MINISTRY OF FINANCE **February 2004**
ICELAND

Principal tax rates 2004

This paper describes the principal tax rates applicable to individuals and companies as they stand at the beginning of 2004.

1. Personal income taxation

Iceland's personal income tax structure is such that there is a basic tax-free income (69,585 krónur per month in 2003 and 71,270 krónur per month in 2004. Once that income has been earned in any given month, a 38.58 per cent PAYE tax rate in 2004 (38.55 per cent in 2003) is applied to all subsequent income[1]. Incomes in excess of 3,980,000 krónur in 2002 for a single individual and 7,960,000 krónur for a couple were subject to a 7 per cent surtax payable in 2003.

Tax rates (assessment year) since 1991 have been as follows:

	Central gov't general tax rate	Municipal tax rate	Total tax rate	Central gov't surtax[1]
1991	32.80	6.99	39.79	
1992	32.80	7.05	39.85	
1993	34.30	7.04	41.34	
1994	33.15	8.69	41.84	5.00
1995	33.15	8.78	41.93	5.00
1996	33.15	8.79	41.94	5.00
1997	29.31	11.57	40.88	5.00
1998	27.41	11.61	39.02	7.00
1999	26.41	11.93	38.34	7.00
2000	26.41	11.96	38.37	7.00
2001	26.08	12.68	38.76	7.00
2002	25.75	12.79	38.54	7.00
2003	25.75	12.80	38.55	7.00
2004	25.75	12.83	38.58	5.00

For 2003, the tax thresholds were raised to 4,089,450 and 8,178,900, respectively, and the surtax is reduced to 5 per cent, payable in 2004[2]. For 2004, the thresholds are 4,191,686 and 8,383,272 krónur, respectively, and the surtax is further reduced to 4 per cent. For 2005, the surtax is reduced to 2 per cent and abolished altogether at the end of that year. Seamen get a

[1] The unused balance of tax-free income is fully transferable between spouses.
[2] Under the surtax collection system, the surtax imposed in year 1 is based on income in year 0. The reduction in the surtax from 7 to 5 per cent in 2004 is thus based on 2003-income. The 5 per cent rate is already applied in the latter half of 2003 to an estimated prepayment of the surtax on 2003-income. The final settlement of the tax takes place with the annual personal income tax assessment at the end of July 2004.

special tax reduction of 728 krónur per day in 2003 and 746 krónur per day in 2004[3]. The personal income tax comprises both the central government and municipal income tax[4].

In addition to the above, each individual pays a flat tax of 5,576 krónur per year to the Elderly's Construction Fund, a central government fund used to finance the construction and operation of nursing homes and care centres for the elderly. Persons under the age of 16 and older than 70 are exempt from this levy as well as those with an income below 829,851 krónur in 2003.

As of the beginning of 1997, the financing and operation of elementary schools were transferred from the central government to the municipalities. In order to finance the operation of the schools at the municipal level, the central government reduced its tax rate by 2.84 percentage points and the municipalities increased their rate by the same percentage points.

The central government has pursued a policy of reducing its marginal tax rate. It did so with a reduction of 1.1 per cent at the beginning of 1997, by 0.9 per cent at the beginning of 1998 and by 1 per cent at the beginning 1999. As of the beginning of 2001 the central government tax rate was reduced by 0.33 percentage points and the municipalities were authorised to increase their rate by up to 0.66 percentage points in 2001 and by a further 0.33 percentage points in 2002. Both measures were intended to improve municipal finances. At the beginning of 2002, the central government reduced its personal income tax rate by a further 0.33 percentage points. The Government has stated that it intends to reduce the standard personal income tax rate further, by up to 4 percentage points during its four-year term of office, amounting to 20 billion krónur in the years 2005-2007 and appropriate up to 3 billion krónur to an increase in child benefits and related projects.

The personal income tax is levied on gross income other than from capital (for the capital income tax, see below), with a number of minor exceptions. Employee contributions to pension funds are deductible. Such contractual contributions normally comprise 4 per cent of gross pay, to which the employer adds a contribution, normally 6 per cent[5] which also is deductible as an operating expense on the business side. In addition, the employee can save a further 4 per cent supplementary pension saving on a voluntary basis and deduct the contribution from taxable income. Up to the end of 2003 the employer could add another 0.4 per cent, which in turn was offset against the employer's payment of the social security tax. This voluntary pension savings option was first introduced at the beginning of 1999 in order to encourage personal saving. At that time the contribution percentage was 2 per cent for employees and 0.2 per cent for employers. In May 2000 these percentages were doubled to 4 and 0.4 per cent, respectively, as noted above. In addition, some employers, such as the central government, have increased their employer counter-contribution by agreement with employees. The central government contributed 1 per cent against a voluntary employee contribution of 4 per cent in 2001 and 2 per cent as of the beginning of 2002. All such

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[3] A Government bill has been introduced to the Alþingi that proposes to eliminate the seamen's tax reduction in stages until it will be abolished at the end of the 2007 income year.

[4] The PAYE tax collection rate is the same for the whole country. Municipalities, however, have different municipal tax rates which explains the slight changes in their average PAYE tax rate from year to year. Actual tax settlements take place in the following year after a tax return has been filed and the actual tax has been assessed.

[5] In many cases the employer contribution is considerably higher. For central government employees it is 11.5 per cent and for airline pilots and similar professions with a shorter working life it is even higher.

contributions are tax-free, both with the employer and the employee. As of the beginning of 2004, the employer option of deducting the above 0.4 per cent against the social security tax was abolished. Since such employer counter-contributions had become a part of wage agreements in most cases it was no longer felt that such a tax incentive was needed.

Interest rebates are granted by the central government for interest expenses incurred from home purchase loans. Such rebates are subject to debt, income and net wealth ceilings. Maximum rebates in 2004 are: 164,603 krónur for a single individual, 211,691 krónur for a single parent and 272,206 krónur for a couple [6]. For 2004, these rebates will be reduced by 10%. This provision will apply in 2004 only and apply to interest expenses incurred in 2003. From 1999, first-time buyers can have the interest rebate remitted to them on a quarterly basis immediately in the year of purchase, whereas for other buyers the rebate only becomes effective at the time of tax settlement in the year following the income year.

Child benefits are granted for each child, subject to income thresholds. In 2004 they are as follows (in krónur per year):

For all children under the age of seven	36,308
Children under the age of sixteen in 2003:	
First child	123,254
Each additional child	146,713
Benefits for single parents:	
First child	205,288
Each additional child	210,854
Income threshold for benefit curtailment:	
For couples	1,444,139
For a single parent	722,070
Curtailment of benefits:	
For one child	3 per cent
For two children	7 per cent
For three children or more	9 per cent

The child benefit system was amended with effect from the beginning of 2001. In basic terms, the net wealth threshold previously applicable was eliminated, benefits for children under the age of seven cease to be linked to income and the income threshold rule was eased. The amendments to the child benefit system were spread over three years, 2001-2003.

The income taxation of rent subsidies supplied by municipalities to low-income tenants was abolished as of the beginning of 2002.

[6] The following constraints apply to interest rebates: (1) They can not exceed 7 per cent of the remaining debt balance incurred in buying a home for one's own use. As of 2005, on interest expenses incurred in 2004, the ceiling will be reduced from 7 per cent to 5.5 per cent. (2) The maximum amount of interest payments that qualify for an interest rebate calculation is 480,371 krónur for an individual, 630,626 krónur for a single parent and 780,878 for a couple. (3) Six per cent of taxable income is subtracted from the interest expense. (4) The rebates begin to be curtailed at a net worth threshold of 3,613,148 krónur for a single individual and 5,989,414 krónur for a couple and are eliminated altogether at a 60 per cent higher amount.

The tax treatment of stock options was introduced into tax legislation in 2001 as a result of the fact that a number of companies have begun to reward their employees with options to buy stock at a defined price as a part of the employees’ total emolument package. Profits from stock options are now defined as capital gains, subject to a 10 per cent tax, whereas previously they were defined as ordinary income, subject to the common personal income tax rate. The exercise of stock options is subject to certain conditions, the chief being: (1) Stock options must be available to all employees; (2) A minimum of twelve months must pass between the conclusion of a stock option contract until it is exercised. (3)The exercise price must not be lower than the average trading price for the last ten trading days before the option is exercised. (4) The employee must own the stock for no less than two years after purchase. (5) The annual stock option must not exceed 600,000 krónur at the exercise price.

2. Taxes on capital income and net wealth

A consolidated tax on capital income was introduced at the beginning of 1997. This change represented a complete overhaul of the former system. Before, there were large discrepancies between taxation of different forms of saving with distorting effects on the saver's choice. Interest income was tax-exempt, while other capital income was subject to personal income tax. Starting in 1997, a general 10% withholding tax is levied on interest income and capital gains, which eliminates the discrepancy between various forms of capital income. Thus, all capital income, such as interest income, dividends, capital gains and rental income is subject to a uniform tax of 10%. The capital income tax is withheld at source for both businesses and individuals, as applicable. Individuals pay no further tax on capital income, whereas capital income incurred by businesses is taxed as ordinary corporate profits with the withholding capital income tax being offset against the corporate income tax.

The net wealth tax in 2004, on net wealth at the end of 2003, is imposed on net assets beginning at 4,838,000 krónur for an individual. Amounts in excess thereof are taxed at an 0.6 per cent rate.

In its Policy Statement of May 2003 following elections to the Alþingi, the Government stated that it intended to eliminate net wealth taxes during its four-year term of office.

In order to offset a sharp increase in assessed real property values in 2002, following a nation-wide assessment review by the Valuation Office, a central government agency, the Government decided to increase the tax-free threshold for purposes of the net wealth tax by 20 per cent. At the same time it decided to halve the general net wealth tax, from 1.2 per cent to 0.6 per cent, and do away with the net wealth surtax of 0.25 per cent on net wealth exceeding 6,332,500 krónur (these amounts being double for couples). The new rates were applied in 2003 in respect of assets at the end of 2002.

3. The social security tax

The 5.73% tax is allocated as follows:

General charge..	4.840%
of which to:...	
Occupational Safety Administration...........................	0.800%
Standards Council..	0.007%
Icepro Committee..	0.001%
Childbirth Leave Fund...	0.850%
Towards financing social security expenditures........	3.182%
Employment insurance..	0.800%
Fund for covering wage claims of bankrupt employers..	0.040%
Marketing levy for financing the Export Council..............	0.050%
Total	**5.730%**
Suppl. charge for fishermen's accident insurance..........	0.650%

The social security tax was raised by 0.5 per cent as of the beginning of 2003[7]. The increase was part of a total tax revision package that also included the reduction in the corporate income tax (see below) and net wealth tax.

4. Corporate taxation

As of the beginning of 2002, Iceland’s corporate income tax was lowered from 30 per cent to 18 per cent. Partnerships with unlimited liability that file for taxes as distinct legal entities had their tax rate lowered from 38 per cent to 26 per cent[8]. The reduction in the tax rates apply to the 2002 income year, the tax for which is assessed in October 2003 and comes up for payment thereafter. Furthermore, the corporate net wealth tax will be reduced from 1.2 per cent to 0.6 per cent at the end of 2002. The corporate net wealth surtax will be abolished at the same time.

At the same time, the so-called inflation accounting system was abolished and replaced by conventional historical accounting. Inflation accounting has been in effect for a number of years due to the fact that inflation was at one time quite substantial and accounting methods had to reflect that fact. For the past decade, however, inflation has been in the single figures and the need for inflation adjustments in company accounts was diminished. Furthermore, international accounting standards are generally based on historical cost, and Icelandic standards are therefore being brought into conformity with international norms.

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7 The social security tax was increased by 0.77 percentage points as of the beginning of 2003 with Act no. 133/2001. Subsequently, the Government agreed with labour unions that if the price assumptions behind the 2002-2003 wage agreements would turn out as had been assumed, it would rescind 0.27 percentage points of the above increase. Legislation to that effect was passed by the Althingi in the autumn of 2002.

8 In fact, the income taxation of corporations and partnerships is about the same. If a corporation has an income of, say, 100, it pays 18 in income tax. If it chooses to use the entire remainder, 82, as dividends, it pays a further 8.2 (i.e. 10 per cent of 82) as capital income tax, for a total of 26.2 (18+8.2) per cent. A partnership pays a total of 26 per cent on an income of 100 up front and is not subject to a further capital income tax.

The table below shows the corporate and partnership taxation rate since 1989:

	Corporations	Partnerships
1989	50.00	50.00
1990	45.00	45.00
1991	45.00	45.00
1992	39.00	41.00
1993	33.00	41.00
1994	33.00	41.00
1995	33.00	41.00
1996	33.00	41.00
1997	33.00	41.00
1998	30.00	38.00
1999	30.00	38.00
2000	30.00	38.00
2001	30.00	38.00
2002	18.00	26.00
2003	18.00	26.00
2004	18.00	26.00

Since March 1999, so-called international trading companies, having established a venue in Iceland, are subject to a 5 per cent income tax. This refers to companies that exclusively trade in goods and services outside Iceland. In December 2003, legislation was passed to abolish the tax benefit for international trading companies as of the beginning of 2008.

In 2002, a number of changes in the corporate income tax system took place in order to make it more flexible and in line with that of other European countries. The carry-forward provision for net losses was extended from eight to ten years. Depreciation rules were amended so that straight-line depreciation on machinery, equipment, vehicles, ships, aircraft and other non-fixed assets is replaced with remaining-balance depreciation and the rates were sharply increased.

	Previous rates		New rates	
	Min.	Max.	Min.	Max.
Ships, ship equipment, passenger vehicles	5	10	10	20
Aircraft and related equipment	5	10	10	20
Industrial machinery and equipment	5	15	10	30
Office equipment	10	20	20	35
Earthmoving and construction equipment,				
other vehicles and transport equipment and				
other non-fixed assets	10	20	20	35

Other assets are depreciated on a straight-line basis. Their main depreciation rates remain unchanged and are as follows:

	Min.	Max.
Residential, office and commercial buildings	1	3
Industrial and farm buildings	3	6
Piers and glass hothouses	6	8
Drill holes, electric overhead wires,		
removable work camps	7.5	10
Acquired intellectual property rights	15	20
Goodwill purchased	10	20

5. The value added tax

There is a general value added tax of 24.5 per cent on domestic goods and services. Exports of goods and services and several other transactions are zero-rated. A lower tax rate, 14%, applies to the following transactions: Most foodstuffs, newspapers, periodicals, books, subscription to radio and television, geothermal hot water, electricity, fuel oil used for heating, and hotel room rentals. As a general rule, all transactions are taxable except where exemptions are specified. The most common categories of exemption are health services, social services, education, libraries and art, sports, passenger transport, postal services, rental of property and parking spaces, insurance and banking services.

In its May Policy Statement the Government declared that it intends to review the structure of the value added tax with the aim of improving household purchasing power.