Norwegian Government issues Fiscal Budget for 2016 and white paper on tax reform

Executive summary

On 7 October 2015, the Norwegian Government published its proposal for the 2016 Fiscal Budget. In addition, the Norwegian Government published a white paper to the Norwegian Parliament outlining proposals for a tax reform to be enacted over the course of 2016 - 2018. The proposal as well as the white paper must be viewed in light of the proposal from the Scheel Committee delivered to the Government on 2 December 2014.1

The 2016 Fiscal Budget proposal includes specific suggestions to amend relevant regulations and will therefore be enacted if approved by the Parliament. The recommendations included in the white paper will be subject to further discussion before specific amendments to the relevant regulations are suggested to the Parliament. It is the intention of the Norwegian Government to have the recommendations implemented, partly or fully by the course of 2018.

Summary of the 2016 Fiscal Budget proposal

• The corporate income tax rate is reduced from 27% to 25%.

• The tax to EBITDA (earnings before interest, taxes, depreciation and amortization) ratio under the current interest limitation rule is reduced from 30% to 25% with effect from 2016. This means an entity may only deduct net internal interest expenses up to 25% of Tax EBITDA instead of 30%.

• The application of the participation exemption with regards to dividends received by a Norwegian company will no longer apply to the extent that the distribution has been tax deductible at the level of the distributing entity (hybrid instruments).

• The assessment of whether the participation exemption applies at the fund investment level is no longer based on whether the relevant fund qualifies as a bond investment fund and equity fund. Instead, the assessment of whether the participation exemption applies is based on the mix of investments carried out by the fund.
• The current limit of NOK15 million increases to NOK20 million for in-house research and development (R&D), while the cap for procured R&D increases from NOK33 million to NOK40 million under the Norwegian tax incentive scheme for R&D (SkatteFUNN).

• For companies taxed under the special petroleum tax regime and the hydro power regime, the reduction in corporate tax rate will be balanced by a corresponding increase in the special tax rates for these regimes.

**Summary of the white paper**

• The corporate income tax rate is reduced to 22% by 2018.

• The Government principally agrees to introduce withholding taxes on interest, royalties, and certain forms of asset leases (importantly bare boat charters). It intends to publish a proposal to this effect at a later stage.

• The Scheel Committee’s proposal to eliminate withholding tax on dividends to shareholders in normally taxed jurisdictions is rejected in the white paper.

• The Government notes that it will follow-up on the Scheel Committee’s recommendation, both in relation to the introduction of a statutory general anti-avoidance rule (GAAR) and narrowing the Norwegian concept of a company’s place of residency.

• The Government will send for public consultation its proposal for implementing country-by-country reporting into Norwegian domestic law. The first reporting should be done in 2018 based on figures for 2016.

• The Government proposes to consider whether the permanent establishment (PE) threshold under Norwegian domestic law should be lowered.

• Amendments or simplifications to the controlled foreign corporation (CFC) rules also will be considered. Possible amendments include increasing the CFC threshold from 2/3 to 3/4 of the Norwegian effective tax rate, as well as questioning whether the current distinction between active and passive income is relevant.

• The Government proposes to introduce indirect taxes within the finance sector, including value-added tax (VAT) on various charges and fees – so-called specific consideration. Proposals are expected in the 2017 Fiscal Budget at the earliest.

**Detailed discussion**

**2016 Fiscal Budget**

**Corporate income tax rate reduction**

The Government proposes to reduce the corporate income tax rate for 2016 from 27% to 25%.

Note that the Scheel Committee proposed a reduction in the Norwegian corporate tax rate from 27% to 20%, aligning this rate with the latest developments in the Organisation for Economic Co-operation and Development (OECD) and neighboring countries. The Scheel Committee believed that this would increase the competitiveness of the Norwegian tax system in the international market, making it more attractive for foreign investments and businesses.

The Government largely acknowledges the Scheel Committee’s approach, and aims at reducing the corporate tax rate further to 22% by 2018.

**Restrictions to the interest deduction limitation rule**

The Government proposes restrictions to the interest limitation rule. According to the current rule, interest deductions are disallowed when net interest cost exceeds 30% of the company’s EBITDA. The Government proposes to reduce this EBITDA ratio from 30% to 25% with effect from 2016. This means that interest cost exceeding 25% of EBITDA will be disallowed.

Interest on loans to unrelated third parties is currently fully deductible even though total net interest costs exceed 30% of the taxable EBITDA. Note that certain loans to independent parties may however be characterized as internal loans, including back-to-back loans and cases where a related party has provided a guarantee.

The Government now agrees, in principle, with the Scheel Committee’s recommendation of applying the interest limitation rule to external interest. However, it notes it will consider the final BEPS recommendations before making any formal proposals on this point. Also, the Government assures it will work towards avoiding
limitations on genuine third-party interest payments by specifically targeting the interest limitation rule in relation to profit shifting arrangements.

**Participation exemption - foreign source income**

The Government has proposed to restrict the application of the participation exemption with regards to dividends received by a Norwegian company to the extent that the distribution has been tax deductible at the level of the distributing entity.

This may be the case where a contribution is classified as a tax deductible interest costs in the jurisdiction of the contributing entity, while for Norwegian purposes classified as tax-exempt dividends under the participation exemption.

The situation typically arises in relation to financial instruments with both equity and debt features, so-called hybrids instruments. However, the proposal does not specify whether the deduction has to be linked to the use of a specific instrument.

The Government's proposal is in line with the recommendations presented by the OECD's *Base Erosion and Profit Shifting (BEPS)* report.

**Fund taxation**

Under the current rules, the tax treatment at both the fund and investor level is based on whether the fund qualifies as an equity fund or a bond investment fund. A fund is generally able to qualify as an equity fund if it owns at least one qualifying share. The participation exemption generally applies with regards to investments in equity funds entirely, whereas the participation exemption is forfeited with regards to investments in a bond investment fund.

The Government suggests that the above distinction is eliminated and, instead, the assessment of whether the participation exemption applies is based on the mix of investments carried out by the fund.

In the event that less than 20% of the fund's Net Asset Value (NAV) is qualifying equity, the participation exemption does not apply. In the event that more than 80% of the funds NAV is qualifying equity, the participation exemption will fully apply. If the qualifying equity ratio is between 20-80%, the participation exemption will apply proportionately to the qualifying equity.

**Tax incentives on R&D (SkatteFUNN)**

The Government proposes to raise the current limit under the SkatteFUNN, a tax incentive scheme for R&D, for both in-house R&D and procured R&D from an approved research institution.

According to the Government's proposal, the current limit of NOK15 million increases to NOK20 million for in-house R&D, while the cap for procured R&D increases from NOK33 million to NOK40 million. If the taxpayer has both procured R&D from an approved research institution and carries out its own R&D activities, the total cap will be set at NOK40 million, whereby in-house R&D cannot exceed NOK20 million. The proposal intends to motivate businesses to carry out more R&D, ultimately for the benefit of the public. The Government believes that increased SkatteFUNN limits will contribute to more substantial projects being initiated, and also resulting in some projects being completed more quickly than under the current SkatteFUNN scheme.

**Petroleum and hydro power taxation**

In addition to the general corporate income tax regime, a special tax regime applies to companies owning hydroelectric power plants. The special tax regime includes a duty to pay ground rent tax of 31%. This rate is suggested to be increased to 33%.

The tax rate for income derived from hydrocarbon related activities is further suggested to be increased from 51% to 53%.

Hence, for companies taxed under the special petroleum tax regime and the hydro power regime, the reduction in corporate tax rate will be balanced by a corresponding increase in the special tax rates for these regimes.

The above changes included in the proposal will enter into effect from 2016 if enacted.

**White paper**

**Measures to combat profit shifting**

The Government recognizes several areas where it intends to follow-up on the measures to combat profit shifting proposed in the Scheel Committee's report. Several of the proposed measures will be published for public consultation, while the Government will consider...
the final BEPS recommendations for certain measures before making formal proposals.

The Government intends to focus on the following anti-profit shifting measures:

**Introducing withholding tax on interest**

The Government will consider introducing withholding tax on outbound interest payments, as proposed by the Scheel Committee. The Government aims at publishing a proposal on withholding tax on interest for public consultation.

**Introducing withholding tax on royalties and certain forms of asset leases**

Royalty payments (typically payments for use of intangibles) and payments for leasing certain assets (typically bare boat charters of vessels) are not subject to withholding tax from a Norwegian tax law perspective. Bare boat payments also qualify as (tax-exempt) income under the special tax regime for shipping companies.

The Government intends to publish for public consultation a proposal on withholding tax on royalties and certain forms of asset leases in order for the royalty withholding tax to apply to these payments.

Further, the Government will consider whether it should restrict the deductibility for bare boat charter payments under a general limitation rule. However, the Government notes that this issue requires further examination and any proposal on this point will be published at a later stage.

**Restricting the scope of the Norwegian residency test**

As suggested by the Scheel Committee, the Government intends to examine the current Norwegian rules governing when a company is deemed tax resident in Norway. The Government states that it will examine the connection requirement further with the aim of publishing a proposal for public consultation at a later stage.

**Limited tax liability for foreign companies**

The Government proposes that the rules concerning the limited tax liability to Norway for foreign entities according to the Norwegian Tax Act should be revised. This is in line with the Scheel Committee's recommendation and the lowering of the PE threshold in the BEPS report.

Currently, the main domestic rule is that a foreign entity which is not tax resident in Norway may have limited tax liability in Norway, if it carries out business here. Further, the PE requirements under the tax treaty have to be satisfied in order for the company to become tax liable to Norway, assuming the taxpayer is resident in tax treaty jurisdiction.

The Government notes that it will consider OECD’s final recommendations in the BEPS report before publishing a proposal.

**Introducing a statutory GAAR**

The Norwegian GAAR is currently based on principles developed by the courts and administrative practice. The Government now proposes to introduce a statutory GAAR. Professor emeritus Fredrik Zimmer has been handed the task of assessing this proposal in more detail. His recommendation is expected to be published in the spring of 2016.

**Country-by-country reporting for groups**

The Government will send for public consultation, a proposal for implementing country-by-country (CbC) reporting into Norwegian domestic law. The proposal reflects the recommendations issued by OECD BEPS report Action 13.

Although this proposal has yet to be published for public consultation, it is likely that the first reporting should be done in 2018 based on figures for 2016. This is because the reporting standard is widely accepted by OECD countries, and Norwegian policy makers are likely to follow suit.

Multinationals will, according the OECD's proposal, be obligated to publish a CbC report which shows the allocation of tax and income across the separate entities in the group. The reporting standard shall apply to groups with annual consolidated revenues of €750 million or more.

The CbC report shall be submitted in the jurisdiction where the group’s ultimate parent company is resident. Further, the report
may be shared between different jurisdictions through the automatic exchange of information.

**Cross-border share income**
The Government has considered the Scheel Committee’s proposed changes to the participation exemption method, the Norwegian shareholder model, CFC rules and withholding tax on dividends.

**The participation exemption**
The Scheel Committee proposes a transition from applying the participation exemption on inbound dividends to allowing tax credits for corporate income tax paid abroad may increase equality, but believes the participation exemption should not be replaced because a transition will complicate the Norwegian tax code. However, the Government will monitor any developments under EEA law and consider potential restrictions in the participation exemption on an ongoing basis.

Meanwhile, the Government agrees that the rules for assessing whether a foreign entity is similar to a Norwegian entity should be simplified. The Government will therefore examine whether companies with limited liability owners should be covered by the participation exemption. Additionally, the Government will assess whether the requirements relating to both ownership percentages and ownership periods outside of the EEA should be repealed.

**CFC rules**
The Government acknowledges that the current Norwegian CFC rules are far-reaching and that it may be time to reevaluate the existing legal framework. Amendments and simplifications will be considered, including the proposal to increase the CFC threshold from 2/3 to 3/4 of the Norwegian effective tax rate. The Government also questions whether the current distinction between active and passive income is relevant.

**VAT on financial transactions**
The Government proposes to introduce indirect taxes within the finance sector, including VAT on various charges and fees – so-called specific consideration. However, note that there are still many unresolved issues in the Government’s proposal. These changes will be proposed in connection with the 2017 Fiscal Budget at the earliest.

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**Endnote**

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