The minimum capital requirement is the same as in a public limited liability company or 4 million ISK.

[5] http://www.althingi.is/lagas/nuna/2007050.html
[6] Article 8 of the General Partnership Act.
[7] Article 6 of the General Partnership Act.
[8] Chapter XX of the Act on Limited Liability Companies No 2/1995 concerns partnerships limited by shares.

Tax law aspects

Introduction

Icelandic tax law provides that general and limited partnerships, as well as partnerships limited by shares can at establishment choose whether they want to be taxed as an independent entity for tax purposes or whether the partnership should be considered transparent for tax purposes.[9] To become an independent entity for tax purposes the partnership agreement reflecting this choice along with a registration form has to be filed with the Public Register of Enterprises.[10] In the case of partnerships, this choice is irreversible and the deciding factor on how independent tax entities are distinguished from transparent entities. If the partnership chooses not to become an independent tax entity it is treated as transparent and any income derived from the partnership is taxed as business income in the hands of the partners. The rules on the taxation of general and limited partnerships are the same and the discussion below will therefore only distinguish between the two if there is a difference which needs to be highlighted. Respectively, if a partnership limited by shares chooses to be an independent tax entity, it is taxed in the same manner as a limited liability company. The discussion below will describe the general tax rules applicable to partnerships, but it should be kept in mind that entities operating in the financial sector are liable to additional taxes, levied on the total amount of debt of a financial institution,[11] wages and profits exceeding 1 billion ISK respectively.[12]

Taxation of a partnership as an independent tax entity

The tax base of a partnership which is taxed as an independent tax entity is calculated in the same way as a limited liability company. That means that the same items can be deducted from the gross income as in a limited liability company, except that the partnership does not enjoy a participation exemption for dividends and is therefore subject to 20% income tax on dividends received which is the same tax rate as individuals would pay on that type of income. The tax percentage is, however, different. Partnerships are subject to a 36% tax on their profits while limited liability companies are subject to 20% tax. The partners in a partnership are however not taxed again on the distributions from the partnership whereas individuals receiving dividends from a limited liability company are taxed with a 20% tax.

Depreciation

The same rules on the depreciation of tangible fixed assets apply to any type of business under Icelandic law.

Loss

A partner in a partnership taxed as an independent tax entity cannot deduct loss from the partnership from any other business income the partner may have. This is in line with the partnership being tax independently, so that any gain or loss is limited to the partnership and is not transferred to the partners.

[9] Litra 1 and 3, paragraph 1, Article 2 of the Income Tax Act No 90/2003.
[10] Litra 1, paragraph 1, Article 2 of the Income Tax Act No 90/2003.
[11] See, Act No 155/2010 on the Bank Tax.
[12] See, Act no 165/2011 on the Financial Activites Tax.

If a partner provides the partnership with a loan, the interest, given that it is comparable to interest calculated between unrelated parties, is deductible from the partnership's profits.

Payments from the partnership

A partner which devotes most of his time working for the partnership should pay himself the minimum imputed wage, which depends on in which line of business the partners are in.[13] According to the rules on the minimum imputed wage, the amount which should be calculated as wages therefore differs depending on the relevant sector. Wages are subject to social security contribution, municipal tax and are deductible from the profits of the partnership. The remaining profits of the partnership are then taxed at the partnership level with a 36% tax. Once distributed to the partners it is not taxed further.

Taxation of a partnership when transparent for tax purposes

Icelandic tax law provides that the net method of taxation is applied when calculating the tax for each partner.[14] This entails that the difference between the gross income and deductible costs of the partnership is divided between the partners depending on their share in the partnership as taxable income. The income is then subject to personal income tax in the case of individuals which is progressive starting at 37,30% and peaking at 46,24%.[15] If the partner is a limited liability company it is taxed along with other business income at the 20% corporate income tax rate. The partners can therefore be subject to different tax rates depending on their individual circumstances.

Depreciation

The same rules on the depreciation of tangible fixed business assets apply to any type of business under Icelandic law.

Loss

If the partnership is run at a loss, the loss should also be divided between the partners according to the provisions of the partnership agreement, which usually would reflect their share in the partnership. Loss incurred from the partnership which is a transparent tax entity can be deducted from other business income of the respective partner.[16] Loss incurred from a partnership which is an independent tax entity is, however, not deductible from other business income.[17] The limited liability of participants in a limited partnership does not affect the possibility of deducting loss from the tax base of the participant.

Payments from the partnership

Payments from the partnership to its partners are taxed differently depending on their nature, interest for instance would be taxed at a 20% income tax rate in the hands of an individual partner which is the tax rate applicable to interest income of individuals. A certain part of the income from the partnership would, however, always qualify as wages and be taxed as such and also be subject to social security contribution and municipal tax.

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[13] Rules on the minimum imputed wage.
[14] Ásmundur G. Vilhjálmsson, *Skattur á fyrirtæki*, Reykjavík 2003, p. 678.
[15] Personal income tax rates, including municipal income tax for 2015.
[16] Ásmundur G. Vilhjálmsson, *Skattur á fyrirtæki*, Reykjavík 2003, bls. 693.
[17] ÚRN 111/1986 and 635/1989.

Taxation of a partnership limited by shares

Since 2006 partnerships limited by shares can also choose whether they want to be transparent or independent for tax purposes.[18] If the partnership limited by shares decides to be an independent taxed entity it is taxed in the same way as limited liability companies in Iceland at a 20% income tax.[19] Distribution of the profits is considered a dividend and taxed at a 20% income tax in the hands of shareholders who are individuals and partnerships. A corporate shareholder would enjoy a participation exemption and therefore this type of income would be deductible from its business income.[20] If a partnership limited by shares decides to be a transparent entity its income is taxed in the hands of the partners. As the partnership is transparent a corporate shareholder would benefit from a participation exemption when receiving dividends.[21]

Change in the ownership of a partnership and dissolution

When a general partnership is established the partners can contribute certain assets to the partnership, although there is no minimum requirement for this contribution by law. In some cases this transaction can be considered as a sale and any capital gains from the sale is taxed in the hands of the partner.

A partnership agreement would normally set some limitations as to how a partner can sell or pledge his or her share in the partnership. This is to be expected as it is very important who your partner in a partnership is, not the least due to the unlimited liability of at least some of the partners. When a new partner enters the partnership, the partner is considered to be buying a share in the partnerships assets and liabilities. The partner would usually become liable for any of the partnerships liabilities, also from the time before he joined the partnership, unless the partnership agreement states otherwise.

Therefore, the partnership agreement would usually also provide for rules on how a partner can leave the partnership and redeem his share in the partnership. Usually, this requires 6 months' notice but the partner is entitled to the value of his share at the point in time when s/he decides to leave.

Generally, the partnership agreement also provides for rules on how the partnership should be terminated. If only one partner remains in the partnership the partnership is terminated. In cases when a partnership is established for an unlimited period of time, a notice from one of the partners would start the dissolution procedure.

The taxation of the partner when selling their share in the partnership is different, depending on whether the partnership is a transparent or an independent tax entity.[22] In the case of a transparent tax entity the partner is considered to be selling a share in different types of assets and the attached liabilities. The gain can therefore be calculated differently depending on the asset and on the rules on depreciation of these assets.[23] In the case of an independent tax entity, the partner is considered to be selling his or her share in the capital of the partnership minus liabilities and the original contribution, i.e. the net method is used to determine the capital gain.

[18] Act No 77/2006 amending the Income Tax Act No 90/2003.
[19] Litra 1, paragraph 1, Article 2 of the Income Tax Act No 90/2003.
[20] Litra 9, paragraph 9, Article 31 of the Income Tax Act No 90/2003.
[21] Advance ruling from the Internal Revenue Service No 4/2007.
[22] Ásmundur G. Vilhjálmsson, *Skattur á fyrirtæki*, Reykjavík 2003, p. 708.
[23] Ásmundur G. Vilhjálmsson, *Skattur á fyrirtæki*, Reykjavík 2003, p. 710.

Anti- avoidance rules

There are various anti-avoidance rules in Icelandic tax law but no general anti-avoidance provision. Article 57 of the Income Tax Act is what scholars and the courts have deemed to be the closest to what could be considered a general anti-avoidance provision. Ad verbatim the rule affirms the principle that transactions between parties should be made at arm's length and that tax authorities can re-determine the value of property and services if their price is unusual. Many have nevertheless argued that the scope of Article 57 of the Income Tax Act is wider and that the provision in fact contains a general anti-avoidance rule. The Supreme Court has in any event held that a transaction may be disregarded if its main purpose is to avoid taxation. It can therefore be said that Icelandic courts have agreed to a "substance over form" approach to some extent. On that basis tax authorities have re-characterised some transactions deeming them to be entered into for the sole purpose of avoiding taxes. There is, however, not a special anti-avoidance rule aimed at partnerships and a partnership would not be considered an independent tax entity unless it had requested so at establishment.

National rules relating to international aspects

According to the General Partnership Act, a partnership is considered Icelandic when registered in Iceland or in the case of a non-registered partnership if the majority of the partners reside in Iceland and the major part of the business takes place in Iceland. A partnership can therefore be considered Icelandic according to the General Partnership Act, even if the partners are foreign. The partnership can choose between being an independent tax entity or a transparent tax entity. A foreign partner in a partnership which is transparent would be taxed on any business income derived from Iceland based on provisions in the Income Tax Act on limited tax liability. If a partner is a foreign company and the partnership is not an independent tax entity, it is also possible that the shareholder's operations in Iceland would be considered a permanent establishment. Such an estimate would first and foremost depend on Icelandic law and secondly on the tax treaties Iceland is party to. Provisions on limitation of benefits in double tax agreements could on the other hand limit the possibilities of such a partnership to make use of such an agreement but this would need to be assessed on a case by case basis.