Jarle Møen
Dirk Schindler
Guttorm Schjelderup
Norwegian Center for Taxation
NHH Norges Handelshøyskole

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Comments on Høringsnotat Saksnr. 17/1850

Forslag til endringer i rentebegrensningsreglene

Norwegian Center for Taxation (NoCeT)

Design of the rules

The changes in the Norwegian thin-capitalization rules, proposed in the document Høringsnotat Saksnr. 17/1850, imply that deductibility of interest expenses on both external and internal debt in Norwegian affiliates of multinational companies will be limited by a so-called earnings stripping rule. Entities that are part of a corporate group ("konsern") shall be allowed to deduct interest expenses to a maximum of 25% of earnings before interest, taxes, depreciation, and amortization (EBITDA). Exemptions are granted for affiliates that can prove that their leverage does not lie more than 2 percentage points lower than the group-wide leverage and for affiliates with total interest expenses of less than 10m NOK.

Effectively, the new rules will be identical to the German earnings stripping rule that is in place since 2008, except for three minor differences. These differences are

1. The German rule applies to all corporate entities in Germany. Entities that are not part of a group can apply the group/trust clause and be exempted from the rules.
2. The threshold level for entities that are exempted from the earnings stripping rule is 3 million Euro (about 27 to 30 million NOK according to the current exchange rate). In both the German rule and the Norwegian proposal, the threshold is no allowance ("fradrag"); that is, the full interest expense will fall under the rules if the threshold is exceeded.
3. The German limit for interest deductibility is set to 30% of EBITDA.

We will comment on two of these three differences later. Overall, the evaluation of the Norwegian proposal should correspond to the evaluation of the German rules.

General evaluation

The OECD used the German set of rules as blueprint for their proposal of limiting interest deductibility in Action 4 of the OECD BEPS Action Plan. This appears like a good choice because the experience with the German rules is very positive, see for example the summary in Ruf and Schindler (2015).

Importantly, the evaluation is positive despite the fact that there is mixed empirical evidence for the German earnings stripping rules.[1] One of the studies with a negative finding is Dreßler and Scheuering (2012, 31) who conclude that the German earnings stripping rules do not work to deter income shifting. The most recent study, Alberternst and Sureth-Sloane (2015), applies a matching approach and finds

[1] See section 4.3.2 in Ruf and Schindler (2015) for a summary of studies on the German earnings stripping rules since 2008.

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a significant reduction in leverage of entities that fall under the German earnings stripping rule (compared to the ones that are not affected by the introduction of the rule). The effect is strongest for entities that do not have financing constraints. All the studies on earnings stripping rules, however, need to be evaluated with a grain of salt, because the earnings stripping rule is difficult to operationalize in an empirical setting and none of these studies has yet been published in a peer-reviewed journal. The reason for this might well be that they all suffer from methodological problems.

In addition, recent theoretical research predicts that the effect on leverage is ambiguous because earnings-stripping rules will affect transfer pricing decisions at the same time so that an overall evaluation of the effectivity of rules would require to analyze the change in income shifting, not the change in leverage (Schindler and Schjelderup, 2016). Gresik et al. (2017) point out that an earnings stripping rule reduces transfer pricing and has a positive substitution effect on the use of internal debt. In total, both leverage and investment will increase, but total income shifting will decrease because transfer pricing will decrease.[2] Because transfer pricing is socially undesirable, whilst the use of internal debt reduces the classical corporate tax distortion and increases investment, an earnings stripping rule always dominates the alternative “safe harbor approach” with a cap on the level of tax-deductible debt. Hence, even if methodologically sound empirical studies find no or a significantly positive effect of earnings stripping rules on (internal) leverage, these effects are welfare increasing and desirable as long as total income shifting decreases.

One aspect that is not discussed in the consultation paper from the Ministry of Finance is the potential of fostering liquidity problems in an economic downturn. This possibility caused substantial discussion in Germany when the rule was introduced. In firms that struggle with market conditions, in particular in a downturn or recession, EBITDA will be low. This increases the likelihood of denying deductibility of interest expenses that are not related to any income-shifting motives. In such cases, the earnings stripping rules can foster liquidity problems and aggravate an economic crisis. No study to date documented such an effect empirically, however. Furthermore, Germany went through a very tough recession in 2008/09, but there were no reports that indicated a detrimental role of the earnings stripping rule. Therefore, we believe that potential counter arguments, brought forward in the hearing process and based on liquidity-problem arguments, should not receive much weight in the final evaluation.

With respect to an escape clause, the consultation paper from the Ministry of Finance carefully discusses the available alternatives and argues in favor of an escape clause based on the group-wide leverage. We agree that an escape clause based on a leverage (debt-to-asset ratio) comparison is easier to operationalize and control. In principle, all escape clauses might offer potential loopholes, but the comparison of leverages should be least prone to manipulation, in particular when the extended obligation of country-by-country reporting for multinational corporations will become effective.[3]

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[2] Gresik et al. (2017) show the effect for overcharging interest rates on internal debt. The analysis applies to all kinds of transfer pricing because any type of tax-motivated transfer pricing will reduce EBITDA and tighten the earnings stripping rule.

[3] The chosen escape rule should also allow Norwegian tax authorities to benefit from experiences made by the German tax authorities in handling this escape clause.

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Specific comments and suggestions for changes

Our specific comments refer to the first and third of the three identified differences between the Norwegian proposal and the German set of rules. In principle, we recommend to follow the German rules more closely.

Scope of the rules: affiliates of groups only

Some researchers at NoCeT wonder whether the Norwegian proposal of only applying the rules to affiliates of groups instead of applying it to all entities and granting a “group clause” as the German rules do, might cause problems with the EEA agreement and the freedoms in the Common Market. Although the difference in wording appears semantic, as it stands, the Norwegian rule will discriminate multinational companies, particularly foreign investors, relative to domestic Norwegian non-group entities. This set-up resembles the German safe harbor rules before 2004 that only targeted foreign investment and did not apply to internal finance by domestic investors. In December 2002, the European Court of Justice decided in the so-called "Lankhorst-Hohorst case" that these rules violated the principle of "freedom of establishment". For the lawyers’ evaluation of the rules, it did not matter that domestic firms do not have any economic incentive to use internal debt.

Similarly, lawyers might conclude that the proposed Norwegian rule discriminates against non-group entities (which are Norwegian entities only). The safer implementation is to follow the German example and apply the rule to all entities active in Norway. Like the German rules, a group clause can be granted that exempts entities that can prove not to be part of a group. Another advantage of such an approach is that it reduces the risk of missing an entity that should be under the rules, but is exempted because it appears to be a non-group entity. Under the “German approach”, firms will need to document that they are not part of a group so that misapplication is more difficult.

Limit of the EBITDA rule

Regulating the use of both internal and external debt will restrict the use of debt and income shifting in multinational companies, and increase the effective tax burden on these companies relative to the existing rules. Setting the limit of total interest deductibility to 25% of EBITDA constitutes a further increase in effective taxation.

Letting such a strict limit also fall on external debt is more likely to aggravate liquidity problems in economic downturns and might cause high adjustment costs in firms. Therefore, we recommend to follow the German example and limit total interest expense to 30 % of EBITDA. This limit has been adopted also by countries like Italy, Portugal and Spain, and they seem to have avoided major

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problems.[4] If it should turn out that the limit is too generous, it can be tightened later. This way the risk of substantially adverse economic effects is reduced.

References

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[4] Portugal even decided to start with a very generous deduction limit of 70% in 2013 that decreased year by year until it reached 30% of EBITDA in 2017.