

Restructuring of distressed businesses in Iceland

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LOGOS PROVIDES COMPANIES AND INSTITUTIONS WITH SERVICES BASED UPON THE FIRM'S LEGACY OF LEGAL PRACTICE SINCE 1907. LOGOS SPECIALISES PRIMARILY IN CORPORATE AND COMMERCIAL LAW PROVIDING SERVICE FOR BOTH THE INTERNATIONAL BUSINESS COMMUNITY AND LOCAL ICELANDIC CLIENTS REQUIRING INTERNATIONAL LEGAL ASSISTANCE. THE CURRENT ECONOMIC ENVIRONMENT HAS RESULTED IN A NEED FOR PROFESSIONAL RESTRUCTURING SERVICES: A NEED THAT LOGOS HAS MET BY SUPPLYING ALL NECESSARY LEGAL SERVICES, INCLUDING TAX ADVICE.

Corporate taxation

General overview

Iceland uses a classical tax system, with a corporate tax rate of 15% applicable to all limited liability companies. The only significant exceptions take the form of no effective taxation of dividends and capital gains from the sale of shares. Dividend distributions are also taxed at the rate of 15%.

The effective non-taxation of dividends and capital gains from the sale of shares makes Iceland a favourable jurisdiction for holding companies. The non-taxation is not achieved via a typical exemption mechanism but by classifying the income as fully taxable while a deemed deduction of the exact same amount is permitted. Although there are several requirements for the deemed deduction to be accepted, the main requirement is that the shareholding is in a company that is subject to an effective tax rate of 10% or more.

Furthermore, the deductibility of interest costs, even if such costs result from the purchase of share capital, increases the efficiency of an Icelandic holding company and effectively provides for the possibility of such company conducting more activities than the holding of shares.



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The main alternatives to limited liability companies in Iceland are partnerships and limited liability partnerships. Such entities are, for Icelandic purposes, separate legal entities both for legal and tax purposes. The distributions from such entities to unlimited partners are not subject to tax, while the entities themselves are subject to tax at the rate of 23.5%. The only significant exception takes the form of dividends being subject to tax at the rate of 10% while the capital gains remain fully taxable.

There are no consistent provisions of Icelandic tax law that deal with restructuring of distressed businesses as a whole. Furthermore, the specific provisions of Icelandic tax law that effectively touch upon the restructuring of distressed businesses are not harmonised and may, or may not, be helpful to a given restructuring scenario depending almost entirely on chance.

Recent changes

The recent introduction of CFC rules in Iceland will have a significant impact on the way Icelandic companies do cross-border business. In short, the Icelandic CFC regime means that Icelandic companies are taxed on the income of their foreign affiliates provided that at least 50% of the foreign affiliate is held by Icelandic entities and the income of that foreign affiliate is subject to an effective tax rate that is lower than two-thirds of the Icelandic one.

Another recent amendment to Icelandic tax legislation is the taxation of outbound interest payments. Due to technicalities in the income tax law, it is not clear what tax rate such outbound interest payments are subject to, as the tax liability is net-based while the collection is to be achieved via withholding.

Further changes to the Icelandic tax law are expected, including an increase in the corporate tax rate and an increase in the tax rate applicable to dividend distributions to individual shareholders. Also, changes providing for incentives for new investment, and research and development are expected.

Notably, no changes to facilitate the restructuring of businesses have been implemented and no such changes have been introduced as concepts by Icelandic authorities. Therefore, they are not expected before the majority of the restructuring needed has been carried out.

Restructuring

There are various restructuring exercises taking place in Iceland, ranging from single company businesses to multinational groups. As a result of this, various issues have come up in practice, most of them requiring immediate solutions. In light of this being an ongoing and developing process, an overview of the main issues is provided herein. They generally have the common characteristic that they have rarely or not at all been tested in administrative or court practice. Furthermore, they are often interlinked and can have a significant impact on the outcome of a given restructuring, although they may not have a synchronised effect.

Acquisition of debt claims

A part of the Icelandic definition of taxable interest income is the nominal value of a debt claim less the acquisition value of that claim, taxable on a linear basis during the remainder of the lifetime of such claim. This provides for a highly interesting question on whether an acquisition of a distressed claim (or a claim from a distressed entity selling at a low value) results in a taxation of the new claimant, possibly in excess of its initial collection of interest depending on the lifetime and acquisition price of such a claim.

The preliminary answer is that the conclusion may depend on the status of the debtor. If the debtor is distressed it may be possible to argue that the possible income from such a claim is uncertain and, therefore, it should be taxed on a cash basis rather than on the generally applicable accrual basis. However, this is not clear in Icelandic law and, therefore, it is possible that the acquisition of debt claims at a value below face value can result in significant timing mismatches between income being realised and tax being levied.

Use of old losses

A company operating a distressed business should generally have considerable accrued losses from its operation. In cases where such a company goes through a restructuring process resulting in a change of its business operation and/or change of ownership, some interesting questions arise on whether it can use its accrued losses to offset its taxable income going forward.

According to Icelandic income tax law, accrued losses can generally be carried forward for 10 years and used in full to offset taxable income during that period. However, there is a restriction as to the use of such old losses if the business of a company has changed significantly, e.g., if a change in ownership has occurred. This restriction does not apply if the change is done for normal business purposes.

There are uncertainties, both in relation to what a significant change is and in relation to when such a change is done for normal business purposes. Therefore, one of the major things for Icelandic companies to watch out for when undergoing restructuring is the preservation of their accrued losses. A restructuring may cause a significant tax asset to be lost.

Losses incurred prior to consolidation

Restructurings resulting in the change of ownership of companies, without old losses being lost, cause a specific issue. The main requirements for tax consolidation of two or more companies in Iceland is the top holding company owning, directly or indirectly, at least 90% of the share capital of its subsidiaries for a whole fiscal year. However, when this shareholding occurs as a result of restructuring out of a distressed situation, the losses of any of the group companies accrued prior to the consolidation being effective cannot be used to set off income of any of the other group companies.

Therefore, there may very well be significant tax inefficiencies in such groups post restructuring.

Taxable income of debtors resulting from writing down debt

Debt of a company being written off as a result of restructuring, either via a formal composition or informal negotiations, can result in the amount written off being classified as taxable income of that company. Such income would be immediately taxable upon tax being levied for that fiscal year. Furthermore, there is no mechanism in the law that links the taxable income to losses, neither specifically nor generally.

As a consequence, a composition can result in taxable income of the distressed company that may very well be in excess of its losses. An example of this could be a company that has sold its shareholdings at a significant loss. Such a loss is not deductible for Icelandic tax purposes. Therefore, its significant losses count for zero when it comes to setting off its income resulting from a composition.

Unless planned for, it is possible that a company going through this type of restructuring can end up with a significant tax claim, payable within a short period of time. In the worst case scenario, this can result in a company emerging from a composition to find itself in a distressed position again.

Deductibility due to loss in value of share capital held

Losses incurred from the sale of share capital are not deductible for tax purposes in Iceland. However, losses that arise from share capital being lost due to the underlying company going bankrupt or its shares being written down as a result of a composition are deductible for tax purposes. This results in how the underlying fares becoming very important for the shareholder, i.e., the shareholder can only realise deductible losses in the worst case scenario.

This means that there is a driver for a shareholder of a distressed company to put it into bankruptcy rather than selling its shares at very low value. The effect of this can be serious restrictions on the conclusion of distressed scenarios. Furthermore, as losses cannot be carried back under Icelandic law, this issue can impose significant time restraints on decision making.

Timing and value issues in relation to lost claims

The loss of an outstanding claim can be deducted for tax purposes, provided that the claim is directly linked to the business of the claimant. However, the deduction cannot be made until in the fiscal year a claim is provably lost. The law provides no clarification on when a claim is provably lost.

A decrease in the value of a claim may not be sufficient for it to be considered lost, i.e., even if it is clear that only a part of it will be repaid, it is not certain when the lost part can be deducted. The decrease in value, i.e., partial loss of a claim, should be considered provable and deductible when it has been written down via composition.

Furthermore, it is possible that this can happen at an earlier date, but this depends on the circumstances and it is not clear at all what circumstances can result in sufficient proof being available. Therefore, the tax law contains a driver for creditors to push the debtor in a specific manner that may or may not be good in a wider context.

In the case of a full loss of a claim, it should be considered provable upon bankruptcy of the debtor. This may also be provable at an earlier date, but it is not clear when that would be or what would be required. Again, there is an incentive for a creditor to try and obtain sufficient proof via a bankruptcy that may or may not be beneficial in a wider context.

Conclusion

The financial crisis has resulted in various Icelandic companies finding themselves in a distressed situation requiring a restructuring exercise in order for them, their creditors and their shareholders to maintain and preserve as much value as possible. This has highlighted various issues in Icelandic tax law; the most significant ones highlighted herein.

As a matter of practice, some of these issues raise questions that are still to be answered. Furthermore, the answers may provide incentives that affect the course of the restructuring. From a tax perspective, a decision may result in differing results as destroying value, preserving value or even creating value.

Therefore, the tax effects of the choices to be made in the restructuring of Icelandic businesses can have a significant impact on how and when such choices are made.

The immediate lesson learned is that companies and their stakeholders need to be very careful in choosing how to carry out the restructuring of a business. Furthermore, as a matter of policy, the lawmaker should take care not to implement tax rules that may have a harmful impact on viable restructuring possibilities.