125. The introduction of a carbon tax on the carbon content of fossil fuels is also to be welcomed, partly because carbon content is a rational basis for determining taxes on fuels and partly because it increases the taxation of vehicle fuels, which is currently rather low (see above). It is also good that all consumers of the fuels, and not just road users, are covered by the tax.

126. However, the tax could be improved by applying the same tax to industrial users of carbon, as efficiency requires that all producers of carbon dioxide should be taxed at the same rate. Also, the rate of tax, currently set at about half the permit price in the EU Emission Trading System (ETS) for carbon permits, should be raised to equal the European permit price as that will be the cost that Iceland will face for carbon emissions in the longer term.

Recommendation

- These taxes are welcome from the environmental and economic efficiency angles. However, there is probably considerable scope for increasing the resource taxes without causing any distortions and the appropriate level requires further analysis. Also, the carbon tax should apply to all carbon consumers and its rate should be increased to equal the ETS price.

APPENDIX: SUMMARY OF RECOMMENDATIONS

CIT and debt forgiveness

- Introduce the necessary provisions in the Income Tax Act that make the profit determined according to the financial statement the basis for the taxable profit, allowing only those deviations explicitly provided for in the Income Tax Act.

- The income tax should treat as ordinary profits capital gains and losses on business assets that are recognized in accordance with financial accounting rules. Consequently, income arising from debt forgiveness should be considered taxable income but would be offset against these losses. Income in excess of losses, if any, should be taxed.

- A one-time transitory mechanism should be adopted to allow the tax recognition of capital losses incurred during the crisis up to an amount commensurate to the income arising from debt forgiveness. This could be closely monitored and authorized by the tax administration on a case by case basis in accordance with publicly announced rules. For individuals, the tax authority should exempt income from mortgage debt forgiveness up to the point where the debt is equal to the market value of the property reduced by reasonable foreclosure and sale costs to the lender.

- A thin capitalization provision based on either the debt-to-equity ratio or the earnings test should be introduced. An earnings test based on EBITDA is possibly preferable due to its simplicity and lower potential for avoidance.

- The 15 percent withholding tax on interest payments to residents in treaty countries should be waived or reduced (as provided by the treaty) at source, using pre-certification of residence. Consider disallowing the deduction of interest payments made to residents in a low tax country.

- The participation deduction should be reformed into a participation exemption, bringing the tax treatment of intercompany dividends in line with other European countries. Add to the current threshold of 10 percent shareholding a second (alternative) threshold in the form of a fixed amount of investment—calibrated to the specific situation in Iceland.

- Investment incentives under consideration should not be adopted. If this is not feasible, the annual turnover requirement should be increased drastically in order to cover only very large investments.

- Maintain the current 10-year period of loss carry forward.

PIT and direct taxes on individuals

- Retain the dual income tax structure rather than switching to a comprehensive income tax.

- Allocate revenue in closely held businesses according to either the net or gross assets methods. The gross assets method would be preferable as it offers less opportunity for tax arbitrage. This income splitting regime should apply to both closely held corporations and partnerships.

- If needed, to increase progressivity and raise revenue, introduce a single 10 percent surcharge on incomes above ISK 4.5 million. Do not raise the basic tax credit or initial tax rate.

- As the economy recovers, phase out mortgage interest deduction over time for all but low-income, first-time home buyers.

- Reduce social security tax rate as budgetary pressures decline.

- Simplify net wealth tax by allowing the use of financial accounting valuations.

Corporate and individual capital income taxation

- If additional revenue is needed, increase both CIT and capital income tax rates to 20 percent. Over the medium term, consider reducing the double taxation of dividends and capital gains by introducing a modified ACE.

VAT

- Move to a single rate of VAT, using between a quarter and a third of the additional revenue for a compensation package for those on low incomes that will improve overall progressivity. Ideally, this would be achieved in a single step. However, if necessary, it could be staged, with a first step that raises the reduced rate back to 14 percent and restricts it to food. Also, remove VAT exemptions that are not included in the EU VAT Directive, with a compensatory subsidy to public transport.

- Provide reimbursement for input VAT to local government services that could be outsourced. In the current fiscal situation it is best to limit the reimbursements to those services.