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EFTA SURVEILLANCE AUTHORITY

Ministry of Finance
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Dear Sir/Madam,

Subject: Complaint against Norway concerning interest deductibility restrictions

On 3 January 2019, the EFTA Surveillance Authority ("the Authority") received a complaint against Norway concerning the new Norwegian rules on the limitation of the deductibility of interest expenses, which entered into force on 1 January 2019[1].

According to the complaint, the elements of the newly adopted legislation, especially the content of the so called "equity escape rule", are in breach of the rules on the freedom of establishment under Article 31 EEA. The complaint specifically concerns situations where a Norwegian tax resident parent company with external debt owns Norwegian tax resident and EEA tax resident subsidiaries that are fully consolidated in the consolidated financial statements of the Norwegian parent ("the outbound situation").

The Norwegian legislation at issue

Section 6-40 of the Norwegian Act on Asset and Income Tax of 26 March 1999[2] ("the NTA") contains the general rule, which provides that interest expense on debt is generally deductible for corporate income tax purposes. The right to deduct debt interest under this provision is unconditional and general and does not require, for example, that the debt is connected to a taxable asset or is used to acquire or maintain taxable income[3]. Hence, under Section 6-40 of the NTA, interest expenses are fully deductible even if the debt is drawn for the purpose of financing the acquisition of shares in Norwegian and EEA based companies that are covered by the participation exemption rules with the effect that dividends/gains on such shares are tax free (save for 3 % income inclusion of dividends under Section 2-38(6) of the NTA).

Effective from 1 January 2014, Norway enacted the interest cap rules that contain limitations on the right to deduct interest on debt to affiliated companies (Section 6-41 of

[1] LOV-2018-12-20-102.
[2] *Lov om skatt av formue og inntekt (skatteloven)*.
[3] The preparatory works to Section 6-40 NTA (Ot. Prp nr. 86 (1997-1998), Chapter 7.6) state: "*[...] the right to deduct debt interest is not conditional upon the debt being linked to a taxable source of income. Therefore the provision represents an exception to the main rule regarding the deduction of costs for acquiring, maintaining and securing taxable income as laid down in Section 6-1.*" (Unofficial translation by the Authority).

the NTA, "the fixed ratio rule"). The fixed ratio rule is complemented by the transfer pricing rules, including thin capitalization rules laid down in Section 13-1 of the NTA.

Effective from 1 January 2019, the interest cap rules were amended to include external debt, *i. e.* the fixed ratio rule now in general applies to external debt. There are no changes to the fixed ratio rule for debt between related parties.

In particular, the new rules apply to Norwegian tax resident companies with external debt provided they form part of a consolidated (global) group for financial accounting reporting purposes (Section 6-41(3) third sentence of the NTA). A consolidated group for financial accounting reporting purposes is defined in Section 6-41(5) of the NTA as follows:

"*A company etc. forming part of a group means a company etc., that in the year prior to the income tax year in question, actually is fully consolidated on a line-by-line basis in the parent company's audited consolidated financial statements prepared under NGAAP, IFRS, GAAP in an EU/EEA country, US GAAP or Japanese GAAP, or that in the year prior to the income tax year in question, would have been fully consolidated on a line-by-line basis in a consolidated financial statements if IFRS had been applied. […]*"

The term "*a company etc.*" is defined in Section 6-41(1)(a) of the NTA and means a Norwegian tax resident company.

A consolidated group for accounting reporting purposes comprises the parent company and its directly/indirectly controlled subsidiaries. Controlled subsidiaries include subsidiaries in which the parent directly/indirectly has a controlling interest in the subsidiaries, typically where the parent owns at least 50 % of a company plus one share[4].

Under the new rules, the fixed ratio rule is complemented by an "equity escape rule", which contains two alternative tests.

1. Under the first test, in the outbound situations the Norwegian parent's interest expense deduction limitation under the fixed ratio rule would not be limited provided its adjusted equity ratio in its statutory accounts is equal to or exceeds the equivalent group equity ratio in the audited consolidated financial statements of the group (Section 6-41(8)(a)(1) of the NTA). Where the ratio is lower than that of the group (within a tolerance of 2 % points), the parent remains by default subject to the fixed ratio rule (the cliff effect).

   For the purposes of applying the first test, the Norwegian parent company must make appropriate adjustments in its own statutory accounts in order to establish a shadow financial statement so that the equity ratio in these shadow financial statements can be compared with the equity ratio in the audited consolidated financial statements of the group (Section 6-41(8)(c) of the NTA). One significant adjustment to be made is that shares held by the Norwegian parent company in fully consolidated subsidiaries shall be deducted from the total assets/liabilities and equity in the shadow financial statement to be prepared for the parent (Section 6-41(8)(d)(5) of the NTA).

2. Under the second test, in the outbound situations the Norwegian parent company can deduct the full interest expense on its external debt if it can demonstrate that

[4] As defined in Section 1-3 of the Norwegian Accounting Act *(Regnskapsloven).*

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the equity ratio in the shadow financial statements of "*the Norwegian part of the consolidated group*", is equal to or exceeds the equity ratio (with 2 % tolerance) in the audited consolidated financial statements of the worldwide group (Section 6-41(8)(a)(2) of the NTA).

The term "*the Norwegian part of the consolidated group*" is defined as "*companies etc. that are consolidated line-by-line in the audited consolidated financial statements, which is used as basis for determining the equity ratio of the consolidated group*'' (Section 6-41(8)(a) second paragraph of the NTA). The term "*companies etc.*" means Norwegian tax resident companies (Section 6-41(1)(a) of the NTA).

Section 6-41(8)(e) of the NTA reads: "*The shadow consolidated financial statements of the Norwegian part of the consolidated group shall be prepared as if the group comprise of the Norwegian part, only*". Again, the term "*the Norwegian part of the consolidated group*" means Norwegian tax resident companies, only, that are consolidated line-by-line in the audited consolidated financial statements of the group ("the Norwegian consolidated group").

This seems to entail that EEA tax resident subsidiaries that are fully consolidated in the Norwegian parent's audited consolidated financial statements of the group will not be part of the Norwegian consolidated group and thus not be included in the shadow consolidated financial statements.

It follows from the above provisions, the preparatory works and Example 2 under point 9.18 in Prop. 1 LS (2018-2019), that the book value of shares in fully consolidated EEA subsidiaries shall be deducted from equity and total assets/liabilities in the shadow consolidated financial statements ("the shares carveout provision").

It follows from statements in the preparatory works (point 9.8.3 of Prop. 1 LS (2018-2019)), that a Norwegian parent company with external debt that owns fully consolidated Norwegian group companies only, can invoke the equity escape rule (Section 6-41(8)(a) of the NTA) without having to prepare a shadow consolidated financial statements provided it can demonstrate that the Norwegian group does not own any EEA company (and any non-EEA company) that are fully consolidated in the audited consolidated financial statements of the group. According to the preparatory works, this is in line with the purpose of the provision, which is to prevent tax avoidance by placing debt in the Norwegian part of the consolidated group. Further, it is stated: "*The fact that it is sufficient for domestic groups to prove that the group does not consist of foreign companies, etc., constitutes an administrative simplification for this group*".

In order for the Authority to examine and assess the complaint, the Norwegian Government is invited to provide the following information:

1. The Norwegian Government is invited to confirm the above description of the Norwegian rules. Please refer to any inaccuracies therein.
2. According to the complaint, when applying the first test described above, the effect of the rule that the book value of shares in fully consolidated subsidiaries (wherever they are located) is deducted from equity and total assets/liabilities in the shadow consolidated financial statements is that (in the outbound situations) the equity ratio in the shadow consolidated financial statements in practice always

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will be 2 % lower than the equity ratio in the audited consolidated financial statements of the worldwide group. Hence, this equity escape rule in practice may not apply in the outbound situations.

In the same vein, when applying the second test, the effect of the Norwegian consolidated group and the shares carveout provision is that the equity ratio in the shadow consolidated financial statements in practice will always be lower than the equity ratio in the audited consolidated financial statements of the worldwide group. Hence, this equity escape rule in practice may not apply in the outbound situations. However, a Norwegian parent company that owns Norwegian group companies only, always will be able to deduct the full interest expense on its external debt.

Please comment on whether the effect indicated by the complainant is accurate. Please provide concrete examples showing when a Norwegian parent company with external debt that owns both Norwegian and EEA fully consolidated companies (or EEA fully consolidated companies only) might be able to effectively invoke the equity escape rule.

3. Does the Norwegian Government consider the interest cap rules, including the equity escape rule, in general, and the shares carveout provision, together with the definition of the Norwegian consolidated group, in particular, to constitute a restriction for the purposes of Article 31 EEA?
4. If the previous question is answered in the affirmative, the Norwegian Government is invited to provide the justification of the restriction by a legitimate objective, as well as its proportionality with regard to the aims sought.

   While providing the justification of the national measure please comment also, where appropriate, on the following aspects:

   4.1. *If the aim of the national measure is to fight against tax avoidance*:

   4.1.1. Please comment on how the above mentioned Norwegian legislation is compatible with the settled case law of the Court of Justice of the European Union concerning thin capitalisation rules referred to in the reasoned opinion of 25 October 2016 (Doc No 818742 in Case No 76153) concerning the interest limitation rules, which were in force in Norway until 31 December 2018. Under this case law, in essence, national interest limitation measures do not comply with the principle of proportionality if they, among other things, either do not provide the taxpayer with an opportunity to substantiate the commercial reasons for not entering into an arm's length loan arrangement, or restrict the deductibility of more interest than an arm's length interest.

   In this respect, please note that in the reasoned opinion of 25 October 2016, the Authority referred to the draft ATA Directive[5] and stated that "*the purpose of the draft proposal is not to overrule decades of case-law on thin capitalisation developed by the CJEU. The travaux préparatoires address this point, albeit in the*

[5] *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market.* COM(2016) 26 final. Brussels, 28.1.2016. Adopted on 12 July 2016 (*Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, not EEA relevant). The date of transposition of this Directive in the EU Member States was 31 December 2018.

context of exit taxation, when it states: "As the application of exit taxation within the Union shall be in line with the fundamental freedoms and in line with the case law of the Court of Justice of the European Union (CJEU) [...].'"".

4.1.2. As explained in the reasoned opinion, "*it is apparent from the case-law of the CJEU that administrative inconvenience does not constitute a ground that can justify a restriction on a fundamental freedom guaranteed by EEA law. […] Consequently, in the Authority's opinion, the risk of posing an administrative constraint on the assessment authorities cannot be considered as an overriding reason to deprive taxpayers of the opportunity to produce evidence that, first, their activities in the other Member State are genuine, and second, there are business reasons behind an arrangement that otherwise would be subject to the interest cap rules limit.*"

4.2. *If the aim of the national measure is to ensure balanced allocation of taxing rights*:

4.2.1. Please comment on whether such a justification ground should be allowed, in line of case law of the Court of Justice of the European Union in its judgments of 18 September 2003, *Bosal Holding*, C-168/01[6], judgment of 23 February 2006, *Keller Holding*, C-471/04[7], judgment of 10 February 2011, *Haribo Lakritzen and Österreichische Salinen*, C-436/08 and C-437/08[8], judgment of 6 October 2015, *Finanzamt Linz*, C-66/14[9], judgment of 2 September 2015, *Groupe Steria*, C-386/14[10], judgment of 22 February 2018, *X BV and X NV*, C-398/16 and C-399/16[11].

4.2.2. According to the complaint, it is the mere ownership of shares in fully consolidated EEA subsidiaries that triggers an obligation under the shares carveout provision to deduct the shares from the equity in the shadow consolidated financial statements. It is thus of no importance that Norwegian parents actually do not receive tax-free dividends, that they will not receive tax-free dividends because the EEA subsidiaries will reinvest their own generated profits in order to maintain/develop their own business, the parents will not realize tax-free gains on the sale of the shares in the EEA subsidiaries as they typically are long term investments and the subsidiaries form an integral part of the group's business and thus will never be sold to a third party *etc*. Hence, to this effect, the provision applies mechanically to Norwegian parent companies that are top financed (*i. e.* where the external debt needs of the entire multinational group is borrowed by the Norwegian parent only).

In addition, according to the complaint, the shares carveout provision is not linked to the purpose of the borrowed funds and thus applies irrespective of the purpose of the debt drawn by the Norwegian parent company. Hence, the provision may effectively prevent deduction of interest expenses on (1) external debt borrowed

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[6] Judgment of 18 September 2003, *Bosal Holding*, C-168/01, EU:C:2003:479, paragraphs 37-41.
[7] Judgment of 23 February 2006, *Keller Holding*, C-471/04, EU:C:2006:143, paragraph 44.
[8] Judgment of 10 February 2011, *Haribo Lakritzen and Österreichische Salinen*, C-436/08 and C-437/08, EU:C:2011:61, paragraphs 121-126.
[9] Judgment of 6 October 2015, *Finanzamt Linz*, C-66/14, EU:C:2015:661, paragraph 42.
[10] Judgment of 2 September 2015, *Groupe Steria*, EU:C:2015:524, C-386/14, paragraph 29.
[11] Judgment of 22 February 2018, *X BV and X NV*, C-398/16 and C-399/16, EU:C:2018:110, paragraphs 39-42.

for the sole purpose of acquiring/equity funding EEA subsidiaries (2) external debt borrowed for the sole purpose of acquiring/equity funding Norwegian subsidiaries and (3) external debt borrowed for the general purpose of servicing various funding needs within a multinational group.

Please comment on the complainant's assertions as outlined above.

5. Please elaborate on the background for the new rules, including any elements inspired by the OECD/G20 BEPS project and/or the above cited ATA Directive, as well as legislation in other EEA States, insofar as this information is readily available to the Government.

The Norwegian Government is invited to submit the above information, as well as any other information it deems relevant to the case, so that it reaches the Authority by ***17 April 2019***. Please enclose copies of any relevant national legislation, including English translations if available.

Yours faithfully,

Kristin Saether Bangsund
Deputy Director
Internal Market Affairs Directorate

This document has been electronically authenticated by Kristin Saether Bangsund.