Taxation of capital and wage income; towards separated or more integrated personal tax systems?

1. Introduction to the personal tax system

Income taxation of individuals in Iceland can broadly be divided into two categories, taxation of wages and taxation of capital income. The latter refers to dividends, interests, capital gains and a few other items of income not derived from the employment or the conduct of business. Wages are subject to general income tax and municipal tax, resulting in an average combined tax rate of 36,72%. The rate is flat, i.e. there are no brackets, but the effective tax rate increases due to an annual personal allowance of ISK 385.800.- In general employees cannot deduct expenses, the significant available deduction is pension contribution.

Capital income of individuals is subject to a flat tax rate of 10%. The 10% capital tax is a gross based tax, i.e. no deductions are permitted with the exception of the possibility of offsetting capital gains from the sale of shares with losses from the sale of shares within the same calendar year.

Although it falls outside the scope of this report it is prudent to note that the frame and basis for all Icelandic law on individual income taxation is in the Icelandic Constitution no. 33/1944 (the Constitution). According to article 40 of the Constitution no tax can be levied, changed, or removed except through a legal act passed by the Icelandic parliament, Althingi. Furthermore, according to article 77[1] of the Constitution matters on tax shall be governed by legal acts passed by Althingi and the administrative level cannot be granted the power to decide if a tax should be levied, changed or removed. The article also states that no tax shall be levied unless permitted by law at the time when the actions resulting in a tax liability occurred, i.e. tax law in Iceland can not be enacted retroactively. The provisions of the Constitution provide for a very interesting frame and basis for Icelandic tax law, however, they have not been addressed thoroughly in literature.

2. Recent Reforms

As there have been no fundamental reforms in individual taxation of Icelandic individuals recently this report will try to describe various changes of the last five years with the aim of illustrating the general trend in Icelandic reform. In general Icelandic reform in the last few years is (i) lowering of the tax rate applicable to wage income, (ii) abolishing of a higher tax rate for high income individuals, (iii) increasing of personal allowances, and (iv) abolishment of net wealth taxes.

2.1. Lower individual tax rate

Act no. 129/2004 provided for a decrease of the individual income tax rate for wages of 4% in total. The decrease was not immediate but slowly to be decreased from 2005 to 2007. For the income year of 2005 the tax rate was to decrease by 1%, for

[1] This article forms a part of the human rights chapter of the Constitution.

2006 by 1%, for 2007 by 1% and for 2008 the tax rate was to decrease by 2% thereby concluding the 4% tax rate decrease provided for in act no. 129/2004.

Act no. 174/2006 provided for a decrease of the individual income tax rate for wages. The act provided for a decrease of 1% from the actual rate at the time and this applies for the income year 2007. A half of the change contemplated by act 129/2004 referred to above had come into effect, i.e. since 2005 the individual tax rate had reduced by 2% and this change secured another decrease of 1% for 2007 in stead of the full 2% reduction previously contemplated. As a result the average individual income tax rate in Iceland is now 36,72%.

2.2. Abolishment of higher tax rate for high income individuals

Act no. 152/2002 extended the existing special higher tax rate for high income individuals for one year. However, the tax rate for the higher income bracket was decreased by 2%, from 7% to 5%, and the amount of income needed to fall into the higher bracket was increased by 2,75%.

Act no. 143/2003 extended the existing special higher tax rate for high income individuals for two years. However, the tax rate for the higher income bracket was to be reduced until being abolished in the end of 2005. For the income year 2004 the tax rate was reduced from 5% to 4% and a further reduction to 2% for 2005 was provided for. After that, i.e. from 1 January 2006 and onwards the special higher bracket income tax rate was abolished in Iceland. Since then the same rates apply for all Icelandic individuals earning wage income.

2.3. Increase of personal allowances

Act no. 143/2003 provided for an increase in the wage amounts used to determine personal allowances for parents to children (Children Allowance) and interest costs due to own home purchase (Interest Allowance). The Children allowance amount was increased from ISK 35.422.- to ISK 36.308.- and special income related Children Allowance was increased. Furthermore, a change in the calculation of the interest costs allowance was made in order to decrease the incentive for households to incur debt, this was done by reducing the interest cap on loans incurred to acquire own house from 7% to 5,5% but the cap of the actual amount of interest expenses was increased in addition to the wage amounts used for determining when to reduce the allowance being increased. In essence the Interest Allowance was increased but the interest cap was made stricter affecting loans bearing higher interests than 5,5% more than others.

Act no. 129/2004 changed the wage amounts used to determine Children Allowance and Interest Allowance. The act increased the Children Allowance from ISK 36.308.- to ISK 56.096.- in three steps, i.e. to ISK 37.397.- in 2005, to ISK 46.747.- in 2006 and to the full ISK 56.096 in 2007, in addition to increasing the wage amount used to determine an added Children allowance. In essence the Children Allowance amount was increased and the decrease due to high wages was mitigated. As for the interest allowance the cap on the interests incurred on loans for the acquisition of an own home was reduced from 5,5% to 5% but the cap of the actual amount of interest expenses was increased in addition to the wage amounts used for determining when to reduce the allowance being increased. In essence the Interest

Allowance was increased but the interest cap was made stricter affecting loans bearing higher interests than 5% more than others.

Act no. 129/2004 also increased the amounts of direct personal allowances to ISK 329.948.- in the income year of 2004, to ISK 339.846.- in 2005 and to 348.343.- in 2006.

Act no. 135/2006 provided for a change in the Interest Allowance. The change was made as a part of a settlement of labor disputes between employee and employer unions. The change increased the asset cap used to reduce the Interest Allowance by 25%, i.e. the actual Interest Allowance was increased.

Act no. 174/2006 changed the age of dependant children used to determine personal allowances for parents to children, i.e. the Children Allowance is granted to parents with children up to 18 years of age in stead of 16 before the change. Furthermore, this act increased the amount of the fixed personal allowance and added a rule to provide for an annual review and update of the fixed allowance. The fixed personal allowance was increased from ISK 356.180.- to ISK 385.800.- and a provision added which links the direct personal allowance to the consumer index, i.e. it increases in the beginning of each year by the same ratio as the consumer index for the last twelve months.

2.4. Abolishment of net wealth taxes

Act no. 129/2004 provided for the abolishment of net wealth taxes previously levied on individuals. According to the act the net wealth taxes in Iceland were abolished as of January 1 2006.

3. Taxation of wage and wage-related income

3.1. General

The taxation of wages and wage-related income in Iceland does not differ, i.e. all income derived from exercising employment, be it wages, fringe benefits or other wage-related income, is classified and taxed in the same manner[2] according to the Icelandic income tax act no 90/2003 (ITA).

3.2. Wages

Wages are defined in article 7 letter A numeric 1 ITA. The definition is very broad and refers to remuneration for any type of work performed for another entity. This includes, without excluding anything, regular payments, fringe payments, bonuses, payments in kind, etc.

The definition of income is, therefore, generally wide enough to include any kind of valuables received in return for employment. In addition to defining wages in this broad manner it is clearly stated that it does neither matter who receives the income nor in what form it is.

[2] There is an exception on certain qualified incentive programs in the form of options where individuals are subject to tax at the rate of 10% on the gain derived from such option programs.

In light of this the definition of wages in ITA merely seems to require (i) someone performing work, (ii) an employer for whom the work is performed, and (iii) any type of valuable being paid for such work. It is quite interesting, however, that no formal or substantial link is required between the employee and the employer. On the contrary, the definition explicitly states that it does not matter who receives the income and although there is no such explicit statement on the entity that pays the income the wording of the provision does not require any specific entity in this regards.

This raises questions that have neither been answered in practice nor theory, i.e. what amount is taxed to whom in the absence of a direct link between employer and employee? Indirectly this may have provided for results at the level of the national tax board where both companies and individuals have been taxed in accordance with an employer-employee relationship existing while such a relationship was formally not existing, c.f. national tax board rulings YSKN 90/2003, YSKN 317/2005, and YSKN 318/2005. Furthermore, there is a recent example of this at the level of the Supreme Court where the court found that in a specific case of hiring out of labor the entity hiring the labor was considered the employee of the relevant employees of the entity hiring out the labor.

At least it is clear that Icelandic law contains a very wide base when it comes to wages, basically including any type of valuables received for the performance of employment. Furthermore, although some type of wages are required in addition to an employer and employee there need not be a formal link between those two entities.

3.3. Deemed wages from own business

Article 7 letter A numeric 1 ITA does not only define the wage income of individuals as described in 3.2. but also contains a special rule for self employed individuals. According to this rule an individual that is self employed shall be deemed to have employment income that is not less than that same individual would have earned had he performed the same work for an unrelated entity. This applies irrespective of the individual running a business in its own name, in cooperation with others or in the form of a legal entity where the individual has a decisive influence on the business due to ownership or control.

ITA, therefore, anticipates that the amount of wages derived from employment shall be the same in case of individually operated businesses or closely held, or controlled companies, as when performed for third parties. In practice it is immensely difficult to determine what a specific person would have earned when working for somebody else. The solution opted for by Icelandic tax authorities is an issuance of a scale for wages to use as deemed wages from employment in these cases.

3.4. Fringe benefits

Fringe benefits are subject to tax in the same manner as other types of wages. This is clearly stated in Article 7 letter A numeric 1 ITA, i.e. fringe benefits, gifts and other employment related payments are subject to the same treatment as wages.

ITA, however, contains no rules on how to determine the amounts subject to tax in case of fringe benefits. Fringe benefits in the form of options is the one exception from this, the applicable rules are described below. This is simple in some cases, e.g. an employer gives an employee a new car so an invoice from the dealer exists clearly showing the benefit of the employee and that amount is subject to tax as any other wages. This is much more difficult in many other cases. Where an employer has the right to use an asset of the employer, a car, a house, an airplane, etc., the valuation can be extremely difficult. Due to the lack of rules in ITA on the valuation it is not clear if the right of use is the basis for the amount to be taxed, the use itself, or something else.

In practice this is solved in ITA by granting authorization to the Minister of Finance to decide on the valuation needed in case of fringe benefits. This is done annually be the ministry but the rules issued only cover certain types of fringe benefits. It can be argued that these rules provide for to strict valuations of some fringe benefits while leaving other types of comparable benefits out so they will possibly not be taxed. Furthermore, the tax basis in case of fringe benefits is decided upon in the regulation which is odd in light of the constitutional requirements in case of tax law but this method has been approved by the Supreme Court.

As for options, they are for some reason the only type of fringe benefit specifically dealt with in ITA so the tax base in case of such benefits is determined by the act. In case of specific qualified option plans subject to strict requirements and monitoring by the tax authorities individual employees are not taxed upon exercising the options but only when they sell the acquired shares. When they sell the shares they are subject to tax in the same manner as in case of capital income, i.e. at the rate of 10% where the basis is the difference between the sale price and the option price.

In case of any other options individual employees are subject to normal wage taxation upon exercising the options, i.e. subject to the general wage tax rate and their tax base is the difference between the option price and the fair market value of the acquired shares.

3.5. General income tax and municipal tax

There is no difference in the tax base for income tax and municipal tax purposes. The distinction is due to the Icelandic government receiving a part of the income tax and the municipalities receiving a part of it. In case of the former the tax rate is fixed, 23,75%, c.f. article 66, paragraph 1 numeric 1 ITA. In case of the latter the tax rate can vary within a specific bracket, i.e. between 11,24% and 13,03% c.f. article 23 paragraph 1 of act no. 4/1995 at the discretion of any given municipality.

3.6. Personal allowance

There is a fixed personal allowance of ISK 385.800.-, it is indexed so it increases in accordance with the increase of the consumer index annually. The fixed personal allowance functions as a direct decrease of levied taxes on an annual bases ISK for ISK. Effectively it, therefore, provides for a specific amount per annum that is not taxed, a sort of a zero rate tax bracket. After that each ISK is subject to tax at the applicable tax rate. Therefore, the Icelandic effective tax rate increases as wages increase although no formal brackets exist.

There is a personal allowance for parents of children, the Children Allowance, which is a fixed amount for every child under seven years of age. Furthermore, there is a special addition to the Children Allowance which is a fixed amount for children under eighteen years of age but this amount decreases in accordance with the wages of the parents. There is no limit to the decrease so for high income individuals there is no special addition to the Children Allowance. The Children Allowance is a part of ITA but effectively it is a subsidy but not a tax discount.

There is a personal allowance for interests incurred due to the acquisition of individuals own homes, the Interest Allowance, which is an amount calculated on the basis of interest costs of an individual purchasing a home to live in. First the interest costs are calculated but capped at the rate of 5% of the nominal value of the loans and/or a specific amount. The interest costs so calculated are then reduced in accordance with the income of the individuals involved and their net assets and for high net worth and/or high income individuals the Interest Allowance can be reduced to nil. For other individuals the Interest Allowance is capped at a fixed amount. The Interest Allowance is a part of ITA but effectively it is a subsidy but not a tax discount.

3.7. Deductions

Deductions for individual employees are limited.

First, payments for costs incurred for an employer are deductible, this includes car allowance and travel allowance.

Second, there is a major piece of deduction allowed for employees of international organizations or associations of states. Provided that international agreements that Iceland is party to state that employees of such organizations or associations should not be taxed Iceland allows for a deduction in the case of such individuals in the full amount of their wages, i.e. they are effectively not taxed. The same applies for diplomats receiving location payments due to services for the Icelandic state within other states.

Third, windfall income in the form of lottery winnings and the alike, provided that all profits from their operation are used for cultural, humanitarian or religious operations, are allowed as a deduction. Effectively, such income is not taxed by use of the deduction rule.

Fourth, pension contribution amounts are deductible. This is an incentive to pension savings but pension income will be taxed as ordinary wages upon reception.

3.8. Principles of tax policy

The Icelandic tax rules for wage income are, as a general rule, quite simple. Leaving aside the Interest Allowance and the Children Allowance which are subsidies the broad, all inclusive, definition of wages income along with a single tax rate and a fixed personal allowance provides for a simple tax system. The simplicity makes it effective for the vast amount of Icelandic tax payers and tax authorities so the PAYE withholding system generally results in the correct withholding[3] so the annual assessment generally does not differ much from the tax already withheld.

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[3] The variable municipal rate distorts this a bit.

The same tax rate applies to everybody although the effective tax rate does increase with higher income. Equity wise it is therefore safe to say the Icelandic tax system generally works.

The major exception to the above is income in the form of fringe benefits. The almost complete lack of rules on the valuation of fringe benefits in order to identify a tax base is likely to cause distortions in taxation of such income. It is clear that such income should be subject to tax and in some cases it is, i.e. in the case of options and in the case of specific items of income officially valued by the Ministry of Finance, but both general rules and specific rules of valuation are missing from Icelandic law. This probably results in some fringe benefits being taxed and others not for no reason but lack of rules to implement the general one.

4. Taxation of capital income

Capital income of individuals in Iceland is subject to tax at the rate of 10% on gross basis, i.e. generally no deductions are allowed. Capital income is exhaustively enumerated in article 7 letter C ITA. The type of income classified as capital income is described below. For the income to be taxed as capital income the individuals involved must not be deriving it in business capacity.

4.1. Rental income from movable property

Rental income from movable property is defined in a very broad manner. Effectively, any type of rental income from any type of movable property is defined as capital income subject to tax at the rate of 10%.

4.2. Rental income from immovable property

Rental income from any type of immovable property and rights to immovable property, including mining rights, water rights, geothermal rights, fishing rights, and any other type of valuables connected to immovable property, is classified as capital income subject to tax at the rate of 10%. However, in case of residential housing being rented out such renting is deemed to be the conduct of business if the tax basis of such housing exceeds ISK 27.000.000.- in case of individuals or ISK 54.000.000.- in case of couples.

4.3. Interests

Interests are subject to tax at the rate of 10% with no possibility of deduction. However, interests are not defined in ITA as the payment for the use of money. There is a complicated definition that rather refers to an exhaustive list of specific types of interests than provide for a general definition with a list of examples. Specifics on the definition of interests under Icelandic law fall outside the scope of this report but it is prudent to mention that the Icelandic definition of interests can both include items of income that generally would not be considered interests and vice versa.

4.4. Dividends

Dividends, as interests, are subject to tax at the rate of 10% with no possibility of deduction. As opposed to interests, however, dividends are defined in a general manner in ITA, c.f. article 11 paragraph 1. The definition of dividends refers to regular dividends, c.f. company law, but also to any type of distribution of valuables that should be considered as income from shareholding.

The definition, therefore, makes it a prerequisite for the existence of dividends that shares are held and the income derives from such shareholding. Therefore, a deemed dividend is conceivable but only in cases where the individual actually holds shares in the relevant company. However, actual distribution is required in the absence of a regular dividend so accrual based taxation is not possible in the case of deemed dividends.

A special provision in paragraph 2 of article 11 ITA provides for taxation of dividends in the same manner as wage taxation if the shareholder is an employee of a company that distributes dividends in breach of company law. This provision is probably aimed at owners of closely held companies in order to prevent wages being paid out in the form of dividends.

4.5. Capital gains

Income from the sale of assets is classified as capital income and, therefore, subject to tax at the rate of 10%. Capital gains are defined as a sale price less the acquisition price according to ITA. The capital gains classified as capital income include, as a general rule, the income from the sale of any type of asset. Therefore, income from the sale of any movable and immovable property is included in the classification.

There are four main exceptions from the general rule. First, in case of the sale of residential homes of individuals, i.e. real estate used as their own homes, the capital gain is not subject to tax if the individual has held that home for at least two years, c.f. article 17 paragraph 1 ITA.

Second, an individual can consider a half of the gross selling price as the income rather than the sale price less the acquisition price, c.f. article 15 paragraph 3 ITA.

Third, capital gains from the sale of movable property that does not form part of business property is not considered income of an individual provided the property was not bought with the purpose to sell it with a gain, c.f. article 16, paragraph 2 ITA.

Fourth, a limited deduction from capital gains is permitted. If a loss is incurred from the sale of an asset in the same year a gain is made from the sale of different but same type of asset the loss can be deducted from the gain of the sale, c.f. article 24 paragraph 1 ITA.

4.6. Principles of tax policy

The capital income rules of ITA are fairly straight forward and simple so in general they are effective for taxpayers and tax authorities. Equity as a result of the simplicity and effectiveness should in most cases be ensured but in marginal matters the definition of interests could prove problematic and the rules on capital gains can also prove difficult to argue on the basis of equity as it is not clear how some of them would apply and why there are differences depending on how or why the capital gains are realized.

Equity as regards capital income is, however, most interesting in relations with income in the form of wages. This will be discussed in chapter 5.1.

5. Problems of income transformation and tax evasion

5.1. Difference between capital income and wage income

The main incentive to transform income from wage income to capital income is the substantially different tax rate depending on which type of income an individual earns. As stated before the average wages tax rate is 36,72% while the capital income tax rate is 10%. When the capital income is derived through the operation of a business a tax rate of 18% is first paid at the level of a ltd. company and then the 10% rate is paid on the dividends or capital gains from the shares in such a company, i.e. the effective tax rate in those cases is 26,2%. In light of this there is an incentive of 10,52% to transform wage income into income from shares of a ltd. company.

In part the benefit described above is easily achievable in the cases of individuals operating a business in their own name. Article 56 ITA provides for a simple method of transferring an individually operated business into a ltd. company in a tax neutral manner. However, even if ITA explicitly provides for a method to transform an individually operated business to a company operated business with the corresponding differences in tax treatment the effect of the change is not simple, this is addressed further in 5.2.

Apart from the method of transforming a business there is a substantial difference between capital income and wage income according to ITA. Wage income is very broadly defined and all inclusive while capital income is exhaustively enumerated and each item defined in ITA. Therefore, all income derived from employment is treated as wages for tax purposes even if such income would be capital income if the employment relationship was non existent. This approach of ITA effectively provides for a clear difference between capital income and wage income resulting in it being very difficult for wage earners to avoid taxation via income transformation. In border line cases the difference may not be very simple but this approach promotes equity, i.e. all employees are subject to tax in the same manner irrespective of what form their income from employment takes.

5.2. Individual conducting business and a company conducting business

Although there is a substantial benefit in transforming an individually operated business into a company operated business at first glance there are various rules that make such a conclusion incorrect.

First, as described in 3.3. the rules on deemed wages from the operation of an individuals own business, including a closely held company, result in the individual at issue having to derive income in line with what would have been earned for a third party. In effect this results in a wage determination in line with guidance rules of the Icelandic tax authorities. Effectively these rules should eliminate the benefit of transforming a business in this manner.

Second, as described in 4.4. dividends from a ltd. company to its employee must be distributed in accordance with company law if they are not to be taxed in the same manner as wage income. Therefore, hidden or constructive dividends will be taxed like wage income of such individuals. As a result, various company law rules have to be complied with before dividends can be distributed which, at least to some extent, results in income being locked in companies for some time before their owners can receive it through dividend payments. While such income is locked in the companies any interests earned on it will be taxed at the corporate rate of 18% while a rate of 10% would have applied to the individuals.

Third, if the business is not a genuine business there is substantial risk of the company being ignored for income tax purposes, as described in 3.2. As a result companies put in place merely for an employee should not be effective to reduce the tax burden of the relevant individual. On the contrary, such an individual will likely be taxed in the same manner as if being a direct employee and effectively only succeeds in bearing the costs of putting a company in place.

The rules on closely held companies should, therefore, result in an attempt to transform wage income into business income ineffective. These rules are somewhat complicated which results in them being difficult to deal with for taxpayers and tax authorities alike. However, they promote equity by reducing the possibility for one employee to be taxed less than another one in the same situation were it not for a company being in place.

6. Future tax reforms

Currently there are no bills pending at Althingi on income tax matters. Furthermore, there are no clear indications on how the Icelandic tax system will be changed in the future. The exception to this is a declaration by the Icelandic government on the wage tax rate being lowered in the next few years.

7. Integration of capital income and wage income taxation

The individual income tax system in Iceland clearly distinguishes between capital income and wage income taxation. In addition to a clear distinction as regards income classification there is a clear distinction as regards the tax rate, i.e. the capital income tax rate is substantially lower than the wage income tax rate.

The evolution of ITA for several years now does not indicate an integration of capital income and wage income taxation. In order to integrate the two either a change in income classification or a change in tax rates of capital income and/or wage income would be necessary. There are no indications of the former being on the agenda as a change of ITA. There are, however, indications in declarations of government that the latter being on the agenda as a possible change of ITA. The proposed changes are not in the form of an increased tax rate of capital income but a decreased tax rate of wage income. The 10,52% difference in tax rate described in 5.1. should, however, not be the target for decrease in the wage tax rate due to the issues described in 5.2.

The actual decrease needed to integrate capital and wage income taxation is presumably difficult to determine. This should be a worthy project for the Icelandic economist counterpart to this report.