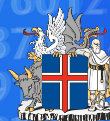


English translation of the Weekly Web Release

MINISTRY OF FINANCE IN ICELAND

August 3rd 2006

Do we need CFC-legislation?

There has been discussion lately on the taxation of holding companies owned by Icelandic nationals that have lodged them in tax havens. The necessity for bringing CFC rules into law has been pointed out since their main purpose is to prevent an undue transfer of taxable income from one country to another for the sole purpose of avoiding or minimising tax payments. This is carried out through a compulsory, consolidated taxation of domestic and foreign tax entities. These rules are mainly directed at taxation of capital income, such as dividends, interest and service fees (passive income). CFC stands for Controlled Foreign Company and applies to a foreign company under the management or ownership of a domestic national. Many countries have already passed CFC rules into law that spell out the tax treatment of such companies. The Nordic countries except Iceland have done so. They differ between countries.

One of the basic rules of taxation is that a country only taxes income that relates to its territory in a certain manner. Such a relation can be twofold. On one hand, it can be determined by the tax-defined domicile of the individual or entity in question in which case the taxpayer is taxable on all income, regardless of its geographical origin (unlimited tax liability). On the other hand, taxation is subject to the origin of income, regardless of where the taxpayer in question is domiciled (limited tax liability).

Increasing globalisation along with the free flow of capital has disturbed these basic rules, especially in the case of the very mobile capital income. The tendency has therefore been to shift income to low-tax areas, in many cases in the absence of a tangible business operation, whereas an unduly high allocation of business expenses is debited in a higher-tax country. CFC rules are intended to resist such a practice through compulsory, consolidated taxation, subject to certain conditions. This means that the income of the foreign entity is taxed in the domestic country where the taxpayer has its tax-defined domicile.

CFC rules specify the conditions that apply to a consolidated taxation, contrary to the general rule of a tax-defined domicile. Regard is had to the tax ratio of foreign countries as compared to the home country, and a blacklist is created for countries that do not fulfil such conditions. As an example, the Swedish CFC legislation defines low-tax areas as those countries where the company income tax rate is less than 55 per cent of the Swedish rate, currently 28 per cent. Countries with a company tax rate below 15-16 per cent are defined as low-tax areas according to the Swedish definition. Such compulsory consolidated taxation is also determined by the degree of control of the domestic national of the foreign company in terms of ownership or voting rights.

Iceland does not have CFC legislation. The Ministry of Finance has carried out a study of this area in light of international developments. It is evident that such compulsory consolidated taxation is a complicated project and touches many areas. Questions have arisen on the coordination of such legislation and double-taxation agreements as well as questions pertaining to the provisions of the EEA-Agreement in light of a number of issues that have arisen within the EU. Such legislation must also have regard to the principle of proportionality, so that it will only cover actual tax-avoidance cases and not apply to foreign companies owned by Icelandic companies that do business in a normal manner. This project is being continued.

In this discussion, it is often forgotten that the Income Tax Act no. 90/2003 contains provisions that are intended to resist tax-avoidance schemes. Paragraph 9 of Article 31 specifies how dividends from a foreign company can be deducted in the books of the domestic company as long as the profits of the foreign company have been taxed in a manner comparable to the practice in Iceland. Article 57 of the same Act should also be pointed out, since it deals with unusual financial transactions and plays a comparable role as the CFC legislation of other countries. This provision has especially been applied in cases of abnormally thin capitalisation, where the principal company lends to the subsidiary or vice versa at unusual interest rates with the intention of minimising the tax base in the higher-tax country.

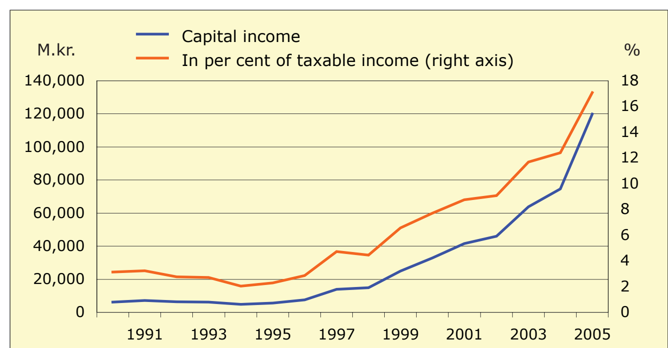
Icelandic incomes increased sharply in 2005

The 2005 tax returns of individuals bear witness to the strength of the economy. The total taxable income of Icelanders amounted to 702 billion krónur, increasing by 101 billion or 16.8 per cent from the previous year. For tax purposes, income is divided into wages, pensions and other emoluments, all of which are subject to standard state and municipal income tax, whereas capital income is subject to capital income tax.

Total wages amounted to 472 billion krónur, an increase of 13 per cent as a whole and 8.5 per cent per wage earner. The number of wage earners increased by 2.2 per cent, the greatest increase in previous years except in 2000. Payments from pension funds amounted to 34 billion last year and increased by 12.5 per cent from the previous year. The number of persons receiving pension payments came to 40,600, increasing by 2.7 per cent. Old-age and disability pensions paid by the State Social Security Institute amounted to nearly 32 billion krónur to some 47,000 persons, an increase of ½ a per cent in number, whereas total payments increased by 5 per cent.

A total of 2.4 billion was paid in unemployment compensation last year, a decline of 1 billion from the previous year. It was paid to 8,400 persons, a decline of 26.5 per cent from 2004. The same may be said for persons receiving rent subsidies and financial assistance from municipalities. Such payments amounted to 970 million krónur to 3,400 persons. The total amount declined by 4.5 per cent between years and the number of recipients decreased by 15 per cent.

Capital income 1990-2005



The largest income increase in recent years is in capital income. Nearly 85,000 families received 120 billion in capital income in 2005, an increase of 45 billion or 60 per cent from the previous year. Capital income has increased sharply, especially after capital income tax was enacted in 1997. Capital income provides 17 per cent of all taxable income. More than half of all capital income comes from the sale of stocks and another one-fifth are dividends from stocks. More than 9,000 families received income from the sale of stocks, whereas 40,000 received dividends. Most received interest income from bank deposits, more than 60,000, a total of 11 billion, averaging 184,000 krónur per family.

As noted earlier, total taxable income in Iceland increased by 16.8 per cent last year. The imposed taxes increased by 11.1 per cent and income after tax by 18.5 per cent. The income of individuals after tax approximates the concept of disposable income. According to these provisional figures, disposable income increased by more than private consumption in 2005 which rose by 14 per cent in nominal terms.

Treasury revenue January-May

12 month changes (%)	*2005*	*2006*
Total tax revenue	19.5	20.2
Taxes on income & profit	17.5	32.4
Taxes on property	59.2	-24.5
Taxes on goods & services	18.3	17.3
Social contributions	17.7	15.3
Total revenue	25.1	13.6

Treasury expenditure January-May

12 month changes (%)	*2005*	*2006*
General public services	170.7	-23.6
Health	69.3	19.3
Social security & welfare	80.0	-0.2
Economic affairs	40.5	0.4
Education	253.7	8.4
Total expenditure	94.6	-0.3

Treasury finances January-May

Million krónur	*2005*	*2006*
Cash from operations	11,566	28,281
Net financial balance	18,102	25,853
Debt redemption	-29,994	-38,104
Gross borr. requirement	-13,442	-13,901
Net borrowing	9,273	11,010
Overall cash balance	-4,168	-2,890

Economic indicators

12 month changes (%)	*2005*	*2006*
Inflation (July)	3.5	8.4
Core inflation (July)	3.6	7.6
Wage index (June)	6.3	8.8
Total turnover (Jan. - April)	5.8	11.9
Retail turnover (Jan. - April)	3.9	6.2
Unemployment rate, sa (June)	2.1	1.3

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