

# **Regulating international debt shifting: A comparison of the new Norwegian regulation with traditional thin-capitalization rules**

*by Christian Smith-Nilsen, MSc in Economics and Business Administration, NHH, Spring 2014*

**To limit the use of internal debt as a vehicle for tax planning, several of Norway's largest trading partners have implemented rules to prevent so-called thin-capitalization. In the wake of this development, Norway introduced a new earnings-stripping rule effective from the fiscal year 2014. I investigate whether this change in the tax law has potential to effectively reduce the leverage of firms that fall under the new rule. Both theoretical modeling and an empirical review indicate that the new rule will reduce leverage, but firms still have incentives and opportunities to be thinly capitalized.**

Driven by the globalization of the world economy, multinational companies have grown a lot and gained substantial importance in each country they operate in. The increasing presence of multinationals has its challenges, however. For multinational corporations, it can be possible to exploit tax differences between countries. To exploit these differences, firms use strategies such as debt shifting and transfer pricing in order to minimize their tax burden. The former kind of tax planning behavior, where debt is used to minimize the tax payments, has received considerable attention in Norway recently.

High tax rates increase the incentives to use more internal and external debt. The reason is that interest payments are tax deductible and reduce the firms' tax burden, unlike the opportunity cost of equity that is not deductible. Given the cost of debt financing, this can lead to a situation in which firms have a high proportion of debt, also called thinly capitalized firms. This incentive occurs especially for multinational firms that can use internal debt as well as external debt as a tax shield.

Norway recently chose to abolish the arm's length principle in favor of the new earnings-stripping rule. In theory, one can argue that this is a less effective regulation, but the assumptions that underlie this claim are so strict that they do not reflect real world imperfections. The new Norwegian earnings-stripping rules are designed to prevent companies from stripping earnings by using

intercompany debt financing. The rules limit the deductibility of interest expenses that originate from related party and third party debt where a related party has provided security for the debt. Third party debt is not subject to interception, but it can displace the deductibility of internal interest expenses.

Using a theory model, I predict that the new Norwegian earning-stripping rules will effectively reduce the leverage of firms that fall under the rules. However, since the new rules do not restrict deductibility of external debt it can be optimal to use more external debt in response to the rules. Such substitution is to some extent confirmed by the empirical literature and makes it possible to increase leverage above the defined threshold. Such circumvention opportunities make the effectiveness of the rules uncertain.

The effectiveness of the new rules depends also on the existence of loopholes. A review of the legal framework of the rule set indicates that a branch of a foreign company, which has limited tax liability in Norway, can adapt to the rules. Since the headquarter of the foreign company determines how much debt the Norwegian branch shall be allocated, the Norwegian tax authorities need to assess what should be categorized as internal and external debt. The Norwegian tax authorities solve this issue by applying the same ratio as the foreign mother company. The Ministry of Finance admits that firms can adapt to these rules by manipulating debt at the end of the year or by ensuring that the foreign mother company has only external debt. It should, however, be noted that the tax authorities have means to prevent this by using the Norwegian “veil-piercing rule”, i.e. they can disregard arrangements and transactions that are done with the sole purpose of saving taxes.

Since the Norwegian rules recently came into force, there exists, at present, no lawsuit or administrative practice for cases where the regulation is circumvented. This makes it difficult to assess how easy it is to circumvent the rules.

In conclusion, it can be argued that the new rules for mainland Norway are a step in the right direction to limit tax avoidance. It is expected that the tax authorities follow the effects of the new rules carefully. Moreover, the “Scheel-Committee”, appointed to consider how Norway can achieve a more robust tax system, will deliver its report in October 2014. This report should include considerations regarding the shortcomings mentioned above.