20 September 2011

Screening report
Iceland

Chapter 16 – Taxation

Date of screening meetings:

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I. CHAPTER CONTENT

The **indirect taxation** *acquis* consists primarily of harmonised legislation in the field of Value Added Tax (VAT) and excise duties. *Value Added Tax* includes the application of a non-cumulative general tax on consumption which is levied on all stages of production and distribution of goods and services. The VAT *acquis* provides for an equal tax treatment of domestic and non-domestic transactions. VAT is also based on the neutrality principle whereby the tax applied is proportional to the price, whatever the number of intermediate transactions.

In the field of *excise duties,* the *acquis* contains harmonised legislation as regards energy products, tobacco products and alcoholic beverages. EU legislation establishes the structure of the excise duty that should be charged, together with a system of minimum rates for each product group. Goods are subject to duty when they are produced within the EU or imported from a third country. However, in principle, the duty is payable only to the Member State in which the goods are released into consumption (with certain limited exceptions), and at the applicable rates in that Member State. The EU legislation lays down provisions on production, holding, movement and monitoring of excisable goods. As regards excise products, their holding and movement for commercial purposes within the Internal Market continued to be closely monitored to establish the chargeability of the duty.

The *acquis* in the area of **direct taxation** concerns certain aspects of profit taxes and capital duty. The focus is on eliminating distortions for cross-border economic activities between enterprises within the Union. It also includes provisions to ensure effective taxation of income from savings in the form of interest payments made to individuals. The *Code of Conduct* for business taxation represents a political commitment by Member States to tackle harmful tax measures. Member States are required not to introduce new harmful tax measures, and to roll-back existing ones.

The EU legislation in the field of **administrative co-operation and mutual assistance** between Member States' tax and customs authorities provides tools to share information in order to circumvent tax evasion and tax avoidance. It allows gathering information about tax subjects automatically, spontaneously or on request.

The *acquis* in the area of **operational capacity and computerisation** covers different areas of taxation. In the field of VAT, the *acquis* on the Value Added Tax Information Exchange System (VIES) provides for direct electronic interchange of data between national VAT administrations. This allows national administrations to monitor and control intra-EU trade and detect possible irregularities. In addition, a specific IT system (VoeS) is required to establish the inter-connection for exchange of information among Member States related to the special scheme for e-Services provided by non-EU traders to EU citizens. Regarding excise duties, the *acquis* requires IT systems to allow Member States to exchange information on producers and traders of excisable products (System for the Exchange of Excise Data - SEED, Movement Verification System - MVS, Early Warning System for Excise - EWSE and Excise Movement and Control System - EMCS). In the area of direct taxation, Member States are required to put in place an automatic system for the exchange of information on savings income in the form of interest payments through an electronic standardised format.

This chapter is not covered by the EEA.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarises the information provided by Iceland and the discussion at the screening meeting. Iceland accepted the *acquis* regarding Taxation and stated that it did not expect difficulties to implement the *acquis* by the time of accession. However, Iceland indicated it would request transitional periods in certain areas, especially as regards some gaps between the Icelandic VAT system and the VAT Directive, but also in the area of energy excises with emphasis on the use of environmentally-friendly energy in Iceland. Some concern was also expressed by Iceland concerning the comprehensive IT requirements due to scarce resources.

The tax system in Iceland is based on the following legal framework:

- Tax on income laws: Act No 90/2003, on income tax (Corporate income tax and Personal income tax), Act No 4/1995, on municipal income tax, Act No 45/1987, on withholding tax of public levies at source and Act No 94/1996, on withholding tax on financial income;

- Tax on consumption laws: Act No 50/1988, on value added tax, Act No 97/1987, on excise duties, Act No 29/1993, on excise duties on vehicles and fuel, Act No 87/2004, on oil tax and kilometre duty, and Act No 96/1995, on alcohol and tobacco tax;

- Other tax laws: Act No 113/1990, on payroll tax (social security contributions), Act No 126/2009, on environmental and resources taxes, and Act No 155/2010, on special tax on financial institutions.

Total tax revenues account for approximately 40% of GDP, half of it collected in direct taxes and the other half in indirect taxes (VAT and excises). The VAT, personal income tax and the social security tax are the biggest contributors to tax receipts. Tax revenues are split between central authorities (around 29% of GDP) and local authorities (around 11% of GDP).

As regards *institutional and administrative capacity*, the following bodies under the auspices of the Icelandic Ministry of Finance are involved in taxation matters: the Revenue and Taxation Department, the Internal Revenue Directorate, the Directorate of Customs, the State Internal Revenue Board and the Directorate of Tax Investigations, each with its own particular role.

The Revenue and Taxation Department is in charge of implementation of the main policy lines established at the level of the Ministry of Finance, as well as the coordination of legal aspects, collection of taxes and international issues. The Department has 14 employees.

The Internal Revenue Directorate is in charge of operational aspects concerning direct and indirect taxation: tax assessments, tax audits/controls, advisory services for the public, operation of the company register, annual register and IT tax systems. It has 260 employees, organized in 9 regional offices.

The main task of the Customs Directorate (apart from its duties related to customs operations) is the collection of all taxes due in Iceland: customs duties, excises, VAT, income and net worth taxes, road and vehicle taxes, or social taxes. The Directorate for Customs has 225 employees, organized in one (country-level) office.

The Directorate of Tax Investigations conducts investigations on cases where there is a suspicion of tax fraud, and if needed prepares criminal cases for further investigation by the National Commissioner of the Icelandic Police and for the Directorate of Public Prosecutions. It has 21 employees.

Finally, the State Internal Revenue Board rules in cases of disagreement between tax payers and the Internal Revenue Directorate, as well as on fines imposed by the Directorate of Tax Investigations on taxpayers. The decisions of the Board are final for the administrative procedure; they can be challenged only in court. The Board has 6 members and 10 employees.

II.a. Indirect taxation

Iceland introduced a **Value Added Tax** system on 1 January 1990, replacing a sales tax system. It is based on the main legal act governing VAT matters is the Value Added Tax Law No 50/1988 which entered into force on 1 January 1990. According to Iceland, the basic principles of its legislation are in line with VAT Directive 2006/112/EC.

Under Icelandic law, VAT is levied on supply of goods and services delivered in Iceland at all stages, as well as on import of goods and services. It covers all goods and valuables, new and used. Specific exemptions on levying VAT - without the right to deduction - apply for: medical, social and cultural services; educational and sportive activities; transport of passengers; rental of real estate property; postal services; insurance activities; bank services; lottery and betting pools; work of authors and musical composers; travel services; funeral and church-related services; charitable activities.

A taxable person is defined as any business entity - a legal or natural person - supplying goods or services. Public energy- and distribution enterprises are also considered taxable persons when engaged in an economic activity. The same applies to the government, municipalities and their institutions and enterprises insofar these parties sell goods or taxable services in competition with enterprises. Persons selling exempted goods/services as described in the paragraph above are exempted from paying VAT. Icelandic business entities with annual sales of taxable goods or services below 1.000.000 ISK (€6.102[1]), as well as artists selling certain works of art under certain Customs Code numbers and school cafeterias are not considered to be taxable persons.

VAT on imports of goods is assessed and collected by the Customs Directorate. According to Act No 50/1988 the list of VAT exemptions on import includes: goods which are duty-free according to Customs Act, goods exempted according to international agreements, certain goods exempted from taxable turnover, c.f. the sale and leasing of aircraft and ships, although not boats less than 6 metres in length, pleasure boats or private aircraft certain works of art imported by the artist himself, written material sent to scientific institutions, libraries and other public institutions (if used for non-business purposes) and alcohol and tobacco if the fob value of a shipment does not exceed 1.500 ISK. The taxable amount is based on the sale of goods and valuables as well as taxable labour services, and refers to the total remuneration or total sales value before VAT. The taxable amount includes other taxes and duties, packing, carriage, insurance and other such expenses, discounts, price increases incurred upon the time of delivery of a good or service, as well as service charges that are not included in the price of the good. Iceland is applying the arms-length principle, where for taxation purposes, the exchange of goods and services without remuneration or between related parties is valued according to market prices. In the case of used vehicles, subject to registration the taxable value considered for VAT purposes is the difference between the sales price and the purchase price.

Taxable turnover includes all sales or deliveries of goods and valuables against payment, as well as sold labour and services, including sales by handling or agent basis, or sale and delivery of machinery, instruments and other operations equipment. Taxable persons can benefit from VAT

[1] Based on 13 May 2011 exchange rate : 1 ISK = €0,0060

exemptions– with the right to deduct – for: exportation of goods and services provided abroad; transportation of goods between countries; work performed by an enterprise on goods at the expense of a foreign party; design and planning on constructions based abroad; provisions, fuel and equipment delivered for use on board of inter-country vessels; sale and leasing of aircraft and ships; shipbuilding and maintenance work on ships and aircraft; contractual payments from the Treasury for milk and sheep farming; services provided to foreign fishing vessels related to landing and sale of fish catches in Iceland; sale of certain services to foreign enterprises neither domiciled nor with a permanent establishment in Iceland (e.g. professional -or IT services); obligations related to business or production activity; job consulting; rental of movable properties except for means of transport; services of agents that assist with the sale of services which are VAT-exempt; and telecommunication services.

The standard VAT rate is 25.5%. Iceland applies a 7% reduced rate to the following goods and services: rental of hotel and guestrooms; radio and TV broadcasting; sales of magazines and newspapers; sales of books and recorded books; sales of hot water, electricity and oil for house heating and swimming pools; food and other goods for human consumption as defined in Annex to the Act, other than wine and alcoholic beverages; road tolls; and music recordings.

VAT refund paid for labour at the building site is granted to builders of residential housing. The refund is limited to 60% of paid VAT. A temporary measure allows for 100% VAT refund until end 2011. A VAT refund is also granted to municipalities and state agencies for the services of garbage collection/waste, cleaning, snow removal, rescue activities and security arrangements due to natural disasters and civil defence, service of engineers, technicians, architects, lawyers, chartered accountants and other similar experts, service centre for coordinated emergency telephone service . VAT is also refunded to non-taxable research parties for their purchases of research equipment for grant money or received as a gift, to operators of motor coaches, to humanitarian organizations for their purchases of equipment and machinery, or received as a gift, and to rescue teams for their vehicles used only for the purpose of rescuing. Foreign tourists, embassies, diplomats, the Nordic investment bank, the European Patent Organization as well as some foreign enterprises fulfilling a number of conditions can also obtain a refund of the VAT paid in Iceland.

Taxable persons have to pay the difference between output VAT and input VAT for each accounting period. Input taxes can include deductions from VAT on items purchased for operations, goods, labour, services and other inputs related to the sale. Deductions in input tax are not allowed in the case of the operation of canteens/cafeterias; acquisition or operations of housing accommodation for owners or staff; remuneration in kind to owners or employees; acquisition and operations of vacation homes, summer cottage, children nurseries and similar for owners and staff; entertainment costs and gifts; and acquisition and operations and rental of passenger cars and coaches.

VAT taxpayers are required to keep their accounts in such a manner that the VAT can be verified for a period of 7 years, including separate accounts for taxable and tax-exempt activities. Any sale is considered VAT taxable unless demonstrated otherwise. Taxpayers are required to issue invoices at every sale; the invoice should contain mandatory elements for identification of the parties and the specifics of the sale, including the VAT amount.

The standard settlement period for VAT is 2 months, or longer in case of small taxpayers (turnover below 3.000.000 ISK/€18.304 per year). In case the VAT input exceeds output, the difference is refunded within a normal period of 21 days, or it can be used to offset other taxes. As a rule, electronic VAT returns are used; paper returns are allowed only exceptionally. Special rules are applicable to taxpayers involved in fish and agriculture business.

In cases where the due VAT (or any other tax) is not paid on time and/or in full , taxpayers are subject to a surcharge of 1% for every day following the due date; the amount of the surcharge is capped at 10% of the due VAT amount. If taxpayers persist in non-payment, Icelandic authorities can apply various measures (interests, penalties/special charges, enforced collection, insolvency/deregistration or penal measures in case of fraud).

Iceland introduced **excise duties** in 1987. The legislation is laid down in a number of acts per product category. Relevant legislation includes Act No 97/1987, on excise duties, which entered into force on 1 January 1988, Act No 29/1993, on excise duties on vehicles and fuel, Act No 87/2004, on oil tax and mileage fee, and Act No 96/1995, on alcohol and tobacco tax.

Responsibility for excise duties is shared between the Internal Revenue Directorate and the Customs Directorate. The Internal Revenue Directorate is responsible for the supervision of national producers/sellers of excisable products, as well as for the calculation, recovery and collection of excises due for alcohol, tobacco, energy and the national excises (ex. vehicles), while the Customs Directorate is in charge of supervising the operations with excisable goods at import and export, as well as collecting the excises due.

Iceland has a state monopoly on retail selling (not on production or bulk selling) of alcohol and tobacco products (see chapter 8 - Competition); the state company representing this monopoly is ÁTVR – the State Alcohol and Tobacco Company of Iceland - which is entitled to collect excises during the retail selling and to transfer these to the Internal Revenue Directorate. The ÁTVR does not pay excises at the moment of import of alcohol or tobaccco products into Iceland; these are suspended until the moment of selling.

Excise duties apply to all products defined in the legislation as subject to excises, new and used, imported to the country or produced, processed, or packed in the country. Exported goods are not taxable. The tax liability incurs at the moment of delivery from the producer to the buyer, or in the case of imports, at the moment the customs debt arises.

Excisable goods stored in free zones are not subject to excise duty. The tax debt arises at the moment of import of the products from the free zones into the customs territory of Iceland.

The provisions on excise duties on ***alcohol*** can be found in Act No 96/1995 on alcohol and tobacco tax. Alcohol is defined as any liquid that contains more than 2.25% of pure alcohol by volume; however, industrial alcohol is exempted from excise duties. The excise duty is calculated proportionally on fractions of centiliters of alcohol per liter of the alcoholic beverage:

- For beverages in the category of beer and ale containing more than 2.25% of alcohol, and those which contain blended and non-alcoholic beverages : 86,90 ISK (€0,52) per 1 centiliter of pure alcohol

- For wine and fermented beverages (up to 15% of alcohol) : 78,15 ISK (€0,47)/1 centiliter ,

- For other alcohol: 101,74 ISK (€0,62)/1 centiliter

Taxable persons are those who import or produce alcohol in Iceland for sale or processing. Taxable persons are also those who bring liquor with them to Iceland for personal use, as well as those who receive alcohol from abroad without a sale or processing. It is authorized to restrict imports for certain types of products with maximum quantity or maximum value. Excise duty on alcohol is paid to Customs. For alcoholic products marketed in Iceland, the duty is paid on sale or at the delivery of the product from the factory/producer to the buyer.

Excise duty is waived or refunded in the following cases: for sale outside Iceland, for import or sale to diplomats, for alcohol used in medical products, and for import and sale of alcohol in duty-free shops and duty-free stocks.

Finally, a 10% reduction rate of excise duties at import for personal use (personal allowances) is applicable for:

- Travelers : either 1 litre of strong alcohol + 1 litre of wine; or 3 litres of wine; or 1 litre of strong alcohol, or 1.5 litres of wine + 6 litres of beer.

- Ship crew members: for less than 15 days (either 0,75 litre of spirits + 1,5 litres of wine, or 0,75 litre of spirits or wine + 12 litres of beer) and for more than 15 days (either 1,5 litre of spirits + 3 litres of wine, or 1,5 litre of spirits or wine + 24 litres of beer).

- Air crew members: for less than 15 days (either 0,375 litre of spirits + 0,75 litre of wine, or 0,375 litre of spirits, or 0,75 litre of wine + 3 litres of beer) and for more than 15 days (either 1 litre of spirits + 0,75 litres of wine, or 1 litre of spirits, or 0,75 litre of wine + 6 litres of beer).

Tobacco products' legislation is based on Act no 96/1996 on excise duty on Alcohol and Tobacco. Tobacco products include cigarettes, cigars, snuff (nose tobacco) and other tobacco. The excise duties are exclusively specific. For importers and local producers, the excise duties are as follows:

- 347,90 ISK (€2,11) on each pack of 20 cigarettes,

- 4,12 ISK (€0,025) pr. gr. on snuff (nose tobacco)

- 12,45 ISK (€ 0,076) pr. gr. on cigars and other tobacco

The excise duties on tobacco products not intended for resale (travellers, crews and other) are as follows:

- 437 ISK (€2,66) on each pack of 20 cigarettes,

- 21,85 ISK (€0,13) pr. gr. on cigars and other tobacco

Icelandic legislation allows for the following 40% reduction rate of excise duty (personal allowances at import):

- For travellers: 200 cigarettes or 250 gr. of other tobacco,
- Ships crew members: for less than 15 days (200 cigarettes or 250 gr. tobacco) and for more than 15 days (400 cigarettes or 500 gr. tobacco),
- Air crew members: for less than 15 days (100 cigarettes or 125 gr. tobacco) and for more than 15 days (200 cigarettes or 250 gr. tobacco).

Supplies of alcohol and tobacco for embassies or diplomats are exempted, based on reciprocity rules established in the Vienna Convention[2].
Iceland is not using a system of fiscal stamps for alcohol and tobacco.

The taxation for ***mineral oils*** is based on Act No 29/1993 on excise duty on vehicles and petroleum, and Act No 87/2004 on excise duty on oil and mileage fee. A general tax (excise) of 23,86 ISK (€0,14) per litre applies to all petroleum products (gas, gasoline, diesel, kerosene, jet fuel, fuel oils).

[2] Vienna Convention on Diplomatic and Consular Relations, UN 1961

On top of this, gasoline is charged with a road tax of €0.23 (38.55 ISK) per litre for unleaded fuel and 40.55 ISK (€ 0.24) per litre for other fuel; the road tax is earmarked for road construction and maintenance. Excise duty is also to be paid on gas and diesel oil used as fuel for vehicles: 54.88 ISK (€0.33) per litre of gas or diesel oil.

The oils which are not of mineral origin (e.g. biofuel) are exempted from excises; if they are blended with mineral oils, the part of non-mineral oils or additives in the final product is exempted too.

Mineral oils used for aircraft, ships, for heating of homes or public swimming pools, for industry, for construction vehicles, for tractors, for vehicles used exclusively off-road or in enclosed spaces, for production of electricity or for the cars owned by rescue teams, are exempted from excises and road tax.

Iceland is using a system of chemical markers for fuels used for special purposes; the markers and the companies allowed to use them are authorized by the Internal Revenue Directorate.

Embassies and diplomatic agents are reimbursed on excises and road taxes paid for fuel used by diplomatic vehicles. Fuel excises for regular (scheduled) bus services are reimbursed up to 85%.

Iceland applies a **carbon tax** on liquid fossil fuel, electricity and hot water, based on the Act on environmental and resource taxes No 129/2009. The carbon tax for liquid fossil fuels is : 4.35 ISK (€0.026) per litre of gas and diesel fuel, 3.80 ISK (€0.023) per litre of gasoline, 4.10 ISK (€0.025) per litre of aircraft and jet fuel, and 5.35 ISK (€0.032) per kilogram of fuel oil.

The carbon tax on electricity is 0.12 ISK (€0.00073) per kilowatt hour (kWh) of electricity sold and 2% of the retail price for hot water. Those who sell electricity or hot water for less than 500.000 ISK (€3.048) per year are exempted from taxation. Taxable sales or supplies do not include electricity or hot water delivered to other taxable entities, or electricity or hot water delivered or used only for producing electricity, or hot water for resale.

II.b. Direct Taxation

Under Act No 90/2003 on income tax, Iceland applies a non-discriminatory personal income tax on both residents and non-residents.

As regards payments falling under the scope of the Interests-Royalties Directive, different rates apply under Icelandic national law, depending on the nature of the payment and the residence of the beneficiary. For the year 2011 a provisional withholding tax of 20% is levied on interests paid to resident legal persons and individuals. The withholding tax is levied in advance and can be deducted from the final income tax or refunded to the tax payer if no income tax is due by the end of the year. The rate applied to non-resident legal persons is 18%. For both residents and non-residents, Iceland applies a personal deduction on the total interest revenue up to 100.000 ISK (€609). Concerning royalties, there is no withholding tax on domestic payments but all resident beneficiaries should pay a corporate income tax of 20% on such income. Conversely, a final withholding tax of 20% is levied on royalties paid to non-residents if no double taxation agreement signed with the country of residence of the beneficiary exempts the royalties in the particular case.

As regards profit tax, the tax rate is fixed at 20% for all types of businesses, public or private, with the exception of an 18% withholding tax rate for non-resident companies and 36% withholding tax rate for non-transparent partnerships.

Iceland has concluded double taxation agreements with 37 countries, including 23 out of 27 EU Member States (except for: Austria, Bulgaria, Slovenia and Cyprus). The OECD model is used. The agreements provide, for example, for reduced withholding tax rates on interest and royalties, application of the transfer pricing rules, and methods for eliminating double taxation.

Icelandic legislation ensures that no tax is levied on operations falling under the scope of the Merger Directive (Council Directive 2005/19/EC). The legislation provides for deferral of taxation in purely domestic situations for mergers, acquisitions, divisions resulting in a split-up and split-off. However, in order to benefit from deferral of taxation, shareholders of companies participating in such restructuring operations can not receive cash and can only be paid with shares. In these cases, the book value is rolled over without changes in valuation of assets and liabilities. A transfer of operating losses of the ten last years is possible provided the receiving company runs a line of business similar to the line of business of the liquidated company and the transferred losses originated in this similar line of business; that the liquidated company was operational and had significant assets before the restructuring; and, finally, that the restructuring operation occurred for normal business purposes.

Regarding asset transfers, Icelandic tax law considers profits from the sale of depreciable assets as fully taxable income in the year of the sale. Deferral of tax can be claimed for two tax years if the taxable person does not possess depreciable assets at the moment of the sale and on the condition that during those two fiscal years it acquires depreciable assets and depreciates them for the amount of the taxable profits.

Tax relief is also granted in case of transfer of sole proprietorship to a private limited company. However, the same line of business must be carried over by the limited company. This limited company should be registered in Iceland and have unlimited tax liability in Iceland just as the owner of the business. Finally, payment of the transfer must be done only by attribution of shares to the owner of the business and not by cash.

Icelandic legislation does not include any special provision on the exchange of shares. However, capital gains earned by legal entities with limited owner liability from the sale of all equity are deductible from income provided the seller had at least a 10%-stake in the target company at the day of sale.

Under Icelandic legislation, a group taxation scheme called 'joint taxation' allows Icelandic companies holding 90% or more in Icelandic subsidiaries - directly or through the holdings of their subsidiaries - to request to be jointly taxed. In case of public limited companies, this regime applies provided all the companies use the same fiscal year and that they have been under the same ownership during the whole fiscal year. Once joint taxation is chosen by a group of companies, it applies for a minimum of five years.

In the area of the Parent-Subsidiary Directive (Council Directive 90/435/EEC), a withholding tax of 20% is applied on dividend payments to companies with a full and unlimited tax liability in Iceland.

In this context, the definition of dividends corresponds to:

- normal dividend payments in case of any transfer of valuables to shareholders with limited or unlimited liability must be regarded as income deriving from the ownership of the company,

- if registered public limited companies or private limited companies are liquidated and companies are not being merged, the difference between the money received by the

shareholders and their original purchase price is regarded as dividends. Reduction beyond the purchase price of the share capital paid out to shareholders is also considered dividend.

However, the withholding tax is not levied under the joint taxation regime, i.e. when the conditions apply for ownership by an Icelandic parent company of 90% or more of another Icelandic company during one whole year. A withholding tax of 18% applies on dividend payments to companies with limited tax liability in Iceland. As they are not subject to unlimited taxation in Iceland, these companies cannot benefit from the joint taxation regime. Therefore, the 18% withholding tax represents a final tax payment unless companies meet the conditions of the qualified participation regime.

The qualified participation regime allows a deduction from taxable income of dividends received by limited liability companies from Icelandic or foreign companies in which the former hold at least 10% of shares. When the dividends are distributed by a foreign company, deduction is granted on the condition that the foreign company is located in a country where its profits are taxed in a similar manner as company profits in Iceland, and at a tax rate not lower than the tax rate of an OECD-member state, EEA-member state or the Faroe Islands.

Icelandic legislation has no legal restrictions for providing an exchange of information on interest and royalty payments with EU Member States.

Iceland does not apply any capital duties, or any similar taxes on the raising of capital.

In the area of transfer pricing, Iceland confirmed it applies the OECD principles. Article 57 of Tax Act No. 90/2003 allows the Internal Revenue Directorate to reassess the taxable income of companies proceeding to financial transactions between themselves provided that:

- The companies are economically connected;
- The arm's length principle is not being applied between the given companies;
- The companies are in a contractual relationship.

As a member of the OECD, Iceland is committed to respect the standards set by the OECD Forum on Harmful Tax Practices. The country affirms its readiness to extend its political commitment to the requirements of the EU Code of Conduct for Business Taxation and to submit its legislation to a thorough assessment. The following special schemes of the Icelandic legislation have been identified as leading to a potentially harmful tax regime:

- Act No. 155/2010 on special tax on financial institutions has been in force since January 2011 and will be reviewed before the end of 2011. It concerns banks, credit and savings institutions operating under a license, as well as all branches of foreign banks and financial institutions accepting deposits in Iceland and on which a tax rate of 0.045% is applied. Institutions established under a special law and wholly owned by public bodies as well as entities that have officially filed for bankruptcy are exempted.

- Act No. 99/2010 on concessions for new investment in Iceland is in force from July 2010 until December 2013. It is based on Commission Regulation (EC) No 800/2008. The income tax rate is fixed at a maximum level for 10 years. This scheme foresees lower stamp duties (max 0.15%, as compared to between 0.5 and 2% on shares, bonds and loans), a 40% rebate from social security levies and 30% rebate from real estate taxes levied by local governments.

- Act No. 152/2009 on support for innovation companies entered into force in 2010. It applies to companies that own research and development projects certified by the Icelandic Centre for Research and consists of special tax credits amounting to 20% of the R&D cost provided that it constitutes a deductible current cost of operation. The cost ceiling for the calculation of a credit for each enterprise shall not exceed ISK 100,000,000 in each year of operation. In the case of purchased research and development services, the maximum cost shall not exceed ISK 150,000,000. A tax credit shall be credited against assessed income tax at the assessment of public dues on legal parties. In a case where the assessed income tax is lower than the determined tax credit or if no income tax is assessed on a legal party due to a tax loss, the tax credit shall be paid out.

- Act No. 170/2008 on taxation of hydrocarbon extraction entered into force in January 2010. There is no such extraction operation yet. The scheme consists of a production fee (the first 10 million barrels per year are exempted) and a hydrocarbon tax (with a progressive rate from 5.5% to 55%).

- Act No. 86/2007 on taxation of merchant vessel activities entered into force in January 2009. The scheme foresees that shipping companies can opt for tonnage tax instead of ordinary corporate income tax for a minimum of three years (tax rate: up to € 152 - 25.000 ISK per 100 Nautical Tonnes). No application yet.

II.c. Administrative co-operation and mutual assistance

Iceland does not have provisions in domestic law reflecting the *acquis* on administrative cooperation and mutual assistance. Nevertheless, the current exchange of information is based on:

- Provisions in double taxation agreements

- Provisions in information exchange agreements. Iceland has signed Information Exchange Agreements with 29 jurisdictions (4 are in force: Cayman, Guernsey, Jersey and the Isle of Man).

- Provisions in the Nordic Assistance Agreement in Tax Matters from 1990 (Act No 46/1990) and MOU of 1991 with the Nordic nations concerning assistance in the collection of taxes under the Convention.

- The OECD Convention on Mutual Administrative Assistance in Tax Matters signed in July 1996. Iceland has signed the Protocol amending the Convention in May 2010 but it has not yet been ratified.

Bilateral agreements are based on the OECD Model Tax Convention on Income and Capital. They provide for an exchange of information on direct taxation; on request, automatically, or spontaneously. In practice the exchange of information is mostly on request. The Nordic Assistance Agreement in Tax Matters provides for an exchange of information on both direct and indirect taxation.

II.d. Operational capacity and computerisation

The Internal Revenue Directorate and, to a lesser extent, the Customs Directorate are in charge of the management of IT systems used in the taxation area. Both administrations are using to a large extent outsourcing arrangements for the development, operation and maintenance of software, hardware and communications.

Concerning human resources, the Internal Revenue Directorate has 13 IT experts (+ 16 persons working exclusively for the IRD in the outsourcing company), while the Customs Directorate has 5 IT experts + 6 people working for Customs in the outsourcing company.

All the offices of the Internal Revenue, Internal Investigation and Customs Directorates are well endowed with IT tools and connected to the IT network (internal and external).

Iceland is using a well-developed system of applications to provide a wide range of e-services to business and the general public. Consequently, nearly all tax returns in Iceland are delivered electronically; very few are still presented and processed on paper.

- 95% vs 5% for individuals, eTax since 1999.
- 99% vs 1% for companies, eTax since 1997.

As regards VAT, Iceland has a value added tax IT system in place since November 1999. Electronic filing of VAT reports has started in 2001. In 2010, the rate of VAT reports electronically filed was 75%; since 2011 electronic filing of VAT returns is mandatory.

III. Assessment of the degree of alignment and implementing capacity

The overall structure of tax legislation is similar to EU *acquis* and is at a satisfactory level of alignment. However, significant efforts are needed for further alignment to close remaining gaps and ensure application and enforcement of the *acquis*.

As regards *institutional and administrative capacity*, the Icelandic Tax Administration needs to have the appropriate systems, procedures and personnel in place in order to implement and enforce the *acquis* in this chapter so that continuation of a homogeneous and harmonised approach in the EU is ensured. This requires development of policies, systems, procedures, technologies and instruments compatible with EU requirements and standards.

III.a. Indirect Taxation

The **Value Added Tax** system in Iceland follows the main structure of EU legislation. However, there are significant discrepancies which should be addressed by the time of accession, including the following elements:

The concept of intra-EU transactions is not a part of the VAT system in Iceland and needs to be introduced into Icelandic legislation by the time of accession. The definitions and rules applicable to VAT territory, 3rd territories and countries, taxable persons, taxable transactions, place of taxable transactions, chargeable events and chargeability of VAT should be aligned with the EU acquis. The VAT Act meets both conditions of the minimum standard rate of 15% and a reduced rate of not less than 5% pursuant to the VAT Directive (Council Directive 2006/112/EC). However, certain items in the Icelandic VAT Act are not covered under Annex III of the VAT Directive, and should be therefore aligned with the acquis:

- Sales of oil for heating of spaces and swimming pool water
- Admission tolls to land transportation projects
- CD disks, records, magnetic tapes and other similar means of music recordings, other than visual records.

Iceland applies specific VAT exemptions that go beyond those provided by the VAT Directive: certain specific sport activities, certain cultural activities limited to Icelandic shows, passenger

transport, work of authors and composers, funeral services and travel agents. On the other hand, Iceland has no exemptions laid down for certain items including; supply of human organs, blood and milk, services supplied by independent groups of persons rendering services to their members, imports of gold by the Central Bank, warehouses other than customs warehouses, etc.

Iceland has to implement the special schemes envisaged in the acquis (e.g. for second-hand goods, travel agencies, gold, etc…), and should further detail the rules for VAT refunds to taxable persons not established in Iceland. In particular, Directive 2008/9/EC will have to be transposed.

The VAT reimbursement system in Iceland on housing maintenance, repair or acquisition by individuals or public bodies, such as local governments, on certain acquisitions made by humanitarian organisations and charities, is not in accordance with the acquis and will have to be repealed or put outside the VAT legislation (for instance for subsidies).

Legislation on tax obligations will have to be aligned with the acquis, in particular those on invoicing and on recapitulative statements for intra-EU transactions.

In the field of **excise duties**, Iceland follows the main structure of EU legislation. Excise duties are applicable on alcohol and alcoholic beverages, tobacco products and energy products.

Iceland taxes all *alcoholic beverages* with an alcohol content of more than 2.25%, whereas EU legislation taxes products with alcoholic content starting from 1.2%.

The products subject to duty are respectively (a) beer, (b) wine & fermented beverages and (c) other alcohol. Iceland would need to adapt its product definitions to match the categories laid down in Council Directive 92/83/EEC of (a) beer, (b) wine, (c) fermented beverages other than wine and beer and (d) intermediate product and ethyl alcohol, as well as the exemptions covered by article 27 of the same Directive.

Iceland's levels of excise duties on alcohol are higher than any Member State in the case of all products except beer. Consequently, Iceland has no problem complying with the EU minima (Council Directive 92/84/EEC).

With regard to travellers' allowances for persons travelling from third countries, Iceland would need to adapt the allowances for alcohol to those specified at Article 9 of Directive 2007/74/EEC. EU legislation allows for a traveller to bring in either: (a) 1 litre of alcohol exceeding 22% of alcohol by volume (abv) or (b) 2 litres of alcohol not exceeding 22% (abv). The traveller is also allowed to bring in 4 litres of still wine and 16 litres of beer. The additional allowances specified for seaman on Icelandic ships, or ships leased by Icelandic parties where the journey is greater than 15 days, is also not provided for in the EU legislation.

On tobacco products, excise duties are levied on tobacco which has been imported or produced in the country. The rates are the same for imported and domestically produced products. Iceland applies a rate for cigarettes which is only specific; EU legislation however requires a specific and an ad valorem rate levied on cigarettes. Tobacco is divided into three subcategories: (a) Cigarettes, (b) Snuff (nose tobacco) and (c) Other tobacco.

The Icelandic categories differ from the EU categories of manufactured tobacco; fine-cut tobacco is not considered a separate category in Icelandic legislation. The level of excises applicable to tobacco products is above the EU minimum, so no further alignment is needed in this area for the time being.

Indeed, the yield per 1000 cigarettes is about 21.850 ISK /€133 and hence complies with the European minimum of €64. Icelandic rates for other tobacco (ca 21.850 ISK /€133 /kg) are above those levied at European level on cigars, cigarillos (€12 /kg) or other smoking tobacco (€ 22 /kg).

As regards *energy products*, the scope and range of products subject to excise payments in Iceland is currently significantly smaller than what is required by Directive 2003/96/EC. However, the practical implications of this divergence in legislation may in fact be rather limited, given that the consumption structure of the country is strongly based on renewable energy sources, for which exemption possibilities exist in the Energy Taxation Directive (Council Directive 2003/96/EC).

Only mineral oils used as motor fuel for on-road traffic are currently subject to excise duties. The following products and uses would in principle have to be made subject to payment of the EU minimum rates beyond what is currently the case:

a. all heating fuels when used by commercial consumers

b. heating fuels other than electricity, natural gas, coal and solid fuels when used by households

c. electricity for all uses other than household heating

d. motor fuels used for off-road applications

Based on current exchange rates, the national tax rates for petrol and gasoil used as motor fuels would have to be raised to comply with the EU minimum:

a. the EU minimum is€421 /1000 l for leaded petrol

b. the EU minimum is €359 /1000 l for unleaded petrol

c. the EU minimum is €330 /1000 l for gasoil.

The rules applied by Iceland for reductions, exemptions or reimbursements for transport fuels would need to be brought in line with EU acquis.

The system used by Iceland for fuel markers is generally in line with the acquis. Iceland is not using fiscal stamps for alcohol and tobacco products.

For all three categories of excisable products – alcohol, tobacco and energy - Iceland would also need to adopt the EU's system of warehousing and duty suspension, and ensure compliance with the duty-points (times for charging duty) that are required by that system.

III.b. Direct Taxation

As regards personal income tax, the application of the non-discriminatory principle inscribed in the *acquis* needs to be monitored closely.

Iceland needs to transpose Directive 2003/48/EC (Savings Directive) and be prepared to exchange information on interest payments to individuals with all the Member States and with the 9 dependent and associated territories that have requested reciprocity. During the transitional period as foreseen by the Savings Directive, Iceland will have to have to ensure the elimination of any double taxation which might result from the imposition of the withholding tax levied on interest payments made to its residents in Austria, Belgium and Luxembourg (as well as in 6 of

the above mentioned dependent territories and in the 5 non-EU European countries having agreed equivalent measures with the EU: Switzerland, Liechtenstein, Andorra, Monaco and San Marino). In this context, Iceland will also have to:

- examine if the Annex to the Savings Directive has to be completed as far as Icelandic entities are concerned;

- conclude bilateral agreements for the same measures as those of the Directive with the 10 dependent or associated territories of the Netherlands and the United Kingdom (the Channel Islands of Jersey and Guernsey, the Isle of Man and seven dependent or associated territories in the Caribbean : Aruba, the Netherlands Antilles, Anguilla, the Cayman Islands, the British Virgin Islands, Montserrat, the Turks and Caicos Islands), in accordance with the models agreed by Member States for this purpose;

- confirm to Switzerland, Liechtenstein, Andorra, and San Marino the political commitments taken by Member States within the Memorandums of Understanding joined to the EU agreements on taxation on savings with these non-EU European countries;

- apply the provisions of Article 15 of the agreement on taxation of savings between the EU and Switzerland as far as dividends, interest and royalties payments between associated companies are concerned; and

- communicate to the Council the application of the Agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino.

As regards corporate tax, Iceland's system follows the same general lines as the EU legislation.

However, Iceland needs to ensure alignment with the Parent Subsidiary Directive (Council Directive 90/435/EEC of 23 July 1990) on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States**.** The elimination of double taxation will have to be guaranteed by the adoption of provisions offering tax credits to resident companies receiving dividends from other Member States which have already supported a tax burden. Regarding dividends distributed by Icelandic resident companies, a system of direct exemption must be adopted. Finally, the current conditions related to the beneficiary of the dividend payments (companies established in another Member State) must be amended so no minimum rate of taxation is required in the country of residence of the parent company.

Alignment needs to be ensured with the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States as well as to the transfer of the registered office, of a *Societas Europaea* - SE or European Cooperative Society - SCE, between Member States**.** The Icelandic rules only apply to domestic situations and therefore need to be extended to cross-border operations with Member States as provided by the Council Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares. The tax relief scheme applying to the transfer of sole proprietorship to a private limited company need to be opened to non-resident limited companies. New provisions must be introduced to allow shareholder compensation in cash and not only by shares of the new entity. The joint taxation regime need to be extended to non-resident companies and new provisions must be introduced on asset transfers and the exchange of shares.

Upon accession at the latest, Iceland needs to have transposed the Interest and Royalties Directive (Council Directive 2003/49/EC) and have eliminated its withholding taxes on interest and royalties payments. As regards taxation on the raising of capital by companies, Iceland

needs to further align its legislation with the acquis (Council Directive 2008/7/EC concerning indirect taxes on the raising of capital), including on stamp duties applied on loans.

Iceland needs to legislate in the area of transfer pricing so that a national legal framework consistent with the "arm's length" principle on transfer pricing[3] is introduced and legal certainty ensured. Article 57 of Tax Act No. 90/2003 must be amended and its scope extended beyond the currently restricted area of financial transactions.

As regards the EU *Code of Conduct for Business Taxation*, Iceland's intention not to introduce harmful tax measures will need to be monitored. A final assessment as to whether Iceland's current tax provisions fully comply with the principles and criteria of the Code of Conduct requires a further in-depth analysis on potentially existing harmful measures in Iceland.

III.c. Administrative co-operation and mutual assistance

Iceland applies mutual assistance for the recovery of taxes with a number of Member States through bilateral cooperation. Administrative cooperation in the fight against fraud in the field of direct taxation is established through bilateral treaties. This provides a degree of preparedness for alignment. Administrative cooperation in the field of VAT is only foreseen in the Nordic Assistance Agreement on Tax Matters, and therefore needs further development. Iceland does not have any legislation reflecting the *acquis* on mutual assistance and administration.

III.d. Operational capacity and computerisation

Iceland has sufficient awareness of the necessities to prepare interconnectivity and interoperability with the physical tax infrastructure of EU Member States, though parallel planning of related legislation requires attention. Iceland needs to further develop its systems in order to allow the exchange of computerised data with the EU.

As regards *computerisation* in the field of VAT, Iceland needs to adapt its IT systems to allow interoperability and interconnectivity with the EU systems (VIES, VoES). Iceland needs also to ensure that the exchange of information among Member States related to the special scheme for e-Services provided by non-EU traders to EU citizens is in place and inter-connected with EU systems, as well as for refund of VAT as envisaged in the Directive 2008/9/EC.

Regarding excise duties, Iceland needs to put in place a national system of surveillance for the movements of excisable products, and develop an infrastructure that allows physical interoperability and interconnectivity with the EU systems. This will allow Member States to exchange information on producers and traders of excisable products (SEED, MVS, EWSE). The use of a Common Communication Network (both Common Communication Network mail and Common System Interface mail) will need to be integrated in the infrastructure of the Tax and Customs Administrations. In developing the Excise Movement Control System (EMCS) a timely alignment of the *acquis* (Directive 2008/118/EC) concerning the general arrangements for excise duty needs to be taken into account.

In the area of direct taxation, Iceland needs to adapt its IT system to allow the exchange of information on income received by non-residents on savings products.

[3] as defined under Article 9 of the OECD Model Tax Convention on Income and Capital and in Article 4 of the "Arbitration Convention" (Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, Official Journal L 225 of 20/08/1990, p. 10

Iceland will also need to prepare for exchange of all other forms in the taxation domain. For example, the Icelandic taxation information needs to be integrated in the "Taxes in Europe" database available on the Europa website.