What are thin capitalization tax schemes and how are they being countered by policy makers.

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Summary

This research’s aim is to conduct an examination of how multinational corporations use thin capitalization in order to avoid taxation and move profits across borders. Furthermore, provide an overview of the rules put in place to counter such behaviours and international steps being taken to further battle profit shifting as a way of tax avoidance. Finally, an explanation of their affects and how or if such rules should be implemented in Iceland where multinational corporations seem to be taking an advantage of such rules to avoid paying any income tax.
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<td>Base erosion and profit shifting</td>
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<td>EBIT</td>
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<td>EBITDA</td>
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<td>European Court of Justice</td>
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<td>Icelandic Supreme Court</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ITC</td>
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<td>MNE</td>
<td>Multinational Enterprise</td>
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<td>OECD</td>
<td>Organization for Economic Co-Operation and Development</td>
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<td>PE</td>
<td>Private Equity firm</td>
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<td>PLCL</td>
<td>Icelandic Private Limited Company Laws</td>
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Foreword

During a master thesis course in European and International Taxation at Lund University, I quickly found that the tax avoidance aspect of international taxation interested me, both from the perspective of the taxpayer and that of tax authorities'. I wrote my thesis about how the companies who own the Icelandic aluminium smelters avoid paying income tax by using so-called thin capitalization schemes. Due to both time and length limitations I was not fully satisfied with that work so I decided to extend my research and take a closer look at thin capitalization in general, what is being done about it. Finally, I wanted to look at the situation in Iceland. I would like to thank my tutor Ingibjörg Ingadóttir for her great help as well as my mother for her support.

Jón Bjarni Steinsson
1. Introduction

Research question: What are thin capitalization tax schemes and how are policy makers countering them.

1.1. Subject and problem

Thin Capitalization tax schemes are schemes where multinational companies use excessive loans between parent and sister companies in order to shift profits between countries by way of using tax-exempt interest payments instead of dividends. In the 1920s, the League of Nations recognized that interaction of domestic tax systems could lead to double taxation, something that countries all over the world agree that needs reducing as much as possible. Thus supporting economic growth in the world.¹ With the Occupy Wall Street movement catching headlines in September 2011 the fact that the wealthy and as well as large corporations minimize their tax burden by engaging in tax planning, using aggressive tax avoidance measures and/or tax evasion, angered people. Another thing that seems to bother people is the fact that many of the most effective anti-avoidance tools lie unused much of the time. Then when they are used, it is long after the invention of new avoidance strategies. Allowing avoiders to retain their tax savings from such schemes. This means lost revenue’s for governments fuelling dissent amongst people.²

Governments will bear with tax avoidance until it is noticeable enough to prompt political opposition or widespread enough to reduce tax revenues considerably.

Tackling aggressive tax avoidance may prove difficult though because of the political influence of the economic interests favoured by indecision by governments.3

Tax systems are systems where the decisions on what to tax is based on different legal and economic criteria, each susceptible to some amount of manipulation by taxpayers. Giving taxpayers the options to structure his affairs by adjusting the criteria relied on when assessing his tax liability. One example is thin capitalization tax schemes: a policy maker makes the decision to tax dividends, while interest payments should not be. An avoidance strategy forms where someone indifferent to the benefit of equity chooses the tax-free debt: a clear a manipulation on the true intention of the lawmakers.4 That is, the intention of the lawmakers was to avoid double taxation not enable taxpayers to choose debt financing in order to avoid any taxation at all.

It is a shared feature of tax law in most countries to make a clear distinction between debt and equity. Under domestic tax law the return on equity, i.e. dividends, is in general not deductible for the company handing out such dividends. The purpose of that is to encourage companies to reinvest distributable profits rather than to hold on to them. However, to avoid economic double taxation on received dividends (economic double taxation occurs when income earned by a corporation is taxable and the dividends are as well when distributed to shareholders). Return on debt, i.e. interest, is on the other hand generally deductible for the borrower and taxed at the level of the lender. International taxation also distinguishes between debt and equity, as dividends

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are taxable in the source state and interest in the residence state. There are also lower withholding taxes levied on interest than on dividends.\textsuperscript{5}

This provides an incentive to finance operations with debt rather than equity, especially in high tax countries.\textsuperscript{6} By financing itself with debt instead of equity, a multinational corporation can make use of interest deduction rules in domestic tax laws in order to lower or eliminate tax burden. This sort of “tax-planning” causes a rather complex problem for tax authorities and governments.\textsuperscript{7}

A company is ‘thinly capitalized’ when its debt capital is high in relation to its equity capital. The substantial distinctions that apply in most countries to the tax treatment of debt and equity have made thin capitalization a widespread method of international tax planning.\textsuperscript{8} This has recently caught the attention of both policy makers and scholars. MNE’s\textsuperscript{9} use international debt shifting in order to reduce their tax burden, utilizing differences in national tax rates and tax rules. Evidence shows that in order to benefit from these discrepancies MNE’s load those affiliate companies with debt, thus generating high net tax savings with external debt. In order to keep overall bankruptcy costs in check, the use of external debt in affiliate companies with lower tax savings is reduced, allowing for higher tax savings than in comparable domestic firms.

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\textsuperscript{5} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 1
\textsuperscript{8} A Duorado and R de la Feria (2008) Thin Capitalization Rules in the context of the CCCTB. p. 1 and J.B. Steinsson (2013) Thin Cap and Iceland - What can happen in the absence of thin capitalization rules? pg. 7-8
\textsuperscript{9} Multinational Corporations

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For internal debt shifting\footnote{borrowing and lending among related affiliates}, the purpose is to deduct interest in high-tax countries while earning interest in low-tax countries in a way that tax savings in the high-tax countries exceeds the increased tax liability in low-tax countries. Setting up internal banks (an internal bank is when a multinational corporation makes one of its subsidiaries in a low tax country lends money to a related company in a high tax country. It then receives tax-free interest payments instead of taxable dividends) in the lowest-taxed affiliate maximizes the debt tax shield, which provides all other affiliates with internal debt. A method that can work as a money making machine, generating tax profits as long as there is positive taxable income.\footnote{D Schindler and M Ruf (2012). Debt Shifting and Thin-Capitalization Rules, p. 2 and J.B. Steinsson, 'Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?', pg. 8}

In an effort to counter the negative consequences of debt finance, a number of countries have instituted thin capitalization or rules that limit interest deduction with the purpose of restricting the deductibility of interests above a certain debt level.\footnote{J. Blouin, H. Huizinga, L. Laeven, G. Nicodeme (2014). IMF Working Paper. Thin Capitalization Rules and Multinational Firm Capital Structure, pg. 3} That is, using quantitative restrictions as a determinant of foreign affiliate leverage.\footnote{J. Blouin, H. Huizinga, L. Laeven, G. Nicodeme(2014). IMF Working Paper. Thin Capitalization Rules and Multinational Firm Capital Structure, pg. 3}

Thin cap regimes vary across countries in what kind of limitations there are in the tax deductibility of interest, in the discretion applying these restrictions, and in the different tax treatment of interest that is applicable.\footnote{J. Blouin, H. Huizinga, L. Laeven, G. Nicodeme(2014). IMF Working Paper. Thin Capitalization Rules and Multinational Firm Capital Structure, pg. 3} Typically, interest deductibility is restricted if a measure of the company’s debt relative to its assets or equity exceeds a certain ratio. The exact definitions vary widely across
countries. The main distinction of the ratio is whether it limits interest deductibility for total debt or internal debt.

Some countries restrict the applicability of the rules to foreign subsidiaries substantially owned by their foreign parent. In December 2002, however, the ECJ decided in “Lankhorst-Hohorst” a case regarding a company with a registered office in Germany that received a shareholder loan from a company registered in The Netherlands. Under Art.8(a) of German corporation law, repayment of loan capital would constitute a covert distribution of profits if obtained by a company subject to corporation tax from a shareholder not entitled to corporation tax credit and should be taxed as such at a rate of 30 per cent. It was argued that the German provision was contrary to Art.43 EC as all non-resident shareholders were not entitled to corporation tax credit and, therefore, would have to be taxed at that rate.

The court concluded that German thin cap rules at the time violated the EU principle of ‘freedom of establishment’. Their rules did not apply to German investors that resulted in discrimination against companies’ loan agreements with non-resident affiliated companies or shareholders relative to loan agreements with resident affiliated companies or shareholders. This ruling, as later discussed, forced nearly all EU countries to reform their thin cap rules.

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18C-324/00
19J.B. Steinsson (2013) Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 9
However, nothing new, the issue has not been important to governments around the world until recently. With both the media and civil society having brought an attention to the fact that many MNEs are paying very little or no taxes at all, resulting in such MNEs being severely condemned by public opinion for exploiting loopholes in the legislation. The public feels that the MNEs are not paying their “fair share”, but how should we define it? What about their part in creating jobs, buying third party goods and services as well as many other positive economic effects of their operations? The worldwide economy has evolved due in part because of a more mobile information technology and intangible based businesses while some tax laws still grounded on economic rules that were particular to the situation 50 years ago. This has made tax avoidance and evasion a lot easier causing tax avoidance and tax evasion to be the hottest topics in the international tax world. 20

1.2. Purpose

The purpose of this examination is to take a closer look at this problem. Done by examining the concept of tax avoidance and tax planning and by looking how addressed in various countries. This examination will be global although the focus will be on European countries. Also taken into account are the OECD’s model tax convention, International laws and relevant EU law. Also, due to authors interest as an Icelander the hope is that by analysing and then comparing Icelandic laws with the covered and relevant areas of corporate taxation provide some direction as to which steps (if any) could or should be taken in order to

counter these sorts of tax avoiding behaviours in Iceland. For this reason, where appropriate, Iceland and possible connection to the material are mentioned and analysed. This paper will conduct a traditional comparative law analysis by studying how the conflicts of tax base erosion by preferred debt-financing are resolved in a few different countries, looking at joint global efforts as well as alternative solutions proposed by both scholars and others.

1.3. Structure

In line with the comparative legal method, following the introduction and the presentation of the problem in chapter 1, an explanation of the concept of tax avoidance will be given in chapter 2, the main subject regarding various approaches are then in chapters 3 and 4. Chapter 5 provides an overview of relevant EU legal framework with chapter. Chapter 6 takes a special look at the situation in Iceland while chapter 7 gives an overview of the global effort of the OECD and G20. The conclusions of the author will then be put forth in the last chapter.

1.4. Delimitations

There has been a lot written and published regarding thin cap and interest deduction limitation rules regarding different approaches in various jurisdictions. Instead of trying to cover or consider them all an attempt is made to include the ones relevant to the research question. Author mostly relied on articles written in English by scholars and other specialist. Furthermore, mostly skipping any mention of US and UK rules was intentional because both have common law systems mostly unfamiliar to the author.
2. Tackling Tax Avoidance

This chapter will provide definitions of anti-tax avoidance rules as well as a quick overview of the arm’s length principle and transfer pricing rules. Also necessary and covered in this chapter before going forward is a definition on the differences between tax planning, tax avoidance and tax evasion.

2.1. Anti-Avoidance rules

Anti-avoidance rules are a way of increasing the tax base. The goals of anti-avoidance rules is to reduce the ability of taxpayers to substitute into non-taxed activities, forcing compliance. However, in many cases, anti-avoidance rules may shift taxpayers into less efficient tax avoidance schemes rather than into compliance. That is instead of increasing the revenue from those taxpayers they simply put more effort and even money into not complying. This results in a loss of usefulness for taxpayers with no benefits for the government. One obvious response would be increasing the scope of the anti-avoidance rules to prevent the new form of avoidance. This can however result in the rules penalizing taxpayers engaging in legitimate transactions making it uncertain whether any benefits of an anti-avoidance measure will outweigh the costs of implementation.21 By hiring a tax professional the ability of taxpayers to employ methods of reducing taxation increases. With the group that can afford the best professionals being able to proactively manage and plan their income earning activities in order to minimize their tax liabilities.22 This fact can have the effect that any

attempts by policy makers to counter tax avoidance causes problems for the less sophisticated taxpayers while the “bigger fishes” are less or not at all affected. Every country has to face the problem of tax avoidance despite significant differences in the aggressiveness of both taxpayers and tax administrations. National courts can deal with tax avoidance by disqualifying the taxpayer from the treatment he sought after. For example, in aggressive debt financing situation, a court might find that the instruments used, could not properly be regarded as debt or that interest sought to be deducted did not meet the statutory requirements for the deduction of interest expense. Such interpretation easily merges with tax laws that include broader anti-avoidance rules, and judge’s willingness to include such rules in the statutory framework often turns on general willingness to adopt a purposive statutory interpretation. But then some courts (such as in Canada) have espoused a purposive interpretation without adopting judicial anti avoidance rules.24 Experience has taught OECD country legislatures and their courts that there is a need to go beyond specific anti avoidance rules and fashion broader doctrines that prohibit tax avoidance. This is however problematic due to problems in the distinction between acceptable and unacceptable transactions.25 Judicial interpretation, general and specific judge-made statutory rules, procedural requirements, penalties and substantive changes to the tax law make it less prone to abuse, and are some of the techniques used to deal with tax avoidance. These approaches are however not likely to solve the problems on its own. Disputes over tax avoidance are therefore likely to remain a permanent feature of tax systems,

21 Victor Thuronyi (2003), Comparative Tax Law pg. 151
22 Victor Thuronyi (2003), Comparative Tax Law pg. 151-152
23 Victor Thuronyi (2003), Comparative Tax Law pg. 152
met with increased anti-avoidance measurements by many states. Moreover, since countries have not adopted a fully uniform approach (although big steps discussed in later chapters, have been taken), it is likely that we will see substantial differences in those measurements.26

Tax avoidance then takes on a peculiar dimension under European law. The ECJ does not authorize member States to deny the benefits of its directives in specified cases in order to prevent the possibility of tax avoidance. In ECJ’s Leur Bloem it is stated that the examination of the operation in each particular case was required to determine whether there actually was any tax evasion or tax avoidance.27

2.2. Tax Avoidance, Tax Evasion or Tax Mitigation

Before going forward, it might be prudent to define what actually constitutes tax avoidance. These things tend to be mixed up, in both media and public discussion.

The definition of the American IRS is as follows:

“Avoidance of tax is not a criminal offense, all taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. The distinction between avoidance and evasion is fine, yet definite. One who avoids tax does not conceal or misrepresent, but shapes and pre plans events to reduce or eliminate tax liability, and then reports the transactions. Evasion on the other hand, involves deceit subterfuge, camouflage, concealment, some attempt to colour or obscure events, or making things seem other than what they are”28

26 Victor Thuronyi (2003), Comparative Tax Law, pg. 153
27 ECJ Leur-Bloem C-28/95
There is a considerable consent that the term “tax evasion” ought to only refer to criminal activities, although it has not always been used with that meaning. What specific behaviour constitutes tax evasion, however, depends on the criminal laws of each country.\textsuperscript{29} Tax avoidance on the other hand, you can use in more than one meaning, a meaning derived from context. In a general sense, it refers to any activity designed with the aim of reducing tax that is not criminal in nature. The term “Tax avoidance” is however often used to suggest tax minimization behaviour that either skirts the limits of the law, or is legally ineffective in reducing the tax liability. In the latter, you can distinguish between tax avoidance and tax mitigation.\textsuperscript{30} Thuronyi sets up a clear definition of the differences between Tax evasion, tax avoidance and tax mitigation:

- Tax Evasion or tax fraud is an illegal act punishable by criminal sanctions.
- Tax avoidance is behaviour aimed at reducing tax liability, but found to be legally ineffective because of anti-abuse laws or regulations although it does not constitute criminal offense.
- Tax minimization (tax mitigation, tax planning) is behaviour this is legally effective in reducing tax liability.\textsuperscript{31}

Statutory anti-avoidance rules are often interpreted as to apply only when “tax avoidance” is the sole, main, or significant purpose for a transaction.\textsuperscript{32}

\begin{quote}
"The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax
\end{quote}

\begin{footnotes}
\item[29] Victor Thuronyi (2003), \textit{Comparative Tax Law}, pg 154-155
\item[30] Victor Thuronyi (2003), \textit{Comparative Tax Law}, pg 155
\item[31] Victor Thuronyi (2003), \textit{Comparative Tax Law}, pg 156
\item[32] Victor Thuronyi (2003), \textit{Comparative Tax Law}, pg 156-157
\end{footnotes}
liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option.\textsuperscript{33}

Apparent from this is that for something to be considered as criminal evasion it has to be punishable based on criminal law while tax avoidance often dances on a grey line somewhere in-between. However, tax avoidance is not a criminal offense and the only “punishment” suffered by those caught by tax avoidance doctrine is to have the tax saving effects of the schemes they entered into cancelled.

2.3. The Arm’s Length Principle

According to the Arm’s length principle, MNEs should carry out controlled transactions at arm’s length prices. A price, which the associated enterprises would have agreed upon in a comparable transactions with a third party. As a taxation policy, the arm’s length principle is justified by the fact that it contributes to tax equality and neutrality between associated enterprises and independent enterprises. The principle of equality and neutrality are core values in tax law and constitute the basis for tax treatment of corporate group formations. In the OECD Model, the arm’s length principle is laid down as the norm for the allocation of profits in Article 9(1), and in Article 7(2), which concern head offices and permanent establishments. It is also set forth as the norm for income allocation in the domestic laws of most countries. Therefore, there is

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\textsuperscript{33} IRC v. Willoughby (1997) STC 995 at 1003
normally a congruence between the allocation norm in domestic and international law.\textsuperscript{34}

2.4. Transfer pricing rules

Transfer pricing” is one of the principal problems in international tax law. The term refers to the prices in transactions between associated enterprises or parties. Tax problems derived from transfer pricing relate in particular to diminishing the tax base for individual associated enterprises.\textsuperscript{35} Transfer pricing rules originated in the USA at the times of the First World War\textsuperscript{36}. The UK then introduced similar laws one year later, in 1918.\textsuperscript{37} The arm’s length rule did not see the light of day until 15 years later.

In 1972, Danish professor Thøger Nielsen, prophesied that legislative and treaty-based power regarding the adjustment of artificially produced operating profits went considerably beyond what was practically possible in this respect for the tax authorities of individual countries, and was therefore one of the most serious problems for international tax law.\textsuperscript{38} A prophecy fulfilled in 1988 when the Danish Supreme Court denied that there were grounds for adjusting the transfer price of oil between a Danish company and foreign companies in the same MNE. Tax authorities in other countries experienced similar problems. In the mid-90s, the OECD issued new rules on transfer pricing, intended to diminish the problems by containing authority to make transfer-pricing adjustments. Many countries have subsequently

\textsuperscript{34}Wittendorf (2010), Transfer Pricing and the Arm’s Length Principle in International Tax Law, pg. 6-7
\textsuperscript{35}Wittendorf (2010), Transfer Pricing and the Arm’s Length Principle in International Tax Law, pg. 3
\textsuperscript{36}1917 War Revenue Act, Regulation 41.
\textsuperscript{37}General Rule 7, Income Tax Act, 1918.
\textsuperscript{38}Wittendorf (2010), Transfer Pricing and the Arm’s Length Principle in International Tax Law, pg. 3
implemented corresponding stricter legislations. The national and international regulatory initiatives of recent years clearly suggest that this new generation of rules has not solved the tax problems associated with transfer pricing. It can therefore be said that transfer pricing remains a current problem in international tax law.\textsuperscript{39}

This was evidenced by the results of a January 2005 OECD Centre on Tax Policy and Administration Roundtable. Where stated that business restructuring raised difficult transfer pricing and treaty issues for which there was insufficient OECD guidance under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the OECD Model Tax Convention on Income and on Capital. These issues primarily involved the application of transfer pricing rules to permanent establishments, and the recognition or non-recognition of transactions. With a lack of a common understanding on how to treat these problems, they might lead to substantial uncertainty for business and governments as well as the possibility of double taxation or double non-taxation.\textsuperscript{40}

Next chapter will discuss the different approaches used to try to tackle problems related to tax avoidance. Seeing that tax avoidance doctrine only aims at avoidance and not tax evasion, there will be no further mention of criminal tax evasion practices.

\textsuperscript{39} Wittendorf (2010), Transfer Pricing and the Arm’s Length Principle in International Tax Law, pg. 3-4

\textsuperscript{40} OECD. (2008) Discussion draft on transfer pricing aspects of Business Restructuring.
3. Overview of different approaches

There are many different ways in which states have tried to tackle problems related to corporations using high leverage as a way to avoid or minimize their tax burden. In this chapter, an attempt will be made to go over some of the ways countries have used to try to deal with these issues. In addition, a new approach has been discussed amongst scholars and specialists. This approach is called the “allocation of world-wide debt”, a rule that is already a part of some states legislations, but there is the idea of having this as the main rule. This is an interesting approach so a short coverage of those ideas will be discussed as well as the idea of using what has been called “frictions” and “game theory” to battle tax avoidance.

3.1. Denmark

The Danish corporation tax act (Selskabsskatteloven\textsuperscript{41}) provides a systematic framework regarding resident and non-resident companies and includes rules regarding Thin Capitalization (Ch. 11), Corporate tax rate (Ch. 17) and Group Consolidation. (Ch. 31)

Denmark has established very refined thin cap rules that are said to be both complex and thorough, too complicated and detailed in the opinion of some. Denmark limits interest deductions by using three different limitations, with each being able to reduce deductible interest expenses. The first one limits deductibility of debts connected to related parties. The second creates a limit based on the value of a firm’s qualifying assets. The last one caps net financing expenses based on the firm’s EBIT, limiting a firm’s interest deductions to 80

\textsuperscript{41} Selskabsskatteloven.LOV nr 1082 af 14/11/2012
percent of its EBIT. Similar to the rules in Germany and Italy, but those rules limit interest expenses to 30 percent of EBITDA.

The deduction of interest expenses is limited by the following three rules (in order):

(1) Thin capitalization rules: these provide for an interest deduction limitation based on a debt/equity ratio of 4:1

(2) Asset limitation: this provides for a limitation based on value of assets: net financing expenses are limited to an amount corresponding to 6.5% of certain assets, with the 6.5% rate being adjusted annually on a group basis.

(3) EBIT limitation: this provides for a limitation based on annual profits: net financing expenses must not exceed 80% of EBIT. Specifically, net financing expenses below DKK 20 M are deductible under the EBIT limitation, but may be reduced because of the thin capitalization rules. (It should be noted that the thin capitalization rules only apply to controlled debt in excess of DKK 10 M.) The DKK 20 M cap is calculated on a group basis. The amount will be adjusted annually.

The Danish corporation tax law do not contain definitions of the notions of “debt” and “equity” therefore most funding instruments need to be qualified under the general rules of the tax law. With a Danish limited liability company issuing a financial instrument, its qualification for tax purposes can be based on the distinction between a contribution and a loan. With no clear definition on a contribution, legal usage and administrative practices do offer guidance towards

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47 Selskabskatteloven. LOV nr 1082 af 14/11/2012

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a more detailed definition of the concept that relates to the transfer of assets (money or assets) to a limited liability company in particular, without this company paying a consideration of the same value. Therefore, a contribution may be deemed to exist even though the substance is entirely different under civil law. In cases when granting a loan, it is obvious that the borrower will not be able to repay it, the loan cannot be acknowledged as a loan for tax purposes, but is deemed a contribution or the like.\textsuperscript{48}

Unwanted tax consequences of given classifications are usually countered through anti-avoidance rules or rules that prescribe a given tax treatment of specific types of income, deduction and gains/losses. Leading to the adoption of a number of complicated anti-avoidance rules, which have given rise to considerable interpretation challenges, which often are not consistent.\textsuperscript{49} The Danish laws have suffered some criticism, the asset limitation rate of 6.5% seems too low and does not reflect that arm’s length interest rates may exceed 6.5%. Why the fair market value at the year-end is applied has also been questioned, since it is difficult to understand why taxpayers who must already take into account the fair market value of the assets and liabilities under the thin capitalization rules also need make an additional and very different computation under the asset and EBIT limitations. It has been pointed out that while Germany replaced its existing thin capitalization rules with an EBIT limitation Denmark did not, in part because the bill was rushed through the parliament.\textsuperscript{50}


\textsuperscript{50} N Bjornhol and I Thiersen (2007) New Danish Limitations on Interest Deductions, p., 591 and and J.B. Steinsson, ‘Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?’, pg. 14
3.2. Germany

“All interests relating to a business activity is tax deductible as a business expense. The deductibility of interests is most notably limited by the interest deduction ceiling rule (Zinsschranke). Since interest is, in principle tax-deductible; an MNE might be inclined to choose the tax treatment of a instead of that of equity. The interest deduction-ceiling rule in effect in Germany has however made debt investments less favourable. Shareholders loans to corporations are qualified as debt in the balance sheet. However, interest payments of such loans that are not at arm’s length are not deductible and are instead treated as dividend payments. Tax groups are treated as “one” business under the interest deduction-ceiling rule, which can have positive effects regarding the deductibility of interest. The debt treatment also applies in respect to loans, in particular to shareholder loans, which are subordinated; a subordinate debt is a debt where the lender of the loans have subordinate status in relationship to the normal debt. An example for this would be a promoter of a company investing money in the form of debt, rather than in the form of stock. In the case of liquidation, the promoter would be paid just before stockholders—

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51 H Fischer, A Lohbeck (2012) Germany, IFA Cahier – The Debt Equity Conundrum. p. 310-311 and J.B. Steinsson, “Thin Cap and Iceland – What can happen in the absence of thin capitalization rules?”, pg. 11 and The German thin capitalization rules are embedded in sec. 4h GITA (Investment Tax Act). According to the general rule, any interest expenses that exceed the amount of incurred interest income (so-called ‘net interest expenses’) are limited in their deductibility as a business expense up to an amount of 30% of taxable EBITDA.

52 Fischer, Lohbeck - Germany, IFA Cahier – The Debt Equity Conundrum, p. 310 and J.B. Steinsson, “Thin Cap and Iceland – What can happen in the absence of thin capitalization rules?” pg.11

assuming there are assets to distribute, other liabilities and debts have been paid and are therefore treated as equity under German insolvency laws.\textsuperscript{54}

At first Germany tried to deal with thin capitalization cases using general anti-avoidance provisions. After being ruled unlawful by the Federal Tax Court in 1992 because German civil law stated that shareholder was free to choose between supplying either equity or debt capital if legal requirements concerning minimum equity capital were fulfilled. It was therefore not possible for a choice by a shareholder in favour of one of these options to be regarded as an unlawful circumvention of the other for tax purposes. In light of that judgement, specific thin capitalization rules were introduced\textsuperscript{55} targeted towards abusive financing by foreign shareholders and related parties.\textsuperscript{56} The rules in force in 1997/1998\textsuperscript{57} were the ones being looked at in Lankhorst-Hohorst\textsuperscript{58}, the most relevant case for thin capitalization before the ECJ. The ECJ ruled that the rules infringed the freedom of establishment causing them to be amended as of 1 January 2004, applying to both domestic and cross-border situations after the change. Under the new rules any interest payments (unless they were at arm’s length) made to shareholders holding more than 25\% of shares were to be reclassified as dividends and taxed accordingly. The rules apply to interest payments above EUR 250,000 and if the

\begin{flushright}
\textsuperscript{54} Fischer, Lohbeck - ‘Germany’, \textit{IFA Cahier – The Debt Equity Conundrum}, p. 316-317 and J.B. Steinsson, 'Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?', pg.11-12
\textsuperscript{57} Under Art.8(a) of German corporation law, repayment of loan capital would constitute a covert distribution of profits if obtained by a company subject to corporation tax from a shareholder not entitled to corporation tax credit.
\textsuperscript{58} C-324/00 \textit{Lankhorst-Hohorst GmbH} v \textit{Finanzamt Steinfurt}
\end{flushright}
safe harbour debt-equity ratio of 1.5:1 was exceeded. Meaning that for the rules to apply the corporation’s total debt has to surpass its equity 1.5 times.

However, since the rules were not really changed in substance, it was argued that *Lankhorst-Hohorst* actually still applied to the amended rules. In addition, the new rules caused different treatment towards resident and non-resident lenders since dividends paid to German shareholders were tax exempt up to 95%, while foreign lenders were subject to withholding tax at 25% or the reduced treaty withholding tax rate.\textsuperscript{59}

Following critique, Germany introduced the ‘interest barrier’ or *Zinsschrank*\textsuperscript{60} in 2008, an innovative interest deduction limitation. The new rules were supposed to increase incentives for investments and businesses in Germany.\textsuperscript{61} With the new rule, any interest expenses, exceeding the amount of incurred interest income (net interest expenses), are limited in their deductibility as a business expense up to an amount of 30% of taxable EBITDA. Contrary to the old rules, the interest barrier limits the deductibility of interest expenses on debt from all sources.\textsuperscript{62} The rules allow for a “carry forward” of any part of the 30% taxable EBITDA that has not been utilized by net interest expenses for five financial years. That provision was introduced retrospectively due to the financial crisis, in order to relieve companies that were profitable before the crisis and still in place\textsuperscript{63}

\textsuperscript{59} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. 7.
\textsuperscript{60} sec. 4h of the Investment Tax Act
\textsuperscript{61} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 7-8.
\textsuperscript{63} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 8
In order to relieve the burden on small businesses, a *de minimis* exemption provides for full deductibility if the net interest expenses do not exceed EUR 3m.\textsuperscript{64} Originally, that threshold was EUR 1m but it was increased retroactively due to the financial crisis. This was supposed to be a temporary arrangement, but a new government in 2009 implemented it indefinitely in order to make the interest deduction limitation less strict.

Deductibility is not applicable if the business does not, or only partially, belong to a group of companies. The term ‘group’ is not referring to a tax group. A business is said to belong to a group if it is, or could be, included in a group’s consolidated financial statement as well as when companies are under common control.\textsuperscript{65} The third exemption, the escape clause, applies if the business’s equity ratio is either equal or higher than the group’s overall equity ratio. However, an equity ratio that is 2% lower is tolerated.\textsuperscript{66}

The *Zinsschranke* has been criticized quite a lot by German tax practitioners. The main arguments are its high level of complexity, the full deductibility of all expenses related to business income, the exemptions some corporations get from its application, the low level of deductible interest expenses, the lack of suitability of the escape clause and finally the lack of any consideration for research and development expenses incurred for purposes of determining taxable EBITDA.\textsuperscript{67}

\textsuperscript{66} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 8-9
3.3. Sweden

In late 2007, the Swedish Supreme Court held that the Swedish general anti-avoidance legislation was not applicable to certain tax planning schemes involving interest expenses. Sweden therefore faced an immediate need for thin capitalization or interest deduction limitation rules, to prevent such tax avoidance. Due to this sudden need, based on research conducted by the Swedish tax authorities showing that tax were on a rather large scale being avoided in Sweden with the help of interest expenses, Sweden introduced interest deduction limitation rules as of January 1 2009. The rules focus on limiting the deduction of interest expenses incurred on debt that finances intra-group acquisitions of shareholdings. Following objections, the rules include two exceptions to ensure that non-abusive transactions are not affected. Since the government recognized an immediate need for an amendment of the rules in regards to intra-group debt, it concluded that there was no time to wait for an impending proposal from the Companies’ Committee.69

Swedish tax law70 generally provides for full deduction of interest expenses with some limitations. According to the main rule, interest payments to affiliated companies are non-deductible unless one of two exceptions applies:

- If either one of the companies, has a substantial influence over the other company, directly or indirectly.
- Or if the companies are under common control, and then considered to be affiliated.

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68 E. Chors (2013), Interest Deduction Limitation Rules in Sweden and Germany, pg. 1
69 E. Chors (2013), Interest Deduction Limitation Rules in Sweden and Germany, pg. 5
70 Ch. 16 para. 1 SITA. Inkomstskattelag (1999:122)
Before the most recent change, the rules applied to ‘determinative’ influence. That means that the rules will also affect cases of shareholdings just below 50%. Interest expenses on intra-group debt, whose deductibility is prohibited, can nevertheless be deducted if the corresponding interest income is taxed with at least 10% in the residence state of the beneficial owner if it was his only income. Companies that do not satisfy the hypothetical 10%-test can deduct their interest expenses if the beneficial owner is subject to Swedish withholding tax or a comparable tax, if during the tax year the debt’s interest rate has on average, not exceeded 250% of the average state bond interest rate of the previous calendar year. The exceptions do not apply though if the main motivation for any relevant transaction is to avoid taxes instead of being business related. This counter provision has been introduced because tax-planning schemes had been structured to fulfil the 10%-test.

Intra-group interest expenses are deductible even if the 10% rule does not apply if there are sound business reasons for them. The second exception applies to beneficial owners residing within the EEA, or in a state that has a double tax treaty covering all income with Sweden. If the debt was incurred financing the acquisition of a company that was or became afterwards a group company, the same rule applies, that there were sound business reasons for the transactions.

The general prohibition of deduction also applies to interest payments to non-

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71 E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 5
72 Ch. 24 para. 106 SITA. Inkomstskattelag (1999:122)
73 E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 5-6
74 E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany. pg. 6
affiliated companies (‘back-to-back’ loans). Although interest related to back-to-back loans from beneficial owners within the EEA or owners in a state that has a double tax treaty with Sweden is nevertheless deductible. If either the corresponding interest income is taxed in accordance with the Swedish tax code or the debt is not primarily tax-driven, or if both acquisition and interest expenses have mainly business reasons.

3.4. Finland

The author decided to include Finland since it is the most recent EU country to have introduced thin capitalization rules. It is therefore interesting to look at how it was done and why it was done in the way it was. There was however very limited variety of English sources regarding the new Finnish rules so author had to rely on only a couple of sources.

As of January 2014, Finland restricts the right of corporate entities and partnerships to deduct interest expenses. With the amount of non-deductible interest calculated based on EBITDA, the rules are similar to the German rules and they apply only to interests paid on related party debt. Before the new rules, extensive deductibility of interest expenses was allowed. With all business related interests, as a rule, being deductible, deductibility of interests paid to non-residents was however limited. The deductibility of interests could only be

\[\text{\footnotesize{\cite{note1}}\text{\footnotesize{\cite{note2}}}}\]

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\[\text{\footnotesize{\cite{note3}}}\]

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limited based on Finnish transfer pricing rules\textsuperscript{80} or a general anti avoidance rule.\textsuperscript{81} There have been cases involving the application of the transfer pricing rules in court cases regarding the deductibility of interests, but none on the application of the general anti-avoidance clause. However, tax authorities in Finland have denied the deductibility of interest based on general anti-avoidance provisions.\textsuperscript{82} Something that should be considered in connection with a discussion on the Icelandic problem discussed in chapter 6.

Very few rules existed limiting deductibility of interest expenses of Finnish corporations. Therefore, the lawmakers took time to evaluate the pros and cons of different legislative solutions, using the experience gained from other countries.\textsuperscript{83} In the end an EBITDA based limitation ("the German model") was chosen over the Swedish one, due mostly to the fact that the German model was better adjusted to EU law and some negative feedback on the Swedish model, including it being said to be inefficient.\textsuperscript{84}

Business related interest expenses remain tax deductible with the new rules, with them being an exception to the general deductibility rule, with applicability to any interest that is deductible under the main rule in relation to related party debt, having all interest expenses taken into account when the non-deductible interest is calculated, regardless of the creditor’s residency. Meaning that the rules apply to both domestic and cross-border situations, even if the problems causing the implementation of the new laws mainly rose in cross border

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\textsuperscript{80} Sec. 31 Assessment Act. The Supreme Administrative Court specifically ruled in judgment 2010:73 that interest is not tax deductible to the extent that it exceeds arm’s length interest.


\textsuperscript{82} S. Penttila and M. Nieminen (2013). Interest Deduction Limitation Rules Introduced. pg 237

\textsuperscript{83} S. Penttila and M. Nieminen (2013). Interest Deduction Limitation Rules Introduced. pg 238

\textsuperscript{84} S. Penttila and M. Nieminen (2013). Interest Deduction Limitation Rules Introduced. pg. 239
situations. The rules thus apply to all corporate entities, resident and non-resident.\textsuperscript{85} However, for interest expenses to be deductible in taxing a Finnish PE, the interest payment must be related to the activities of the PE.\textsuperscript{86} Interestingly, non-deductible interest can be deducted in subsequent years, up to the amount of deductible interest expenses of each tax year, if the deduction limitations of the respective tax years allow it.\textsuperscript{87}

The concept of “net interest expenses” has been introduced with the new law, referring to the difference between a company’ s taxable interest income and the interest expenses that would be tax deductible under the main rule. Therefore, in a situation where a company has more interest income than its interest expenses, the company has no net interest expenses and, thus, its interest payments are fully deductible as well as when net interest expenses do not exceed EUR 500,000, they are fully deductible.\textsuperscript{88} With net interest expenses between related parties exceeding EUR 500,000, interests are non-deductible to the extent they exceed 30\% of the fiscal EBITDA. Interests on debt between unrelated parties is fully deductible.\textsuperscript{89} With the Finnish deduction limitation rules applying only to related party debt, they are less strict than the German model, which limits the deductibility of all interests. In determining if a party is related or not the corresponding article in the transfer pricing rules are used.\textsuperscript{90}

\begin{flushleft}
\textsuperscript{85} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 239-240
\textsuperscript{86} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 240
\textsuperscript{87} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 241
\textsuperscript{88} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 240
\textsuperscript{89} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 241
\textsuperscript{90} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 241
\end{flushleft}
A back-to-back arrangement, where a third party operates as an intermediary in a debt arrangement between related parties, is considered to be a related party loan, even though the direct creditor is an independent party.\textsuperscript{91} The law does not mention a transfer of non-deductible net interest expenses concerning the transfer of assets. Therefore, unused interest deductions are not transferred to the recipient company in relation to a transfer of assets.\textsuperscript{92}

The rules include some “safe harbour” provisions:

- With certain enterprises being excluded from the scope of the rules, based on their legal form or nature of their activities,
- The not exceeding EUR 500,000 rule.
- And the third safe harbour provision concerns the equity ratio of the taxpayer’s balance sheet compared to the equity ratio of the consolidated balance sheet of the entire group. With the deduction limitation rules not being applied if the amount of equity compared to the total balance of the taxpayer’s confirmed financial statement is greater than or equal to the same number in the group’s confirmed consolidated balance sheet at the end of the tax year.\textsuperscript{93}

Each group company is a separate taxpayer. However, companies in the same group can balance their profits by making group contributions, requiring a 90\% direct or indirect ownership between the participating companies. A group contribution is a tax-deductible expense for the contributors and a taxable income for the recipient. The applicability of the interest deduction limitation is assessed separately with regard to each group company. Making a group contribution reduces the fiscal EBITDA of the contributing company whilst

\textsuperscript{91} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 241
\textsuperscript{92} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 241
\textsuperscript{93} S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 242
increasing the fiscal EBITDA of the recipient company. As a result, a group contribution may result in non-deductibility of interest for the contributing company. However, non-deductibility of interest can be avoided with a group contribution to increase fiscal EBITDA. However, when this is not possible (ownership is less than 90% for example), the new rules can cause problems in regards to intra-group debts, the interests non-deductible for the paying company while being taxed in the hands of the recipient. The carry forward of unused interests does however reduce the severity of this problem.  

3.5. **Worldwide overview**

As can be seen from the overview above, countries seem to choose different ways in which to tackle the problems regarding tax avoidance using debt financing. This chapter will focus on “the rest of the world” with some discussion on the smaller states of the EU, hopefully that can help in the authors quest of getting some sort of a conclusion in the discussion on Iceland.

Analysis of rules like the ones in Germany illustrate many of the problems inherent in the makings of an effective thin capitalization/earnings stripping tax legislation. However, rules in some of the other G-7 states can demonstrate other problems economically powerful nations face when drafting such rules. As a rule, thin capitalization legislation is aimed at excessive shareholder debt financing (internal debt). If the conditions of the rules are met, the deduction of interest payments, which relate to shareholder debt financing, is disallowed. Some countries reclassify non-deductible interests as dividends. This chapter sets its sights on some of the systems that have been used in dealing with the

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S. Penttila and M. Nieminen (2013) Interest Deduction Limitation Rules Introduced, pg. 242

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problem of thin capitalization. The German rules have been recommended as a benchmark for future Icelandic legislation by the IMF.95 In conclusion, debt-to-equity limits can be ineffective in thwarting firms from moving profits between countries. With sufficient capital, a firm can simply inject debt and equity into the subsidiary, thus complying with any debt/equity limits, and still shift profits. This is why several countries, including Germany and Italy, have adopted interest deduction limitations.96 One escape clause in Germany’s interest deduction rule, exempts firms that have equal or less leverage than the consolidated firm. Japanese thin cap rules permit firms to use the debt/equity ratio of a similar Japanese firm when deciding their max debt/equity ratio. New Zealand’s rules limit a subsidiary’s debt-to-equity ratio to 110 per cent of the consolidated business. As shown, quite a few countries levy thin cap rules that allow for the debt of the worldwide enterprise or comparable firms in similar industries to be used as a benchmark.97

3.5.1. Italy

Italy’s approach favours income statement limitations like the German rules while also limiting net interest expense to 30% of EBITDA while also applying interest paid to non-related parties. However, the 30% interest limitation relates to financial statements, but not to taxable income like in Germany, the Italians also extend the benefits of group relief to foreign companies of a group, providing they met all the conditions set forth under Italian law for the formation of a

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95 Monetary Fund (2010) - Improving the Equity and Revenue Productivity of the Icelandic Tax System, p. 22
consolidated group, with the exception of the residence requirement. Prohibited interest deductions can be carried forward indefinitely into the future.\textsuperscript{98}

3.5.2. France

France relies on a debt-to-equity ratio to limit excessive financial leverage. With their rules considered being complex. The key elements of the France rules is that they cap the debt-to-equity ratio at 1.5 to 1. With interests non-deductible when interest exceed 25 per cent of the current pre-tax result, increased notably by intra-group loan interests and the depreciation considered to decide this pre-tax result, with the debt-to-equity ratio calculated based on a firm’s net equity, rather than contributed capital. Debt includes all debt extended from related parties. The laws allow for a carry forward of non-deductible interest. Nevertheless, after two years, the carry forwards are discounted by 5 per cent per year. That being said, the new rules in France actually tighten interest deductibility restrictions.\textsuperscript{99}

3.5.3. Canada

Canada limits interest deductibility when a non-resident shareholder owns at least 25 per cent of a domestic corporation and lends money to that corporation with the firm’s debt-to-equity ratio exceeding 2 to 1 after being reduced from 3 to 1 in 2001. A change motivated by a study, which stated that other countries were reducing their debt-to-equity ratio below 3 to 1.\textsuperscript{100}

\textsuperscript{100}S. Webber (2010) Thin Capitalization and Interest Deduction Rules: A Worldwide Survey, pg.696
3.5.4. Japan

Japan’s current thin capitalization rules have been in place since 2006. The rules apply when a firm’s debt-to-equity ratio exceeds the ratio of 3 to 1, and it applies to both domestic and foreign companies. Although a 2-1 ratio applies in some situations. As an example, a large bond repurchase transactions debt can be excluded from the calculation with a lower ratio being applied. Rules also permit a company to use the debt-to-equity ratio of a comparable domestic company concerning the similar company’s business operations and its size. Similar to the German rules where market debt-to-equity ratios can be used. Identifying one debt-to-equity ratio for all businesses is however problematic and might be called unfair by businesses that tend to incur more debt. However, any debt-to-equity ratio may not be effective, as it does not limit the absolute level of debt, and therefore interest expenses.101

3.5.5. New Zealand

New Zealand implemented thin cap rules in 1996 while applying new transfer pricing rules at the same time. Their belief was that any lack of formal thin cap rules when introducing new transfer pricing rules could generate opportunities for tax avoidance and create uncertainty as to New Zealand’s stand on thin capitalization concerning foreign investors. With clarity of the tax policy being essential to promote foreign investment. They explicitly apply to three categories of taxpayers: non-residents; Domestic companies where a non-resident owns 50 per cent or more of the firm and trustees of a non-qualifying trust controlled 50 per cent or more by a non-resident. If the taxpayer falls into any of those

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categories during the year, the rules apply. Consequently, the rules do not apply to New Zealand residents, failing the freedom of establishment clause in the EC Treaty, were New Zealand a member.

If the ownership test is met, two further tests are applied to decide if a debt is excessive. If a firm’s debt-to-equity ratio is less than 3 to 1, the debt is not considered excessive. While this limit appears similar to debt-to-equity ratio caps in other countries, it is in fact stricter. Compared to the thin cap rules of Canada, Japan and Germany, the New Zealand debt percentage is effectively lower since it takes into account all interest bearing debt while the others take into account only related-party interest-bearing debt. However, New Zealand’s rules also allow exceeding the 3:1 ratio in some situations. If the worldwide business has a debt-to-equity ratio that exceeds 3 to 1, the New Zealand entity can as well. The worldwide debt percentage is calculated annually, at the end of the firm’s fiscal year.\textsuperscript{102}

3.5.6. Summary

Below is a table with an overview of how the G-7, a few “mid-size” countries and then some of the smaller countries of Europe approach the problem of highly leveraged corporations:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|}
\hline
Country & Method & Limit & Calculation & Result \\
\hline
G-7 & Ownership Test & 3:1 & Interest Bearing Debt & Exceeds 3:1 \\
Japan & Debt Cap & 1% & Interest Bearing Debt & Exceeds 1% \\
Germany & Debt Cap & 5% & Interest Bearing Debt & Exceeds 5% \\
Canada & Debt Cap & 5% & Interest Bearing Debt & Exceeds 5% \\
New Zealand & Debt Cap & 3% & All Interest Bearing Debt & Exceeds 3% \\
\hline
\end{tabular}
\caption{Comparison of Thin Capitalization Rules}
\end{table}

<table>
<thead>
<tr>
<th>Country</th>
<th>Corp. Tax 2013 population</th>
<th>Rules to limit leverage</th>
<th>Approach to limit abuse</th>
<th>Financial test</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>39.10%</td>
<td>319.174.000</td>
<td>Yes</td>
<td>Balance sheet test, which limits interest expense deductibility</td>
</tr>
<tr>
<td>Japan</td>
<td>39.54%</td>
<td>127.130.000</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
<tr>
<td>Germany</td>
<td>30.18%</td>
<td>81.037.000</td>
<td>Yes</td>
<td>Income statement test</td>
</tr>
<tr>
<td>UK</td>
<td>28%</td>
<td>64.713.000</td>
<td>Yes</td>
<td>Arm’s length principle</td>
</tr>
<tr>
<td>France</td>
<td>34.43%</td>
<td>64.228.000</td>
<td>Yes</td>
<td>Debt-to-equity ratio should not exceed 1.5 to 1, and interest expenses should not exceed 25% of pretax income, after interest and depreciation are added back</td>
</tr>
<tr>
<td>Italy</td>
<td>27.50%</td>
<td>60.925.000</td>
<td>Yes</td>
<td>Income statement test</td>
</tr>
<tr>
<td>Canada</td>
<td>31.32%</td>
<td>35.540.419</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Corp. Tax 2013 population</th>
<th>Rules to limit leverage</th>
<th>Approach to limit abuse</th>
<th>Financial test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>25%</td>
<td>5.655.750</td>
<td>Yes</td>
<td>A series of three rules that progressively limit interest deductions</td>
</tr>
<tr>
<td>Ireland</td>
<td>25.5%</td>
<td>4.609.600</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>New Zealand</td>
<td>30%</td>
<td>4.544.730</td>
<td>Yes</td>
<td>Balance sheet tests</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Corp. Tax 2013 population</th>
<th>Rules to limit leverage</th>
<th>Approach to limit abuse</th>
<th>Financial test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lithuania</td>
<td>15%</td>
<td>2.922.600</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
<tr>
<td>Slovenia</td>
<td>22%</td>
<td>2.065.000</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
<tr>
<td>Latvia</td>
<td>15%</td>
<td>1.987.000</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
<tr>
<td>Estonia</td>
<td>21%</td>
<td>1.327.000</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10%</td>
<td>878.000</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>29.63%</td>
<td>563.000</td>
<td>Yes</td>
<td>Balance sheet test</td>
</tr>
<tr>
<td>Malta</td>
<td>35%</td>
<td>424.000</td>
<td>No</td>
<td>N/A</td>
</tr>
<tr>
<td>Iceland</td>
<td>20%</td>
<td>329.000</td>
<td>No</td>
<td>N/A</td>
</tr>
</tbody>
</table>

What is clear from this comparison is the difference in taxation between the larger and smaller countries. The smallest ones are less likely to have any rules regarding high leverage, corporate tax rate is on average much lower, and those that do have any sort of interest deduction limitation rules have rules that are unlikely to have any effect on most corporations due to their “generous” safe

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harbours. When considering any steps Iceland might take as regards to any rules or laws regarding thin cap or interest deduction limitation rules this is something that needs to be seriously considered. Should Iceland try to go the same way as the G7 countries when it comes to anti avoidance doctrine or would it be more sensible to follow in the footsteps of countries in situations more comparable to Iceland? This will discussed in more detail in conclusions.

4. Alternative solutions

This chapter will provide a short overview of what might be called alternative solutions to the problem. These are however not stand alone solutions and some aspects of many of them can already be found in many jurisdictions in some shape or form. This will be explained in more detail in the following sub chapters.

4.1. General Anti Avoidance Rules

Judith Freedman is Professor of Taxation Law at the University of Oxford and a fellow of Worcester College and she has written about the use of General anti avoidance rules. Dr. Freedman says that in recent years we have seen in some countries the introduction of a considerable volume of anti-avoidance legislation, much in the form of targeted anti-avoidance rules (TAARs). In addition, some of the most aggressive types of avoidance have been restricted this way. However, problems in tax systems and their operation, like gaps between court’s interpretation of the law and the law as governments want it to be, should be dealt with through a change in the law and the way we make tax law, in terms of content, form and procedure. Changing the law every time, a

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10a Judith Freedman (2009). A GANTIP Was it really such a bad idea? pg. 8-9
problem is encountered creates complexity and is always a little too late. This is where general anti avoidance rules or principles come into play. Applying an overriding principle at a level above other tax legislations to deal with problems, not specially encountered or predicted, might eventually save the need for legislation and would affect the laws in advance of the problem.\textsuperscript{105}

Within the tax avoidance debate, morality and ethics are getting increasingly important. Legal certainty is also given importance as an outcome, and it is often thought that to achieve that certainty, explicit rules rather than a general anti-avoidance principle are needed. Dr. Freedman however argues that this could best be achieved by a legislative general anti-avoidance principle. She does not claim this would achieve legal certainty, instead she explains that certainty is not the right test for such a principle,\textsuperscript{106} “even if much of the discussion on tax avoidance centres on the need to draw boundaries to differentiate types of behaviour; evasion and avoidance; tax avoidance and tax mitigation.”\textsuperscript{107}

Lack of certainty, however, does not need to be a considered a flaw, since certainty is not the aim of the exercise. It is not as though certainty has been achieved where detailed rules are applied and it is hard to point to any jurisdiction, which has done so.\textsuperscript{108} Legal certainty has is very important in commercial law. Nevertheless, there are circumstances in which it should not be the overriding aim and where in any event, it may be elusive or even undesirable. Dr. Freedman argues that a legislative provision is needed to provide an overlay

\textsuperscript{105} Judith Freedman (2009). A GANTIP Was it really such a bad idea? pg. 9
to the substantive tax rules. In addition, that such a principle would not need judicial development, since judges would always have a role to play. It rather provides the overlay needed to give legitimacy to judicial development and offer a framework in which the uncertainty inherent in any system capable of tackling tax avoidance could be fairly managed. This overlay could then be developed by the judges with full constitutional legitimacy.

In the words of Judith Freedman:

“With such a legislative provision in place, courts would be entitled to go further than the ordinary rules of statutory construction permitted in negating artificial tax avoidance schemes, which abused the wording of the legislation. Once that overlay had been created, there would be better scope than at present for the judiciary, the revenue authorities and the taxpaying community to manage any uncertainty within a sensible regulatory framework”.

4.2. Allocation of worldwide debt

Interest limitation rules can be sorted into “standalone” and “worldwide ratio” approaches. A stand-alone approach asks how much and at what interest a subsidiary can borrow from third parties, if it were not a member of a multinational group. A worldwide ratio approach considers the total third-party debt of the multinational group and compares this to its subsidiaries in various jurisdictions. Most systems are a hybrid of the two. A worldwide debt-to-capital
ratio rule allows interest deductions to the extent that the local subsidiary’s debt-to-capital ratio equals to or is less than that of the worldwide-consolidated group. Some forms of these types of rules exist within the German, Australian and New Zealand interest limitation regimes at present. A worldwide ratio, being based on the actual third party debt amount of an entire MNE, is powerful in removing tax avoidance opportunities, as it is based on the actual third party debt amount, not the hypothetical debt amount that can be justified on arm’s length terms. MNE’s aggregate interest deductions can be much higher under a stand-alone approach than a worldwide ratio approach, and can be located where they generate the largest tax advantage. The worldwide ratio rule can however be applied consistently across countries, on both the deduction and income sides. A reliable method is important, given the double taxation and non-taxation under the current disharmony of rules.

The worldwide debt allocation rule is based on five principles:

1) Supposing that base erosion using interest expense primarily happens within international groups of companies. Such a company can shift its debts to group companies located in countries where the deduction of interest can accomplish the greatest tax savings. Rules aimed at battling this type of profit shifting will have to be aimed at companies which are members of an international group

2) A state ought to only allow deductions of interest on loans used to finance business operations that generate income taxable in that state.

\[\text{References}\]


\[\text{116} \text{ J. Vlieggeert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg. 103}\]

\[\text{117} \text{ J. Vlieggeert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg. 103}\]
3) The worldwide debt allocation rule must be consistent with the EU freedoms. Meaning that no difference should be made between domestic and cross-border situations. The rule should also provide that interests on loans, used to finance shareholdings in foreign and domestic subsidiaries are not deductible from the taxpayer’s domestic income.\note{118}

4) The rule is based on the OECD views on the capitalization of a permanent establishment. A permanent establishment should be attributed an arm's length amount of free capital.\note{119} The rule uses as its point of reference, the financing arrangement of the enterprise as a whole. The capital allocation approach is applied by analogy to companies that are members of a group. A multinational’s worldwide third party debt is allocated to the group companies using assets as an allocation factor.\note{120}

5) With any restrictions to the deductibility of interests, economic double taxation of interests must be avoided. Under the rule, a disallowance of an interest deduction at the level of a thinly capitalized group company should be offset by a corresponding additional deduction of interest, at the level of an overcapitalized group company.\note{121}

Under the rule, worldwide third-party debt is assigned to a specific group company according to the assets shown in the group company’s commercial balance, proportionate to the assets in the multinational’s commercial consolidated balance sheet. The interests due on excess debt is not deductible.\note{122}

\notetext[118]{J. Vliegheert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg. 104}
\notetext[119]{J. Vliegheert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg.104}
\notetext[120]{J. Vliegheert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg.104}
\notetext[121]{J. Vliegheert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg.104}
\notetext[122]{J. Vliegheert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg.104}
Intragroup debt is not considered as a worldwide third-party debt since intragroup debt is not on the consolidated balance sheet. Therefore, intra-group debt has no impact on the calculation of allowable interest deductions. The interest on the excess debt is a portion of the interests on the group company’s total debt. If the group company is overcapitalized, a deduction will be allowed on the excess equity. The deduction on the excess equity is a portion of the interest on the group company’s total debt. This portion reflects the group company’s excess equity to total debt ratio. If the group company has no debt, the deduction on excess equity cannot be based on the group company’s interest expenses. Instead, the deduction on excess equity is determined according to the group’s consolidated commercial financial statements. In this case, the deduction is a portion of the group’s interest expenses in the consolidated accounts. This portion reflects the group company’s excess equity to the group’s total debt ratio.

The worldwide debt allocation rule will only apply to interests on a group company’s debts and receivables. It will not provide for an allocation of any currency exchange, gains or losses, on a group’s third-party debt. The reason for this lies in the rationale behind the worldwide debt allocation rule. It is designed to prevent base erosion using interest expenses. Therefore, there is no need for an allocation of currency exchange, gains or losses, on a group’s debt. The worldwide debt allocation rule applies only if the taxpayer is a member of a group of companies, determined according to international financial reporting standards or domestic generally accepted accounting principles.\textsuperscript{123}

The closest example of a “worldwide ratio” approach is Germany, given an aspect of the interest barrier rule it introduced in 2008. The worldwide aspect of the

\textsuperscript{123} J. Vleggeert (2014). Interest Deduction Based on the Allocation of Worldwide Debt. pg. 104-105
German interest barrier rule is the worldwide equity-to-assets ratio “escape clause”. The German regime has been criticized within Germany for being complex, likely to lead to insolvencies and loss of investments, and potentially invalid under national and supra-national law. The empirical evidence about its effectiveness is mixed. It remains in force and anecdotal evidence suggests that corporate taxpayers and their advisers are adapting to it. Another criticism is levelled at the calculation methodology, specifically the compulsory reduction for book equity in subsidiaries, which German multinationals have to make.\textsuperscript{124} However, equalizing a multinational’s leverage ratios across its different jurisdictions for tax purposes, has the benefits of being a principled allocation rule and countering tax avoidance strategies. Although imperfect where there are strong non-tax reasons for locating higher leverage within a particular jurisdiction, this is a relatively minor imperfection as the rule would not disallow the extra interest deductions, but allocates them across the group and may be further amended with special rules for true non-recourse debt.\textsuperscript{125}

4.3. **Frictions**

This chapter will discuss Dr. sky’s article, “Who’s Naughty and who’s Nice Frictions, Screening, and Tax Law Design.” Using so-called frictions to fight tax avoidance is a relatively new concept although some aspects of it have been used in certain jurisdictions. In order to limit their tax liability by means of tax planning, taxpayers face a problem with costs that seem to have little to do with the desired tax result.

\textsuperscript{124} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 50-51

\textsuperscript{125} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 69
Imagine an accounting firm telling the tax director of a major corporation that they can reduce their tax liability by $500 million. With the only catch being that in order to do so, the corporation will be subjected to undesirable business risk, a risk that the corporation takes and obtains the tax savings. However, with the corporation being worse off, and no one being better off, the business risk requirement itself appears to be ill conceived. So why is it being done? In an effort to answer that, economists and tax scholars have developed the theory of “frictions.” According to which, tax law relies on frictions, or non-tax costs, in order to make tax planning more expensive. A frictions only role is to deter tax planning. A business risk like the one discussed above would count as successful if it prevented the corporation from entering into the tax scheme and unsuccessful if the corporation did it regardless. What can be drawn from this is that for a friction to be considered a success it should discourage tax planning without imposing costs on regular business transactions:126

“The tax system must screen between tax planners and non-planners and then deter tax planners, in order to preserve revenue, fairness, and efficiency. When frictions are designed appropriately as screening mechanisms on tax planning, they do so by tracking characteristics of tax planners and imposing greater costs on them.”127

The cost to taxpayers of changing their behaviour to reduce or avoid their tax liability is the deadweight loss from taxation. The taxpayers “loss” is societies gain. However, if the taxpayer instead does something else to avoid tax liability,

126 L. Osokowsky (2013), Who’s Naughty and Who’s Nice Frictions, Screening, and Tax Law Design. pg. 1057-1058
like for example a non-taxed activity like leisure, society is worse off because the taxpayer has adopted a less preferred behaviour to avoid the tax. The cost of the taxpayer changing his behaviour is a societal net cost (deadweight loss) from taxation. Deadweight loss from taxation includes not just changes in taxpayers’ underlying behaviour to avoid taxation, but also tax planning, making such planning socially wasteful. This includes for example corporations issuing debt instead of equity to get a tax deduction; corporations may also incur considerable sums in attorney and other fees when creating hybrid securities, which are considered debt for tax purposes but equity for accounting purposes. Therefore, corporations are using their possibly productive resources on non-productive tax planning schemes. Not producing anything of value. A loss all across the board.¹²⁸

The wasteful nature of tax planning is especially difficult since policy makers frequently intend to define the tax law, without affirmatively trying to urge taxpayers to respond to it. Therefore often giving taxpayers with both the incentive and means to engage in tax planning. To explain this, we can almost be sure that when legislators made laws regarding the different tax treatment of debt and equity, they did not do so to encourage corporations to issue more debt. In this way and others similar, taxpayers change their behaviour to reduce their tax liability when laws are set or changed, in a way that was not intended by the policy makers. Making such behaviour an efficiency reducing by-products of the rules and laws. As a result, the designers of tax law face a major challenge. That is how to discourage taxpayers from tax planning when the very promulgation of

the tax law provides both the incentive and means to do so?\textsuperscript{129}

Frictions are nontax costs that make tax planning more difficult or costly and thereby hinder such behaviours. Some tax rules are made to rely on such costs in order to deter it. Economist Joseph Stiglitz identified that taxpayer could “in theory”, under the tax rules themselves, reduce much, if not all, of their tax liability through various tax-planning strategies.\textsuperscript{130} Therefore, non-tax limitations are needed to prevent or limit taxpayers’ abilities to engage in this tax planning. Such frictions can therefore be defined as transaction costs made in an effort to make the implementation of certain tax-planning strategies costly.\textsuperscript{131} By doing so, frictions can better prevent tax planning from occurring by (as previously mentioned) deter tax planning rather than cause it to continue in a more wasteful fashion while not causing increased costs on regular transactions. Dan Shaviro described the “back-somersault” friction. “:

“one might as well condition favourable tax consequences on whether the taxpayer’s chief financial officer can execute 20 back-somersaults in the IRS National Office at midnight on April Fool’s Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting requirements that are pointless in themselves.”\textsuperscript{132}

This may sound a bit silly at first glance but is necessary in order to understand the basic concept of using frictions as a vehicle to deter tax planning while not

\textsuperscript{129} L. Osokowsky (2013). Who's Naughty and Who's Nice Frictions, Screening, and Tax Law Design. pg 1062-1069

\textsuperscript{130} Joseph E. Stiglitz (1985) The General Theory of Tax Avoidance, pg. 325-328

\textsuperscript{131} L. Osokowsky (2013). Who's Naughty and Who's Nice Frictions, Screening, and Tax Law Design. Pg. 1069-1070

imposing any costs on non-tax-planners.\textsuperscript{133} However, evidence suggests that taxpayers do not all have the same degree of tax planning motivation. Notwithstanding the usual notion made in economics literature that taxpayers will tax plan until the cost of doing so equals the tax savings from planning, taxpayers often still fail to do so.\textsuperscript{134}

In conclusion, Leigh Osokowsky says that there is a need to integrate frictions into the design of tax law. When appropriately constructed, frictions can function as screening instruments on tax planning, preferably placing greater costs on taxpayers engaged in such planning without certain groups of taxpayers bearing higher costs in unintended ways. Frictions act as deterrence vehicles and screening mechanisms. Osofsky finally asks how different groups of taxpayers are bearing these costs differently, based on underlying characteristics, and how these differences should affect tax law design.\textsuperscript{135} The tax system needs to differentiate between low and high ability taxpayers and then discourage high ability taxpayers from earning low income. With tax planning, some taxpayers pay low taxes because that is what they owe without any tax planning on their behalf. Others pay low taxes because they used tax planning in order to reduce their tax liability. The tax systems need to assess taxpayers’ motivation for tax planning and then deter taxpayers from engaging in such behaviour.\textsuperscript{136}

\textsuperscript{131} L. Osokowsky (2013). Who’s Naughty and Who’s Nice Frictions, Screening, and Tax Law Design. pg. 1072-1074
\textsuperscript{132} L. Osokowsky (2013). Who’s Naughty and Who’s Nice Frictions, Screening, and Tax Law Design. pg. 1082-1083
\textsuperscript{133} L. Osokowsky (2013). Who’s Naughty and Who’s Nice Frictions, Screening, and Tax Law Design. pg. 1116-1118
\textsuperscript{134} L. Osokowsky (2013). Who’s Naughty and Who’s Nice Frictions, Screening, and Tax Law Design. pg. 1081-1082

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4.4. Game Theory

Raskolnikov came up with a way that makes use of theories of economics by simply taking the concept of a consumer of service or product and replacing it with a taxpayer. In order to do this he first defined two different types of taxpayers: gamers, and non-gamers. Gamers being rational taxpayers that avoid taxes as long as the cost of avoidance is less than that of compliance, while non-gamers comply with taxation, even if it is avoidable at less cost. He suggests a system where taxpayers self-select into a particular enforcement regime. The government would then offer one system that is best for gamers and another being best for compliers. The government would then be able to present tailored and efficient enforcement policies for each taxpayer type.\(^\text{137}\) The solution in the translation from consumer to taxpayer is to replace the usual demand function, with a function representing the responsiveness of taxpayers to higher income tax. It relies on perfect information, so that the government can go forth and set a tax rate that is exactly equal to what an individual is willing to pay in taxes. There must be a common set of options available to all taxpayers for this to work. One way to do this would be by setting out a rather high tax rate on a tax base common to all taxpayers. Inviting taxpayers to choose between the permitted tax treatments. In such scenario, a highly responsive taxpayer will efficiently be able to manage their income tax burden through innovative tax avoidance measures. As a result, highly responsive taxpayers will most of the time be able to help themselves to tax rates that are lower than the tax rates applied to less responsive

taxpayers.\textsuperscript{138}

The purpose of this chapter of alternative solutions was mainly to give an idea of some of the many ways people have come up with to tackle the problem of tax avoidance. The next chapter will discuss the effect of EU rules and regulations concerning thin cap and/or interest limitation rules.

5. The EU

Iceland may someday consider implementing some sort of interest deduction limitation or thin cap rules. Members of the last government voiced their opinion saying so, and there was work done within the Ministry of Finance preparing such legislation with the former Minister of Finance putting forth a proposal regarding thin cap rules in the fall of 2013\textsuperscript{139}. Despite the fact that the EEA agreement does not cover taxes, the Icelandic Supreme Court has held that when it comes to legislation the EEA countries are bound by the international obligations the agreement entails and must there for consider them when applying their taxation power\textsuperscript{140} According to Art. 3 of Act no. 2/1993 on the European Economic Area The Icelandic government must implement certain provisions as well as laws and regulations have be interpreted in accordance with the EEA Agreement which has primacy, and direct effect in Community Member States, like any EU legislation does. What that means is that all of the EU

\textsuperscript{139}Frunvarp til laga um breytingu á lögum um tekjuskatt, nr. 90/2003, með síðari breytingum (þunnt eiginjárðmögnum), þskj. 100, 38. mál. Vefútgaða Alþingistíðinda, sköð: http://www.althingi.is/altext/142/s/0100.html. Sótt á vefinn 04.01.2015
\textsuperscript{140}Hrd. 477/2002 and J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 29

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fundamental freedoms include the EFTA states, protecting all EEA nationals throughout the whole area. These joint freedoms have been confirmed by the ECJ and the EFTA Court, in regards to, for example, the free movement of capital and the freedom of establishment. Denying benefits to EFTA nationals while granting them to Community nationals may be in breach of the EEA fundamental freedoms. This is something that can happen when the national legislation of a member state is discriminatory or restricts market access. When EFTA state nationals are in a similar situation as nationals of EC member states, denying them the benefits of the legislations constitutes discrimination in breach of the EEA fundamental freedoms. This indicates that ruling like the one in *Lankhorst-Hohorst*, where the German rules regarding thin capitalization, were found to be in breach of the freedom of establishment has a direct effect on any laws or regulations regarding the same in Iceland. Meaning that the Icelandic legislator needs to have the case law of the ECJ in mind if or when making any new laws regarding thin capitalization because of the EEA Agreement, even if the said agreement specifically excludes taxes from its scope.

In *Lankhorst-Hohorst* the German company Lankhorst-Hohorst GmbH paid interest to its Dutch grandparent Lankhorst Taselaar BV on a loan granted in order to help with its financial troubles. Tax authorities claimed that such a loan was given without any securities and supported by a letter of support, 

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141 J.B. Steinsson (2013). *Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?*, pg. 29
142 Iceland, Lichtenstein, Norway, Switzerland
143 J.B. Steinsson (2013). *Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?*, pg. 29
144 J. Guðmundsson (2006) *European Tax Law in Relations with EFTA Countries*, p. 80-81
145 J.B. Steinsson (2013). *Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?*, pg. 29
146 C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*, paras. 6 – 8, 14.
waiving repayment in favour of third party claims, could not have been obtained from a third party and was therefore in fact equity.\textsuperscript{147} This caused interest expenses exceeding a certain debt-equity ratio to be reclassified as dividends. Although not directly linked to nationality, the ECJ ruled that the rules were discriminatory and an unjustifiable hindrance to the freedom of establishment.\textsuperscript{148} The reclassification applied solely to interest payments to companies not entitled to corporation tax credit; therefore, interest-paying subsidiaries were treated differently based on the residency of their parent company.\textsuperscript{149} Foreign companies, as well as German corporations, exempt from corporate income tax were not entitled to such a tax credit.\textsuperscript{150} Although the rules also applied to certain German taxpayers, in practice the rules applied primarily to foreign shareholders and were thus discriminatory.\textsuperscript{151} It can therefore be concluded that even thin capitalization rules that indirectly discriminate resident and non-resident creditors can infringe the freedom of establishment.\textsuperscript{152} Following this judgment, several Member States amended their thin capitalization rules. In order to comply with EU law, EU-resident companies have to be treated equally disadvantageously. Therefore, the legislators in the EU Member States have to choose between either accepting tax planning with interest expenses within the EU or restricting domestic cases.\textsuperscript{153}

\textsuperscript{147} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, paras. 8, 12.
\textsuperscript{148} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, paras. 8, 22, 36 – 38, 43.
\textsuperscript{149} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, paras. 22, 27.
\textsuperscript{150} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, para. 4.
\textsuperscript{151} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt, para. 18 and E. Chors, Interest Deduction Limitation Rules in Sweden and Germany, pg
\textsuperscript{152} C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt
\textsuperscript{153} E. Chors, Interest Deduction Limitation Rules in Sweden and Germany, pg. 9-10
Thin Cap Group\textsuperscript{154} and Cadbury Schweppes\textsuperscript{155} are also important judgements. Many thin capitalization rules try to distinguish between legitimate use and abuse of their interest deduction provisions. In Cadbury Schweppes, the question was whether the establishment of companies in Member States regarded as a low-tax jurisdiction, was abusive.\textsuperscript{156} The ECJ said, based on the Centros\textsuperscript{157} case, that companies may not take advantage of the Community law to circumvent their domestic provisions.\textsuperscript{158} This does not mean that an interest payment to a foreign establishment, cannot give a presumption of abuse.\textsuperscript{159} The ECJ ruled that national measures could be justified by preventing tax avoidance if they apply only to wholly artificial arrangements that are aimed at circumventing domestic legislation.\textsuperscript{160} Therefore, a transaction is legitimate if it reflects economic reality, despite potential underlying tax motives.\textsuperscript{161}

The Thin Cap Group case concerned interest payments from UK resident companies to non-resident group companies.\textsuperscript{162} Deductibility of interests was not limited in the same way when the creditor was a domestic group company.\textsuperscript{163}

\textsuperscript{154} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue

\textsuperscript{155} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue

\textsuperscript{156} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, paras. 22, 34.

\textsuperscript{157} Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstyrelsen

\textsuperscript{158} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, para. 35

\textsuperscript{159} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, paras. 37, 50 and Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstyrelsen para. 18.

\textsuperscript{160} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, paras. 51, 55.

\textsuperscript{161} Case C-196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue, para. 65.

\textsuperscript{162} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, para. 2.

\textsuperscript{163} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, para. 4.
With different tax treatments, depending on residency, the measure restricts the freedom of establishment for EU-resident lenders.\textsuperscript{164} However, contrary to \textit{Lankhorst-Hohorst} the British thin capitalization rules were, according to the ECJ, justifiable as measures targeting wholly artificial arrangements that do not reflect economic reality. The ECJ stressed though that foreign residency of a lender cannot give a general presumption of abuse.\textsuperscript{165} Although the UK measure was suitable to its primary objective, the measure was not proportional.\textsuperscript{166} For thin capitalization rules to be proportional, two conditions need to be met. First, the taxpayer needs to be given an opportunity to provide evidence without unreasonable administrative requisites that the arrangement was commercially justified.\textsuperscript{167} Secondly, re-characterization of interest payments is only proportional for the amount that exceeds arm’s length.\textsuperscript{168} It can therefore be concluded that thin capitalization rules can be justified as a prevention of tax avoidance. The ECJ generally considers an artificial arrangement to be classified as abuse when it is created to fulfil a provision’s required conditions for the sole purpose of obtaining its advantages, despite not being in line with the spirit and purpose of said provision.\textsuperscript{169} Therefore, to summarize, thin capitalization rules must be limited to wholly artificial arrangements. However, neither intra-group loans, nor loans by foreign lenders can lead to the assumption that they are being

\textsuperscript{164} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, paras. 40, 63.
\textsuperscript{165} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, paras. 72 – 74.
\textsuperscript{166} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, paras. 77, 82.
\textsuperscript{167} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, paras. 77, 82.
\textsuperscript{168} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, para. 83.
\textsuperscript{169} Case C-110/99 Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas, paras. 52 – 53.
made solely for tax avoidance purposes. Since both rulings deal with reclassified interests, it has been argued that such rules might not even comply with EU law, therefore favouring interest deduction limitation rules.\textsuperscript{170}

The questions in \textit{Thin Cap Group} mention the free movement of capital.\textsuperscript{171} Contrary to the freedom of establishment, the free movement of capital applies in third country situations. The ECJ ruled that thin capitalization rules affect owners having an influence on a company’s decisions and thus the freedom of establishment applies.\textsuperscript{172} Any restrictions of the free movement of capital are an unavoidable result of restricting the freedom of establishment. The ECJ therefore denied a separate examination.\textsuperscript{173}

Regarding possible adaptations on rules on the worldwide allocation of debt existing international tax framework of bilateral and multilateral treaties do not need to be changed in order to implement such rules.\textsuperscript{174} The Multilateral Convention on Mutual Administrative Assistance in Tax Matters enables the effective operation of the worldwide ratio rule with 64 countries being able to use it to obtain or confirm information about a group’s worldwide third-party leverage ratio. Their ability to endure an ECJ examination should be considered as a breach of the freedom of establishment by discriminating between domestic companies and foreign-controlled companies might be considered a violation. By

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\textsuperscript{170} E. Chors (2013). Interest Deduction Limitation Rules in Sweden and Germany, pg. 12
\textsuperscript{171} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, paras. 1, 18 – 19.
\textsuperscript{172} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, para. 27, 32.
\textsuperscript{173} Case C-524/04 Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue, para. 34.
\textsuperscript{174} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach, pg. 71
\end{flushright}
the same reasoning, the rule might also be accused of breaching bilateral non-discrimination articles of tax treaties.\textsuperscript{175} As an explanation, let us imagine Poland introducing a worldwide ratio rule. A Polish subsidiary with an Irish parent and a low third party leverage ratio is before the ECJ. It compares itself to a highly leveraged Polish group and feels discriminated since the Polish group has higher interests. The Irish controlled Polish company argues that being disallowed to deduct interests at the same leverage ratios as its Polish peer, the worldwide debt test is discriminatory and inhibits free establishment in Poland.\textsuperscript{176} In such case, you could argue that there is no discrimination based on the location of the companies. The difference in the tax treatment of the Irish-controlled Polish company and its Polish peer is a dissimilarity based on different third-party leverage ratios. Two Polish groups might have different leverage ratios even if their operations are similar, which, in itself does not violate the fundamental freedoms.\textsuperscript{177} The Irish group though, might still be less than satisfied with these results, seeing as interest deductions are worth less in Ireland than in Poland due to a lower corporate tax rate. However, the ECJ has said that differences based on different tax rates (and other tax system features) are not a discrimination which violates the fundamental freedoms since deciding what tax rates to apply remains a sovereign right of any Member State.\textsuperscript{178} From an ECJ perspective, the worldwide leverage ratio rule needs to apply to domestic groups as well as to MNEs. A de minimis rule should be applied so groups under a certain amount of gross interest expense are exempt.\textsuperscript{179}

\textsuperscript{175} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 71-72
\textsuperscript{176} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 72
\textsuperscript{177} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 72
\textsuperscript{178} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 72-73
\textsuperscript{179} C. Burnett (2014) Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach. pg. 72-73
The next chapter will take a closer look at relevant Icelandic legislation. How or if thin cap rules similar to those discussed here, could or should be implemented into Icelandic tax law.

6. Iceland

As previously mentioned and due to special interest as an Icelandic national the author would like to pay some attention to the current thin cap and tax avoidance situation overall in Iceland.

There was no definition of the term tax evasion in Icelandic laws until the setting of the regulation on the implementation of tax enforcement and tax investigation no. 373/2001. Before that time, it was not entirely clear what was considered tax evasion. In the first paragraph of Art 7. of the new regulation on the implementation of tax enforcement and tax investigation the following definition of tax evasion is provided:

"It is considered tax evasion when a person intentionally or by gross negligence gives false or misleading information intended for tax decisions. The same applies if a party fails to provide information which may be relevant to the tax decisions."

There are no interest deduction limitation or thin capitalization rules in the Icelandic legislation. Article 57 of the ITC does however contain a general anti avoidance rule as well as a transfer-pricing rule (as of January 2014). In a ruling later discussed in this chapter the Supreme Court held that a transaction can be disregarded under the general anti avoidance rule if its purpose is not business related but in instead only to circumvent tax legislation.
In the aftermath of the financial collapse of 2008, the International Monetary Fund monitored the Icelandic tax environment. In one of its reports it said that the system of corporate taxation in Iceland was a traditional system similar to what can be found in most European countries, adding that it was relatively simple and efficient and was therefore not in need for any major changes. The report however added that economic situation following the 2008 collapse had brought attention to certain shortcomings connected to the treatment of holding gains and losses, debt forgiveness, complex financial operations, and extreme leverage.\textsuperscript{180} Amongst those issues was the fact that the corporate tax rules presents a bias towards debt instead of equity financing because profits are taxable while all interest payments are deductible and thus motivating corporations towards excessive debt financing for tax purposes. Currently, Icelandic tax authorities have no real way of tackling tax planning that involves excessive debt financing except for maybe the arm’s length provision of article 57 ITC or the general anti avoidance principle of the same article supported by developed case law. Of which neither seem to be effectively applicable with the effect that Iceland tax authorities doubt their capacity to confront and/or prevent thin capitalization practices.\textsuperscript{181}

An example of the problem thin capitalization can cause in Iceland can be given by looking at how two of the biggest aluminium smelter companies in Iceland are set up. In March 2013 an Icelandic investigative reporter\textsuperscript{182} pointed out that the

\textsuperscript{180} International Monetary Fund (2010) - Improving the Equity and Revenue Productivity of the Icelandic Tax System. p. 18
\textsuperscript{181} International Monetary Fund (2010) - Improving the Equity and Revenue Productivity of the Icelandic Tax System. p. 21
\textsuperscript{182} H Seljan, Kastljós, 21/3 2013
owners of two of the largest ones\(^{183}\) were not paying any income taxes in Iceland, that they instead had large debts with their sister or parent companies to which they pay tens of million $US in interest annually.\(^{184}\) When asked about this former Icelandic Minister of Finance, S.J. Sigfússon\(^{185}\) said that the companies were finding ways to make a huge profit go this way through the high-interest terms on enormous debt which these companies are financed with and very little owners’ equity.\(^{186}\)

The Aluminium plants are however “immune” to any change in legislation regarding limitations on interest deductions. This is due to laws regarding the government's authorization to make investment contracts\(^{187}\), for an aluminium smelter in Reyðarfjarðar\(^{188}\) and similar acts regarding plants in Grundartangi\(^{189}\) and in Helguvík\(^{190}\). In the contract regarding the Reyðarfjarðar smelter it says: “The deductibility of interest expense shall remain unchanged during the Initial Term as it is under Act No. 75/1981 on Income Tax and Net Worth Tax, as amended, on the date of the signing of this agreement.”\(^{191}\) another one regarding the one in Helguvík says that: “After the signing of this Agreement the Company is exempted from changes that may occur on provisions regarding deduction of interest costs in the Act on Income Tax, taking into account the OECD Guidelines

\(^{181}\) Alcoaice and Nordurál

\(^{184}\) J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 6

\(^{185}\) S.J. Sigfússon, minister of Finance 2009-20013

\(^{186}\) H Seljan, interview in Kastljös, 21/3 2013 and J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 5

\(^{187}\) These are special agreements the Icelandic government sometimes does in certain situations with companies or corporations planning to invest substantially in some form of industry

\(^{188}\) Art. 6(11), act no. 12/2003

\(^{189}\) Art. 6(12), act no. 62/1997

\(^{190}\) Art. 4(7) (act no. 51/2009 and J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 5

\(^{191}\) Investment agreement for Aluminum smelter in Reyðarfjarðar.
on Arm’s Length Principles and Transfer Pricing”\footnote{Investment agreement for Aluminum smelter in Helguvik.}. The agreement regarding Grundartangi originally contained no such provision, but it was added in 2008.\footnote{J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 6} Obvious from this is not only the fact that lack of any rules regarding thin cap or interest deduction limitations is causing problems in the taxation of the corporations in Iceland, but also the existence of these investment contracts that exclude said corporations from any changes in rules or laws regarding the deductibility of interest. Similar contract have been done with other foreign corporations investing in Iceland. It is therefore not very difficult to conclude that the legislator and members of current and previous governments in Iceland have any intention or will to do anything regarding the issue.

6.1. Article 57. Of the Income Tax Law

However, not all may be lost. To explain why not, it is necessary to take a closer look at the before mentioned article 57 of the Income tax code. The following chapter is largely based on a similar chapter in the author’s previous publication regarding the excessive financing of the aluminium smelter corporations in Iceland. \footnote{J.B. Steinsson (2013). Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 27} Paragraph 1 of Article 57 states that if tax persons when arranging financial agreements do so in a way that is considerably different from what is considered normal in comparable transactions on the open market. Any valuables that without such an abnormal agreement would have gone to either of the parties,
but do not because of said agreement, shall be counted as taxable income for said person.

The provisions origin is article 9 of the OECD model tax treaty as it was in 1971 when the laws were set. Its text is fundamentally identical to the original provision in the tax law, although the Icelandic provision has become a bit wider as it includes both individuals and corporations, but narrower in the sense that the difference between the contractual interest terms must be considerable, whereas the ninth article of the model referrers to the terms having to be "different".196

In its ruling, Icelandic Court of first Instance E-4843/2010 confirms this assessment. Stating that the "reality principle" derived from Article 57 should not be applied since that provision could only be regarded in transfer pricing transactions. Additionally, in a case appealed to the Supreme Court197, the court specified that when interpreting the provision the unwritten principles concerning tax avoidance on which it rested needed to be taken into consideration. The court then went on and stated that there was in no way possible, based on said provision, to tax a legal transaction designed to reduce tax burden of a taxable person, even though the transactions in question might not be considered customary and/or rare. In its reasoning the court said that when assessing whether or not the provision applied, it was needed to take a look at the relationship between the parties in question and if unrelated parties would

195 Art. 57 par. 1 of Icelandic income tax code and .B. Steinsson, Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 27-28
196 OECD Model Tax Treaty, article 9 and .B. Steinsson, Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg. 28
engage in similar transactions or if the form of said transactions was the direct result of relations between the parties involved. The result of the Supreme Court in the case was that the transaction in question had no clear business purposes other than to lower tax burden and that close relations between the parties in question played an essential role. The court therefore agreed with the transactional changes made by tax authorities.

Courts seem to have confirmed that the provision should be purposely interpreted as entailing a principle that allows for substance of an agreement to be taken over its form when it comes to taxation. It is therefore a general tax avoidance or reality rule, a reality shaped by case law and allows taxation to be based on what has actually happened. In a way that gives tax authorities the ability to assess independently whether a monopoly regulated instrument has led to a situation that exists, and can be used as base for taxation.\(^{198}\)

Its first legal foundation was in ruling by the Supreme Court in 1998\(^{199}\), the case involved a fraud where improper deductions relating to acquisitions of companies incurring losses and then utilizing those losses against profits. The only purpose of those acquisitions of companies was to utilize the tax loss. The Court referred to the principle laid down in Article 57. Since then, the reality rule has been confirmed in several additional rulings of Icelandic courts as well as by the decisions of the Internal Revenue Board (Yfirskattanefnd). There have not been many cases before the courts in recent years though. Only one in addition to the ones previously mentioned in fact. There have however been quite a few

\(^{198}\) J.B. Steinsson (2013), Thin Cap and Iceland - What can happen in the absence of thin capitalization rules?, pg.28
before the Internal Revenue Board and a short overview of some of those cases might help further in assessing how the provision is interpreted:

**YSKN. 1053/1998:** “Given the connections between parties in said transactions and in the face of article 57, said instruments must be ignored when determining taxable income of the applicant trade in shares. It is clear that if such a relationship had not been present, that sort of transaction would not had taken place.”

Here is a clear indication that the laws do allow for ignoring a financial instrument in regards to unusual transactions between related parties, if we then take a look at later rulings this becomes even clearer.

**YSKN. 113/2001:** Tracking the asset and management relationship of companies with significant tax benefits resulting from business transactions there was no doubt that they were considerably different from what could be considered normal. Having as its sole purpose the movement of taxable revenues from the company to a company that could make use of loss deduction. As a result, tax authorities were allowed to make transactional changes and tax accordingly.

**YSKN. 264/2002:** “Tax authorities decreased operating expenses on the grounds that they were unusual transactions between related parties. The fact that the taxpayer had provided limited information on the disputed transaction was enough to confirm the tax authorities’ decision.”

**YSKN. 261/2003:** Company received a shareholder loan, to be paid in a lump sum in 12 years. Tax authorities ignored the transaction for tax purposes because it was unusual since the real purpose of the transaction was to reduce tax payments. Providing no convincing explanations to its operational reasons the
transactions were deemed not being in accordance with what was considered usual in such loan transactions.

This ruling is interesting since the revenue board uses as an argument the fact that no operational reasons for said transaction was a enough to ignore the transaction.

YSKN. 296/2006: The ruling stated that laws cannot hinder shareholders of private limited companies from providing loans to them and that private companies could pay dividends in cash equal to the funds it might provide for this purpose. However, the court also pointed out that the complainant should have provided a much clearer account of the loans in question. On those grounds, he was not considered to have shown convincingly that these were loans to the company and that the interest related to them could be considered as deductible costs.

YSKN. 11/2010: Tax authorities are allowed to impose its own evaluation when the question is whether a transaction was in such a manner that a certain rule of law applies to it. Authorities are not bound by a taxpayer’s assessment in the same situation. Tax authorities are only in certain cases required to demonstrate that the taxpayer organized their affairs in such a way as to avoid taxation, with the aim to circumvent specific tax rule.”

In all of the cases it appears that the burden of proof is reversed, tax authorities claim breach of article 57 and it is then up to the taxpayer to prove that, the transactions in question have normal operational reasons and the tax authorities seem to have quite a flexibility in their estimate.

To sum things up when can tell by the case law that it seems to be clear that three main conditions must be met before a tax authority can apply Article 57:
a) The taxpayers must have negotiated their terms in a manner that is substantially different from what is generally done in similar transactions,
b) Their relationship with each other, that is if or how they are connected must be clear,
c) Whether there were any real operational reasons for their transactions.

When considering all of the above it is the author’s opinion that it in regards to the aluminium smelters for example it is necessary to see if an application by the tax authorities of article 57 on their “unusual” loan agreements with parent and sister companies would hold up in court.

The question then has to be if Icelandic law allow transactional changes in cases similar to the cases of the aluminium smelters. Sadly, there is no clear answer to that since Icelandic courts have never been asked that question. However, for some indication a quick look can be taken at Norway as well as the OECD guidelines: Norwegian law do not contain any articles or provisions authorizing structural adjustments of controlled transactions because their economic form differs from their form and its arm’s length provision has not been interpreted as to establish some economic substance requirement. The term “economic substance” used in OECD guidelines para 1.65 is only concerned with the arm’s length point – the provision may nonetheless allow structural adjustments under the economic substance exception when it concerns thin capitalization. Thus, it is firmly established that the Norwegian arm’s length provision authorizes re-characterization of debt into equity when a borrowing company is thinly capitalized. Such re-characterization is considered as an application the arm’s length principle.\(^{200}\)

\(^{200}\) A Bullen (2011). Arm’s Length Transaction Structures
said about the Danish legislation: “a contribution may be deemed to exist even though the substance is entirely different under civil law. In cases when granting a loan, it is obvious that the borrower will not be able to repay it, the loan cannot be acknowledged as a loan for tax purposes, but is deemed a contribution or the like.”\textsuperscript{201}

What can be drawn from this in the author’s opinion is that there is a chance that current Icelandic legislation might perhaps be used to tackle for example the practises of the aluminium smelter corporations previously mentioned.

\subsection*{6.2. Next steps}

As previously mentioned there was a proposal put forth in the Icelandic parliament regarding the implementation of thin cap rules. It however seems to have been “put to sleep” in a committee.\textsuperscript{202} In the year 2014, the former minister of finance asked the current minister of any progress on the matter. Minister Bjarni Benediktsson answered and said that the ministry was actively monitoring the progress being made within the OECD on how to address the problem of Base Erosion and profit shifting. That work has been in progress for a few years and the work is scheduled to finish by the end of 2015.\textsuperscript{203} Those efforts are the subject of the next chapter.


\textsuperscript{202} Frumvarp um breytingu á lögum um tekjuskatt, nr. 90/2003, með síðari breytingum (þann eiginfjármögnun). Þskj. 15, 15. mál. Vefútgæfa Alþingistíðinda, slóð: \url{http://www.althingi.is/altext/143/s/0015.html}. Sótt á vefinn 04.1.2015

\textsuperscript{203} Svar fjármála- og efnahagsráðherra við fyrirsagn frá Steingrími J. Sigfússyni um lögfestingu reglum þann eiginfjármögnun, Þskj. 834, 460. mál. Vefútgæfa Alþingistíðinda, slóð: \url{http://www.althingi.is/altext/144/s/0834.html}. Sótt á vefinn 12.10.2015
7. OECD efforts

This chapter will provide an overview of an OECD report published 2013, addressing tax avoidance and tax evasion as well as the conclusions of the most recent Tax Transparency report from the OECD. It should be noted that there was recently a new report published which introduces no major changes. \(^{204}\)

Two recent developments addressing tax avoidance are on the right track. The first is a report from the OECD: “Addressing Base Erosion and Profit Shifting” (BEPS). The report advocates collective action by all OECD member governments to create similar, if not uniform tax rules to prevent corporations from shifting profits from higher tax to lower tax jurisdictions. The second recent development is the coordinated announcement on July 19, 2013 by the finance ministers of the G20 of an “action plan on BEPS” that essentially adopts the OECD’s recommendation of a fundamental rethink of international tax rules. While the report focuses primarily on profit shifting, a number of the corrective measures proposed could be to other forms of tax avoidance. The action plan includes 15 different areas where tax rules need to be improved in order to mitigate tax avoidance and contemplates concerted action in these areas within 24 months. How likely is serious reform?\(^{205}\)

The OECD and G20 joined to combat base erosion and profit shifting making significant progress in setting automatic exchange of information as the new standard.\(^{206}\)

\(^{204}\) OECD/G20, (2015), *Base Erosion and Profit Shifting Project Explanatory statement*  


Until very recently the difference between tax avoidance, tax evasion and tax planning seemed quite simple. However, the understanding of these terms is now increasingly interrelated. The OECD has launched actions expected to have a major impact on the way cross-border transactions are taxed.207

The pace of integration of national economies and markets has increased substantially in recent years. Boosting trade and increased foreign direct investments. With a more globally integrated economy, MNE’s now represent a large proportion of global gross domestic product with intra-firm trade being a growing proportion of overall trade. It has become much easier for businesses to locate productive activities far away from their customers. Following this has been a steep increase in the sophistication of tax planners, with them identifying and exploiting the legal opportunities that have risen with these changes. Providing MNEs with more confidence in taking aggressive tax positions to minimize their tax burden. Many governments have to cope with less revenue and a higher cost to ensure compliance. Moreover, Base Erosion and Profit Shifting (BEPS) undermines the integrity of the tax system and the lack of tax revenue leads to under-funding of public investment. Domestic and smaller businesses have difficulty competing with MNEs that have the ability to shift their profits across borders to avoid or reduce tax, thus harming fair competition. States often do not take sufficiently into account the effect of other countries’ rules when creating their own tax laws. Creating various problems, for example the risk of double or non-taxation for MNE’s. BEPS relates mainly to when the interaction of different rules leads to double non-taxation or less than single

taxation as well as to arrangements that achieve no or low taxation by jurisdiction profit shifting. No or low taxation is not necessarily a problem or a cause for concern, but when it is due to gaps in the interaction of different tax systems, and in some cases because of the application of bilateral tax treaties, income from cross-border activities may go untaxed anywhere. This can result in a relocation of core business functions and following that, different distribution of taxing rights. It is important to examine this closely to determine whether and to what extent it may be necessary to adapt the current rules in order to prevent BEPS. Drastic measures need to be taken in order to prevent these problems becoming even worse.

The OECD Action plan calls for fundamental changes to the current mechanisms and the adoption of new globally agreed upon approaches, containing anti-abuse provisions, aimed to prevent and counter base erosion and profit shifting. BEPS issues may arise in relation loopholes, gaps, frictions or mismatches between countries’ domestic tax laws. So far this has not or not much been dealt with by OECD standards or bilateral treaty provisions but countries must work together to tackle damaging tax practices and aggressive tax planning. Although bilateral tax treaties have in some ways been effective or helpful in preventing double taxation, they too often fail to prevent double non-taxation resulting from interactions between two or more countries. Any actions put forth to counter BEPS cannot succeed without further transparency, nor without certainty and predictability for business. The actions will help address these concerns.\footnote{OECD (2013), Action plan on base erosion and profit shifting, pg. 7-14}

The actions proposed are 15 in total; following is a short overview of all of them from the OECD report:

\footnote{OECD (2013), Action plan on base erosion and profit shifting, pg. 7-14}
**ACTION 1**

Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation. Including the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of nexus under current international rules.²⁰⁹

**ACTION 2**

Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effects of hybrid instruments and entities. Maybe including changes to the OECD Model Tax Convention to ensure that hybrid instruments and entities are not used to obtain the benefits of treaties unduly. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the OECD Model Tax Convention... This work will be coordinated with the work on interest expense deduction limitations, the work on CFC rules, and the work on treaty shopping.²¹⁰

**ACTION 3**

Strengthen CFC rules “Develop recommendations regarding the design of controlled foreign company rules.”²¹¹

**ACTION 4**

Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to

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²¹⁰ OECD (2013). Action plan on base erosion and profit shifting. pg. 15-16
²¹¹ OECD (2013). Action plan on base erosion and profit shifting. pg. 16
interest payments... The work will be coordinated with the work on hybrids and CFC rules.  

**ACTION 5**

Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime... Interacting with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework.  

**ACTION 6**

Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances. Work will also be done to clarify that tax treaties are not intended to be used to generate double non-taxation and to identify the tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country. The work will be coordinated with the work on hybrids.  

**ACTION 7**

Develop changes to the definition of PE to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions. Work on these issues will also address related profit attribution issues.  

**Action 8**

*Develop rules to prevent BEPS by moving intangibles among group members.*  

**Action 9**

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212 OECD (2013). Action plan on base erosion and profit shifting. pg. 17  
213 OECD (2013). Action plan on base erosion and profit shifting. pg. 18  
214 OECD (2013). Action plan on base erosion and profit shifting. pg. 19  
215 OECD (2013). Action plan on base erosion and profit shifting. pg. 19  
216 OECD (2013). Action plan on base erosion and profit shifting. pg. 20
Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members... This work will be co-ordinated with the work on interest expense deductions and other financial payments.  

**Action 10**

Develop rules to prevent BEPS by engaging in transactions, which would not, or would only very rarely, occur between third parties.  

**ACTION 11**

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.  

**ACTION 12**

Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules... The work will be coordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations.  

**ACTION 13**

Develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business. The rules to be developed will include a requirement that MNE’s provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.  

**ACTION 14**

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217 OECD (2013). Action plan on base erosion and profit shifting, pg. 20  
218 OECD (2013). Action plan on base erosion and profit shifting, pg. 20-21  
219 OECD (2013). Action plan on base erosion and profit shifting, pg. 21-22  
220 OECD (2013). Action plan on base erosion and profit shifting, pg. 22  
221 OECD (2013). Action plan on base erosion and profit shifting, pg. 23
Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under MAP, including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases.\textsuperscript{222}

**ACTION 15**

Analyse the tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement measures developed in the course of the work on BEPS and amend bilateral tax treaties. On the basis of this analysis, interested Parties will develop a multilateral instrument designed to provide an innovative approach to international tax matters, reflecting the rapidly evolving nature of the global economy and the need to adapt quickly to this evolution.\textsuperscript{223}

Until now, the main international tool used to counter these problems has been the exchange of information, a topic where there have been many encouraging changes in recent years. In June 2013, with the support of the G20 Finance Ministers and Central Bank Governors the OECD released its Tax Transparency Report, including the first steps for drafting and implementing a standardized multilateral model for automatic exchange of information. Such exchange is however, only a piece of the puzzle in tackling tax avoidance and tax evasion. Domestic legislation that allows for mismatches exploitable by taxpayers, for example, through aggressive tax planning based on after-tax hedging, should by analysed by domestic tax authorities. One part of a possible solution are co-operation programs already introduced in many countries, they have been proven successful in spotting tax-planning schemes by providing the tax authorities with upfront information.

\textsuperscript{222} OECD(2013). Action plan on base erosion and profit shifting. pg. 23
\textsuperscript{223} OECD(2013). Action plan on base erosion and profit shifting. pg. 24
Most important is the BEPS project, not trying to change to the current international tax rules regarding the allocation of income, but intends instead to implement measures that can strengthen them. Having both the OECD and G20 on board, will lead to a better representation of countries and more legitimacy in drafting and implementation.

Although expected by many, the plan does not include country-by-country reporting measures. Such measures would require MNEs to reveal the name of every country where they conduct any business, the names of the companies in each country, as well as financial information in every country. MNEs account for the major part of global trading, so if governments want to combat tax avoidance they require specific and comprehensive information. All the OECD reports from 2013 point to a clear direction towards integration, transparency and coordinated efforts in combating tax evasion and tax avoidance. Only future will tell if there is, or will be, a political agreement among the steering members, with the result of the measures suggested being implemented. What is clear is that tax is high in the mind of global leaders, these numerous tax initiatives have been endorsed by the most influential organizations and leaders, and that the effects are starting to become visible. It will be interesting to see what comes of the BEPS action plan. Popular discontent with the growing levels of income and wealth inequality in many countries suggests that there is an imbalance between the degree of tax avoidance now achieved by many sophisticated taxpayers and the tax collection by governments to support expenditures that are socially just and in the public

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interest. Neither governments nor taxpayers should be given an easy ride in avoiding tax or in imposing taxes.\textsuperscript{225}

In the conclusion of the 2014 OECD report on Tax Transparency it says that the work so far has resulted in widespread support for tax transparency. Strict banking secrecy for tax purposes which is no longer part of any Global Forum members’ legislation. Automatic exchange of information of financial accounts, considered unimaginable before, is being introduced in almost all of the world's major financial centres. The provisions on fiscal transparency are also becoming increasingly strict. As a result, the risk of shell companies or other similar arrangements to evade tax will be further reduced. Countries need to request information and developing countries will also require ongoing support if they are to be fully connected into the international network. These will be the main challenges over the next five years. Political backing for the promotion of tax transparency and the Global Forum has been fundamental to the success so far. The signs for the next 5 years are very encouraging but political support for the implementation of these higher standards will continue to be needed as countries adjust to the next level of international cooperation.\textsuperscript{226}

**Conclusion**

The following quote has been attributed to Jean Baptiste Colbert, a French politician who served as the Minister of Finances of France under the rule of King Louis XIV: “


“The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing” 227

Being more than 300 years old it still sums up quite nicely the essence of taxation, both domestic as well as internationally. However, in recent years the hissing has increased. Although, it does not come from the geese being “plucked” but from the public, a public that has become annoyed or even outraged by the fact that huge multinational corporations seem to not only be able to decide for themselves how much if any tax they pay, they also seem to be able to decide where. Until very recently it seemed like governments tolerated this. A government may choose a way where tax burden will mostly be borne by those whose political inclinations are least likely to be affected by increases in their tax burden. This can be extended to tax avoidance rules. Tolerating tax avoidance is therefore one way that a government could encourage taxation at a level close to the marginal political cost for each taxpayer. Meaning that the government can essentially be seen as to tolerate tax avoidance in its own self-interest. 228

Governments tend to be slower than taxpayers when new unexpected schemes are created that manage to avoid tax under the current income tax law. Only when governments act collectively will the results be satisfactory. 229 Taxpayers that operate in multiple jurisdictions will most likely counter changes in their tax liability by relocating their income earning operations to other jurisdiction, directly or indirectly. With taxpayers being motivated to reduce their exposure to income tax in various ways, including shifting income to other jurisdictions. A

228 Hettich, Walter, and Stanley L. Winer (1999). Democratic choice and taxation: A theoretical and empirical analysis. pg.46

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perfectly rational taxpayer is therefore willing to spend money to save on taxes, even with a small profit margin. However, less responsive taxpayers do not behave in this way most of the time due to their social identity, attitude towards government, or fright of getting caught avoiding taxes.\(^{230}\)

The G-7 countries and others trying to regulate thin capitalization have to balance short-term revenue goals against creating an attractive investment environment. Many of the countries mentioned in previous chapters have altered their regulations in recent years in an attempt to accomplish both goals.\(^{231}\)

Additionally, interest limitation rules may not achieve their objectives. A debt-to-equity ratio does not limit absolute debt levels, and may therefore not avert profit shifting. To reduce taxes an MNE can determine the debt necessary to shift earnings from a country and add sufficient debt and equity to abide by any limitations, and in that way transfer their profits. Most thin cap rules have safe harbours forcing related companies to apply normal market conditions in their transactions that are simple to circumvent by simply increasing the equity of the financed subsidiary sufficiently pushing down as much debt as necessary.\(^{232}\)

Current inverted firms “technical” compliance with any barriers to earnings stripping is generating outcomes that bear very little resemblance to underlying economic events and circumstances. In fact, some of the behaviours documented are so flagrant that both the substance-over-form tax standard and the fairness principle are being violated. It seems unlikely that the earnings stripping behaviour is consistent with the idea that a fair tax system must favour substance over form, and that the tax treatment of income and expense items should


produce a result that clearly reflects an entity’s income. Meaning that capping the debt-to-equity ratio may conflict with the effectiveness and fairness principles. As a result, some nations have supplemented debt-to-equity limitations with other regulations to limit interest deductions. Thus, from the international and collective perspective, the only real choice is to embrace the reality that relatively high rate income tax jurisdictions will need to work together to be more dynamic, flexible and responsive in exerting counteracting pressure on taxpayers advised by leading accounting and law firms. It is only with constant partial enforcement of anti-avoidance measures that governments can maintain their revenues. As such, governments must be constantly on guard against being too permissive or too draconian with respect to tax avoidance. Meaning that they might simultaneously complain about tax avoidance while not pursuing all measures legally available to combat it.

It is this author’s opinion that the work being done within the OECD is very positive and countries without any thin cap or interest limitation rules should follow the example of the Icelandic government and wait until that finishes and go from there. Same goes for countries that are contemplate changing their own rules. The problem of profit shifting as means to avoid taxes is a global one and therefore needs to be tackled globally.

However, regarding the Icelandic problem with the aluminium smelter companies this author is of the opinion that by applying the “no cheating” rule found in article 57 of the Income tax code there is perhaps a way to do something about some of the possible offenders. By applying article 57, the corporations

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would need to “prove” that there were sound business reasons for their transactions. In addition, at least in the case of Alcoa, a company that is technically bankrupt due to its sky-high debt/equity ratio as well as having never produced any profits. In that particular case the state could for example argue that since it was doubtful that it would ever be able to pay back its loan that there was in place an agreement between the Icelandic company and its foreign lending affiliate that would not happen between unrelated parties, thus being in breach of article 57. Making it possible to nullify the tax benefits gained by their tax avoidance schemes. Another approach was to demand some explanations as to the business purpose of the loans or an explanation of how a company that has never produced a profit like Alcoa Iceland remains operational. Maybe the chances that the Icelandic courts would accept such charges and do something about it are slim, but at least they would have to give a verdict, thus shredding the cloak of shadows currently surrounding these matters in Iceland. It is however this authors opinion that in most of the cases involving the aluminium plants there are what can be considered artificial loan arrangement put in place with the sole purpose of avoiding taxes. In addition, as covered before, Icelandic courts have in such instances made transactional changes or ignored the arrangements in their entirety. This author calls for Icelandic tax authorities to at least give it a go and try to see if anything can be done using the general anti avoidance rule found article 57 of the Icelandic income tax code. It has been done in Finland why not here.

Finally, to answer the question whether or not Iceland should implement any thin cap or interest deduction limitation rules, the author is of the opinion that Iceland, at least for the time being, should not. There are a couple of reasons why.
First of all, although the cases of the before mentioned aluminium smelters do not look good there is probably not much that can be done for now since they are immune to any changes in laws regarding the deductibility of interest and there is not much known about similar problems with corporations that would not be immune to such rules. Second, before any such rules were implemented some work would have to be done to ensure that any gain in tax revenue rules would not cause equal or more losses in vital foreign investments in Iceland. Finally, implementing such rules is not simple and for a small economy, it might be expensive to survey the market and make sure that taxpayers complied with the rules and as previously mentioned all the smaller EU states have either none or very forgiving rules. There are in the authors’ opinion no special circumstances in Iceland that justify a different way than the smaller EU states, and instead follow the example of countries like Germany. A more sensible approach is to do what seems to be the current government’s agenda and wait until OECD finishes its BESP work with hopefully a global solution that Iceland could then make use of.
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