Better Taxation – A Tax Reform for Transformation and Growth

An unofficial English translation of the summary chapter, Chapter 1, of the Report to the Storting No. 4 (2015–2016).

1.1 Tax reform for transformation and growth

Tax is a means, rather than an aim. The Government will use the system of direct and indirect taxes to finance collective benefits, ensure social mobility, achieve more efficient resource use and secure better conditions for Norwegian trade and industry. Private ownership is to be strengthened, and it must become more profitable to work, save and invest.

The main role of taxes is to fund public goods and services in the most efficient manner. Moreover, the Government plans to reduce the level of direct and indirect taxes to boost production and give families and individuals greater freedom. Direct and indirect taxes must also stimulate more environmentally friendly behaviour. Improvements to the tax system are thus a key aspect of the Government's economic policy, and one of the most important instruments for increasing productivity.

The Norwegian economy needs to undergo readjustments following many years of strong growth in demand from the petroleum industry. The mainland economy must over time make larger contributions to the financing of the increasing expenditures on pensions, health and care services. Accordingly, it is vital that the tax system does not unnecessarily weaken incentives to save, invest and work. Tax reforms with positive dynamic effects will ease the transformation process.

Since the 1992 tax reform, Norway has had a stable and well-functioning tax system with broad tax bases, relatively low rates and a high degree of equal treatment of different investments, financing forms and organisational forms. This has helped to give the business community predictable and favourable framework conditions. The Norwegian tax system must therefore continue to be based on the guiding principles of equal treatment, broad tax bases and low tax rates.

However, the tax system must be adjusted to new developments. Tax bases have become more mobile as a result of increased trade and closer market integration. This is particularly true in the case of corporate taxation. Internationally, the trend is towards lower corporate tax rates, accompanied by measures to prevent the erosion of tax bases. In the years ahead, Norway must therefore be given a robust tax system that is adapted to high international tax base mobility.

The Tax Commission was appointed to evaluate corporate taxation in light of international developments; see Official Norwegian Report (NOU) 2014:13 *Capital Taxation in an International Economy*. The Tax Commission concludes that, broadly speaking, Norway has a robust tax system, and recommends the retention of the principles underpinning the 1992 tax reform. The Commission's main proposal is to reduce the corporate tax rate from 27 per cent to 20 per cent and to cut the tax rate on ordinary personal income correspondingly. The Commission proposes that the majority of the revenue loss should be recovered through the introduction of a new progressive tax on personal income that replaces the current surtax. In order to avoid making it more profitable to transform labour income into dividends (income shifting), the Commission proposes an increase in the dividend tax for personal shareholders. The Commission also proposes other changes to corporate and personal taxation and value added tax.

Overall, the Commission's proposals entail a shifting of the tax burden from corporate tax, tax on savings and tax on work to taxes on consumption and property, among other things. This is consistent with international recommendations, including from the OECD, for developing a more efficient, growth-enhancing tax system. Several of the proposals imply the expansion of tax bases and reductions in rates. These steps will help to reduce the overall socioeconomic costs of tax collection.

The Government is of the view that The Tax Commission's report provides a good starting point for proposing a tax reform with positive dynamic effects. As the Commission points out, reductions in tax on the ordinary income of companies and persons will have positive dynamic effects through increased investment, increased labour supply and increased saving. This in turn will promote higher labour productivity, higher real wages and higher returns on real capital.

The Government recommends reducing the corporate tax rate to 22 per cent during the three-year period 2016–2018. Additional reductions will be considered in the light of the further international developments. The Government also proposes changes in the personal taxation, giving broad tax cut on labour income. Tax base expansion will facilitate further cuts in tax rates, and thus reinforce the positive dynamic effects of the reform when combined with broad tax reductions.

The Tax Commission has described one revenue-neutral alternative and one alternative entailing NOK 15 billion in tax reductions. To support the objective of boosting economic growth, facilitating transformation and creating new jobs, the Government wishes to implement a tax reform involving net tax reductions. The Government's reform proposal for the three-year period 2016–2018 entails total tax reductions of NOK 13.8 billion.

1.2 Challenges, objectives and principles

1.2.1 The need to address future challenges

Several factors indicate that, given normal cyclical circumstances, potential economic growth in the years ahead will not be as high as in recent decades. Over the past 40 years, Norway has developed a petroleum industry whose demand for goods and services has helped to boost mainland economic growth. Going forward, this demand is expected to decline as a proportion of mainland economic output. Lower demand from the petroleum industry will force numerous businesses currently supplying the Norwegian continental shelf to turn to new markets.

At the same, productivity growth has been low since the mid-2000s, and must rise again if living standards are to continue rising at the pace seen in recent decades. Moreover, an aging population may reduce economic growth somewhat through lower labour supply. The objectives of transformation, increased productivity and higher labour supply are all arguments in favour of reductions in the taxation of company profits, capital and work, and higher taxes on consumption.

Norway has gradually developed even closer ties with other countries through trade, labour migration and capital flows. These factors have also altered the impact of taxes on corporate investment, financing and ownership. The opportunities for both legal and illegal cross-border tax planning have increased, and there are strong indications that taxpayers are exploiting these opportunities to a greater extent than before.

The Tax Commission points out that several tax bases are more mobile than before. Not only are both companies and persons more mobile in physical terms, but the increased digitalisation of the economy is also reducing the relevance of physical presence. Further, the EEA Agreement has made such cross-border transactions easier to implement within the EEA. However, the agreement limits Norway’s opportunities to enact measures to counteract profit shifting. Although increased mobility is favourable for production, it represents a challenge in the context of taxation.

Internationally, there is discussion of how national and international tax rules should be adjusted to protect the corporate tax base and counter the shifting of profits to low-tax countries, primarily through the legal exploitation of current rules. Studies indicate that the taxable profits of multinational companies do not correspond to their production levels and actual earnings.

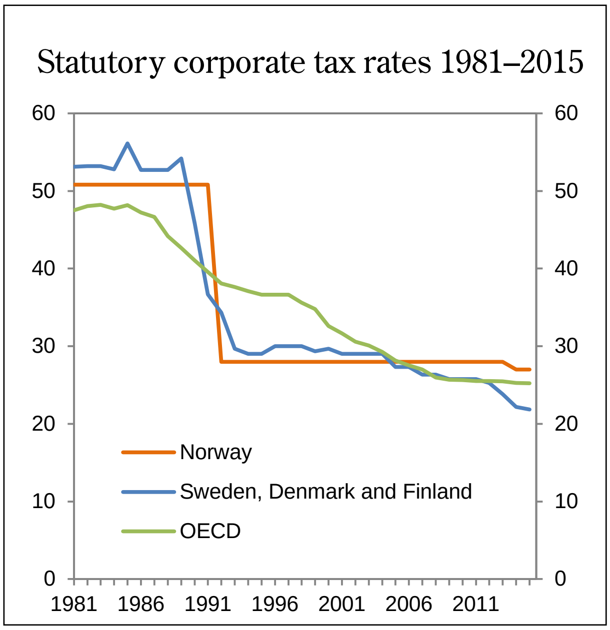

Figure 1 Statutory corporate tax rates in selected countries, 1981 – 2015. Percent

Sources: OECD and The Norwegian Ministry of Finance

The Tax Commission has also pointed out that corporate taxation is changing in many countries. The average corporate tax rate in the OECD area has fallen from almost 50 per cent in the early 1980s to around 25 per cent today (see Figure 1). However, revenues from corporate taxation in proportion to the economy's total production have remained unchanged over same period. Several countries have also implemented special cuts in the tax rate for selected types of income, such as profits on certain intangible assets (patent boxes). At the same time, ever more countries are introducing rules to counter the shifting of profits and erosion of the corporate tax base. For example, many countries are limiting the deductibility of interest expenses.

The Commission emphasises three primary challenges relating to corporate taxation:

- A relatively high corporate tax rate gives incentives to invest in countries with lower tax rates.
- Debt and equity are treated differently, since costs of debt financing (interest) are deductible, whereas costs of equity financing are not.
- A relatively high tax rate gives multinational enterprises incentives to shift profits to other countries.

Many factors influence the level of investment in Norway, including access to skilled labour and natural resources, the low level of corruption and the stable political system. Investments are also impacted by the tax level. It would be particularly unfortunate if the corporate tax level were to differ substantially from the tax levels in countries that are otherwise comparable to Norway.

In the Government's opinion, it is therefore sensible to reduce the corporate tax level in Norway to around the levels applied in comparable countries. At the same time, the Government does not want Norway to take the lead in an international race to the bottom with regard to corporate taxation. The level of taxes in Sweden and Denmark is particularly relevant, since these countries are close to Norway both socially and geographically. The effective tax rates on investments – which take into account both tax rates and tax bases – are relatively high in Norway compared to these two countries.

1.2.2 Improved conditions for business activity and private Norwegian ownership

If Norway is to offer good conditions for business activity, the total taxation of capital cannot be too high compared to other countries. The taxation of companies and shareholders, and of capital income and capital stocks, should therefore be considered together. A lower corporate tax rate will cut capital costs and make investing in Norway more attractive. This will promote higher labour productivity, higher real wages and higher returns on real capital, and thereby make an important contribution to transformation and growth.

Unlike most other countries, Norway levies a net wealth tax that increases the overall capital tax burden. The net wealth tax has several weaknesses. It undermines incentives to save, and the skewed valuation of different assets distorts saving away from business activity to residential property. This reduces the total return on savings, and the level of total saving falls. The net wealth tax restricts access to investment capital for entrepreneurs in need of Norwegian equity to finance their investments. Accordingly, the net wealth tax may cause the cancellation of projects that would otherwise be beneficial to society and create new jobs. Moreover, Norwegian owners have to pay net wealth tax on the value of their businesses even if these have not produced a return or profit in the tax year in question. This can present liquidity challenges. The net wealth tax also makes it more difficult to keep businesses in Norwegian hands, since it is only levied on Norwegian owners.

The overall tax burden on owners must be considered in a broader context. Under the Government's proposal, income taxation of Norwegian private owners will remain largely unchanged, while broad reductions are proposed for other taxpayers. To strengthen Norwegian private ownership, the Government wishes to reduce the net wealth tax further in the years ahead. The Government also intends to present an evaluation of targeted tax reductions for commercial capital at a later date.

1.2.3 Continuation of the principles underpinning the 1992 tax reform

Since the 1992 tax reform, Norway's tax system has been based on the principles of broad tax bases, low rates, equal treatment and symmetrical treatment of revenues and costs. The Government is of the opinion that these principles should still be fundamental in the Norwegian tax system. Like the Commission, the Government considers that Norway's tax system is generally robust, but that there is a need for adjustment in light of international developments.

It is vital that capital taxation is given as neutral a design as possible. Among other things, this means treating different investments, industries, organisational forms and funding types as equally as possible. This will help ensure that saving and investment decisions are made as free of tax considerations as possible. Norwegian capital taxation is based on the following principles:

- *Neutrality*. Different forms of ownership, forms of saving and investments should be treated equally.
- *Symmetry*. Revenues and associated costs should be treated equally.
- *Continuity*. The tax position of capital should not be altered in the event of inheritance, gift, merger, etc.
- *Coordination*. The equalisation of profits over time and between different enterprises. For example, losses should be deductible from profits.
- *Low tax rates*. This will reduce efficiency losses from taxation and make tax avoidance and tax planning less profitable.
- *Broad tax bases* that correspond to actual income. This promotes efficient use of resources.

The Tax Commission is of the view that capital taxation should apply the *residence principle*. The residence principle states that capital income must be taxed under the rules and rates applicable in the home country of the capital owner, irrespective of where the capital is invested. When applied consistently, the residence principle prevents capital taxation from making it more profitable to invest abroad than in Norway. The Government also considers that this factor should be given great weight, and that capital taxation should therefore primarily be based on the residence principle.

Emphasis must also be given to *predictability* in the context of corporate and capital taxation. A lack of stability may impact corporate investment in an undesirable manner, and weaken production. Stability and predictability require a tax system that is based on general, consistent principles with as few exceptions as possible. Moreover, it is important that the guiding principles for Norway's tax policy in the following years are based on parliamentary support, as in the case of the 1992 and 2006 tax reforms. Broad support for a robust, efficient tax system ready to meet the challenges likely to arise in the years ahead is desirable. Accordingly, the Government would invite the Storting to consider the future of the tax system, on the basis of this white paper on follow-up of the Tax Commission's report as its starting point.

1.3 The Government's proposals

1.3.1 Choice of corporate tax system

The Tax Commission considers alternatives to the current corporate tax model. These alternative models have in common that corporate debt and equity are treated equally, in full or in part. One category of models allows deduction of the financing costs for both debt and equity, while the second category does not permit deduction of interest. However, the models have different impacts on the profitability of investments and the incentives to shift profits out of Norway. The Commission points out that one way of strengthening investment incentives further is to adopt a so-called ACE model, which also grants deductions for the cost of equity. All of the alternative models are difficult to integrate with personal taxation. The Commission therefore recommends that the current corporate taxation model be retained.

The Commission identifies a risk of a drop in investment levels if, over time, the effective tax rates are significantly higher than in countries which are otherwise fairly similar to Norway. To bring the effective tax rates closer to the levels in Norway's closest neighbours, the Commission majority proposes cutting the tax rate to 20 per cent. The Commission recommends taxing capital income for companies and individuals equally to avoid tax planning, and therefore suggests reducing the tax rate on ordinary personal income from 27 per cent to 20 per cent.

Although some of the alternative corporate taxation models have attractive characteristics, as stated above they are also difficult to integrate with personal taxation, and may introduce opportunities for tax planning. The Government therefore supports the view that the current corporate taxation model should be retained. The Government recommends a reduction in the corporate tax rate to 22 per cent over the period 2016–2018. Further reductions should be considered in light of international developments. Finland, Iceland and the United Kingdom all have a tax rate of 20 per cent, while Sweden's rate is 22 per cent (see Figure 2). Denmark plans to reduce its rate to 22 per cent. The effective tax rates in Sweden and Denmark are lower for certain investments due to generous depreciation rules. The Government has already proposed a substantial cut in the corporate tax rate in its 2016 budget. The rate of tax on ordinary income for both individuals and companies will be cut from 27 per cent to 25 per cent.

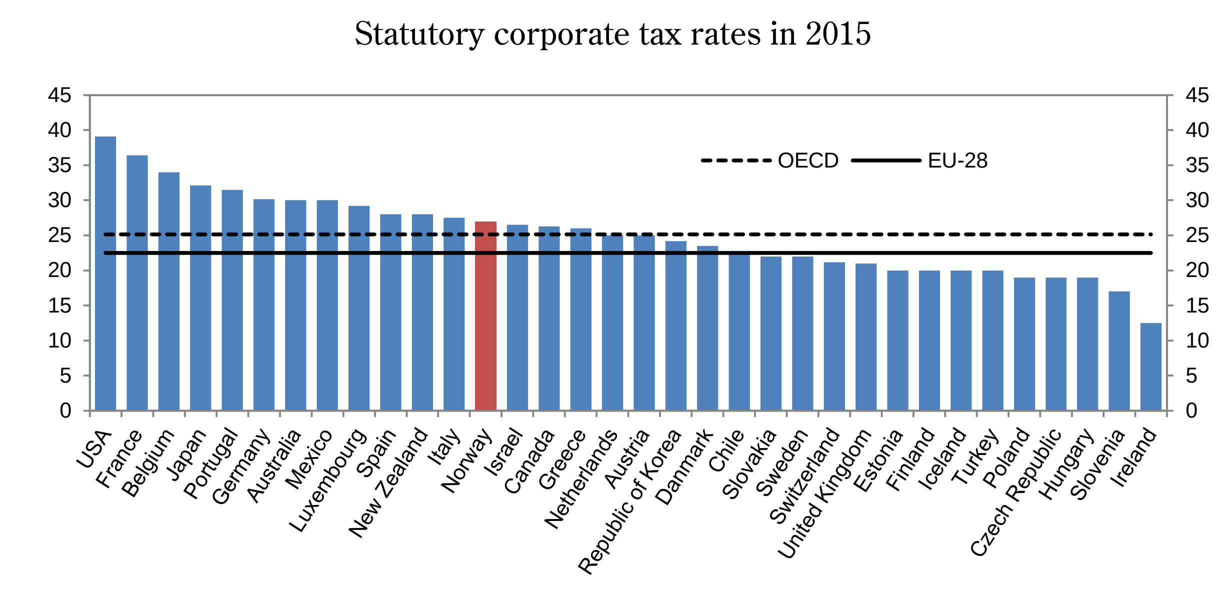

Figure 2 Statutory corporate tax rates in 2015. Per cent

Sources: OECD and KPMG Corporate Tax Rate Survey.

In the Government's view, there are good reasons for broadening the tax bases to compensate for some of the revenue loss resulting from a reduced corporate tax rate. Several specific expansions of the corporate tax based are proposed, which in turn gives room to reducing the tax rate. The proposals will also curb profit shifting and give incentives to a more effective use of resources.

In an open economy with mobile tax bases, it is particularly important to protect revenues from taxes on economic rents on immobile natural resources. This suggests that the overall taxation of industries with economic rent should not be reduced as a result of cuts in the corporate tax rate. In isolation, reduced corporate taxes will entail lower taxation of industries with economic rent, which is not desirable. The Government therefore recommends combining lower corporate tax rates with an adjustment of the tax on economic rents. In 2016 the Government proposes a 2 percentage points increase in the tax rate on economic rents for the oil & gas and the hydropower industries, which gives a certain loss in revenue. When the corporate tax rate is further reduced, the taxation of economic rents should be adjusted so that the total revenue from industries with economic rents is not further reduced.

1.3.2 Changes in personal income taxation

The Government is of the opinion that, in principle, the tax rates on ordinary income should be the same for personal and corporate tax payers. This view underpins both the changes in the Amendment to the Budget 2014 and the Government's tax proposal for 2016.

A special, lower corporate rate would create incentives to save tax by earning capital income at a low rate in a company and deducting capital expenditures at a high rate in the personal tax return. This can be achieved by shifting existing debt and equity between the personal and corporate sector. Taxpayers could also exploit a tax rate differential through new tax-motivated tax planning. The tax system should not encourage such arrangements. Since the 1992 tax reform, the tax system has featured a common tax rate on ordinary income. This has produced a simple, uncomplicated system and limited the opportunities for personal-corporate tax planning.

A further disadvantage of a special, lower corporate tax rate is that it would promote differential treatment of different organisational forms. This is because sole proprietorships and partnerships cannot automatically be granted the same tax reduction as limited liability companies. Moreover, a lower tax rate on ordinary income for personal tax payers will also have positive effects on the Norwegian economy by making it more profitable to save and work. Higher saving and increased labour supply will make the economy more productive, and thereby boost tax revenue over time.

A lower tax rate on ordinary income will result in a substantial revenue loss within the personal taxation. Tax Commission proposes recovering the majority of this revenue loss by introducing a new progressive tax on (gross) personal income that replaces the current surtax.

Some consultation parties have pointed out that an increased emphasis on gross taxation may be undesirable from an ability to pay perspective. However, several factors indicate that this is not a major problem. At present, considerable deductions from ordinary income are already granted. These often far exceed the real expenses incurred in earning income (e.g. the minimum deduction and the agricultural deduction), or have a weak link with the associated income (e.g. the interest deduction and various special deductions). Further, the lowest incomes are for the most part not affected by higher tax on personal income.

The Government recommends that the tax on personal income is designed such that the tax on labour is reduced for most tax payers. In its 2016 budget, the Government proposes replacing the current surtax with a new progressive gross tax incorporating four brackets (the bracket tax), where the upper two brackets correspond to the present surtax. Under the Government's proposal the total marginal tax rate in 2016 will be reduced by 0.4 percentage points for a majority of personal tax payers. This will stimulate labour supply and grant tax reductions to broad groups of tax payers. Over the two-year period 2017–2018, the Government proposes to reduce the marginal rate on personal income further, by 0.4 percentage points for most wage earners.

Broadening the income tax base allows for lower tax rates and makes the system less complicated. This will stimulate higher labour force participation and reduce bureaucracy. Although pure efficiency considerations indicate that deductions and special arrangements should be limited, several of these serve specific purposes. In many cases, it would be more effective to give direct support through the expenditure side of the budget. The Government considers that, in the context of a major tax reform with tax reductions to broad groups, it is appropriate to review different deductions and special arrangements in the personal taxation system. A broad tax base can facilitate further reductions in the marginal tax rate on personal income.

Reducing the corporate tax rate will also reduce the overall tax levied on dividends, and thus in isolation making it more profitable to convert labour income into dividends (income shifting). The Commission takes the view that the tax levied on dividends exceeding the allowance for shareholder equity should be increased. The Commission proposes making dividends a separate tax base subject to a separate tax rate.

The current tax system is characterised by a low, flat tax on capital income and corporate income and a higher, progressive tax on pension and labour income. The shareholder model, which implies that shareholders are taxed on ownership income exceeding the allowance for shareholder equity, is designed to reduce the motivation to engage in income shifting and thereby make the tax system more redistributive. The Government regards it as important that the tax system is seen as legitimate, and that excessive motivation to engage in income shifting therefore should be avoided. If the marginal tax rates on dividends and wage income differ, it will be profitable for persons to convert labour income into dividends.

The Bondevik II Government's white paper on tax reform emphasised, among other things, that broad acceptance of the tax system depends on equal tax treatment of labour income, irrespective of whether the income is earned by an employee, an active owner of a limited liability company or a self-employed person; see Report to the Storting No. 29 (2003–2004). This white paper, which was based on the recommendations of the Skauge Commission (NOU 2003: 9), paved the way for the 2006 tax reform, which introduced the current shareholder model with a tax on dividends exceeding the allowance for shareholder equity and lower tax rates on labour income. The Bondevik II Government also pointed out weaknesses in the net wealth tax, and expressed that it wanted to reduce it before eventually removing it. Implementation of this tax switch was interrupted by the Stoltenberg II Government, which chose to maintain the net wealth tax.

The incentive to engage in income shifting is determned by the difference between the marginal tax on wage income including employer's social security contributions and the marginal tax on dividends including corporate tax. Since the 2006 reform, an aim has been to ensure that the maximum marginal tax on wage income including employer's social security contributions does not exceed the marginal tax on dividends including corporate tax by too much. The tax rate differential is currently 7 percentage points (see Figure 3), whereas it was 6.1 percentage points from 2006 to 2013. A lower tax rate on ordinary income for persons and companies will increase the rate differential because dividends will benefit from the tax rate reduction twice, i.e. both at the corporate level and upon distribution/realisation. Even if the marginal tax on labour is reduced somewhat, it will be necessary to raise the dividend tax levied on shareholders. Tax Commission proposes to completely eliminate the difference between the marginal tax on dividends and wage income.

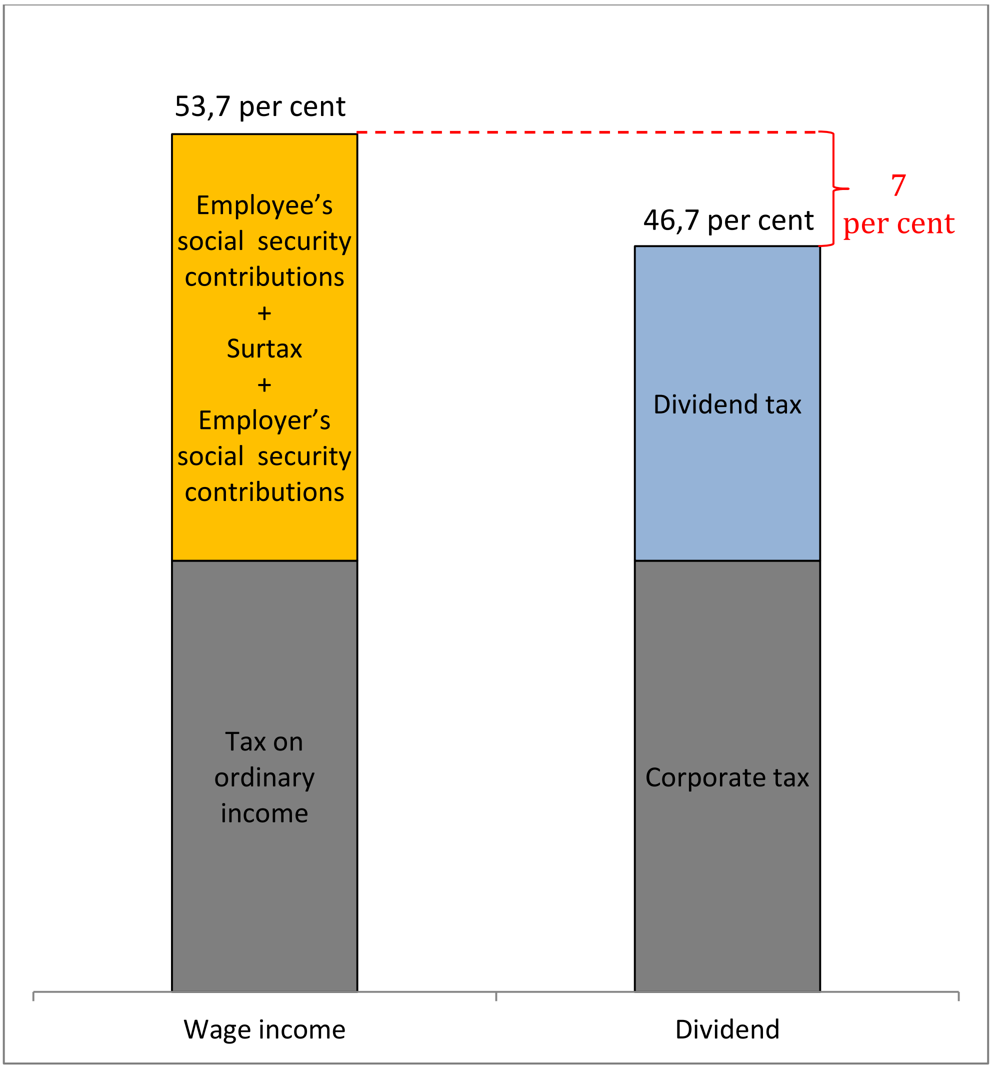

Figure 3 Top marginal tax rates on wage income and dividends

Source: The Norwegian Ministry of Finance

An increase in dividend tax also has disadvantages. These include the motivation to avoid the dividend tax and the motivation to emigrate from Norway. The Government does not intend to increase the overall tax level faced by Norwegian owners as proposed by the Commission. An increase in the tax rate on dividends which follows from the reduced corporate tax rate will by itself reduce the tax levied on owners on new profits. This is because part of the dividend is shielded against dividend tax, whereas the company's profits are taxed in full.

The Government proposes that the marginal tax rate on dividends including corporate tax should be kept at approximately the current level. Given a corporate tax level of 22 per cent, this implies a dividend tax levied on shareholders of just below 32 per cent by 2018. This reflects the changes proposed in the National Budget 2016. A lower marginal rate of tax on wage income will reduce the motivation to engage in income shifting compared to the present situation.

1.3.3 Sole proprietorships and the treatment of different organisational forms

The owners of sole proprietorships are taxed on a recurrent basis on both their business income and other income (the self-employed model). The Tax Commission did not discuss the taxation of sole proprietorships separately, although the Commission's proposed changes to personal taxation will impact this group as well. First, the reduction in the rate of tax on ordinary income for individuals will also apply to owners of sole proprietorships. Second, a new gross tax introduced to replace the current surtax will also apply to calculated personal income under the self-employed model.

Self-employed persons who operate sole proprietorships currently pay less tax than employed persons (see Figure 4). At medium and higher income levels, self-employed persons pay tax at approximately the same level as owners of limited liability companies. The Commission's proposals would result in higher marginal tax for shareholders than self-employed persons operating sole proprietorships. In the Government's view, substantial differences between sole proprietorships and corresponding limited liability companies are undesirable. As stated, the Government is of the opinion that the dividend tax must be increased, but also that the disadvantages of a tax increase may indicate that the tax should be increased by less than proposed by the Commission. Under certain circumstances, this will also promote more equal treatment of enterprises organised as companies and sole proprietorships, particularly where such enterprises are labour-intensive.

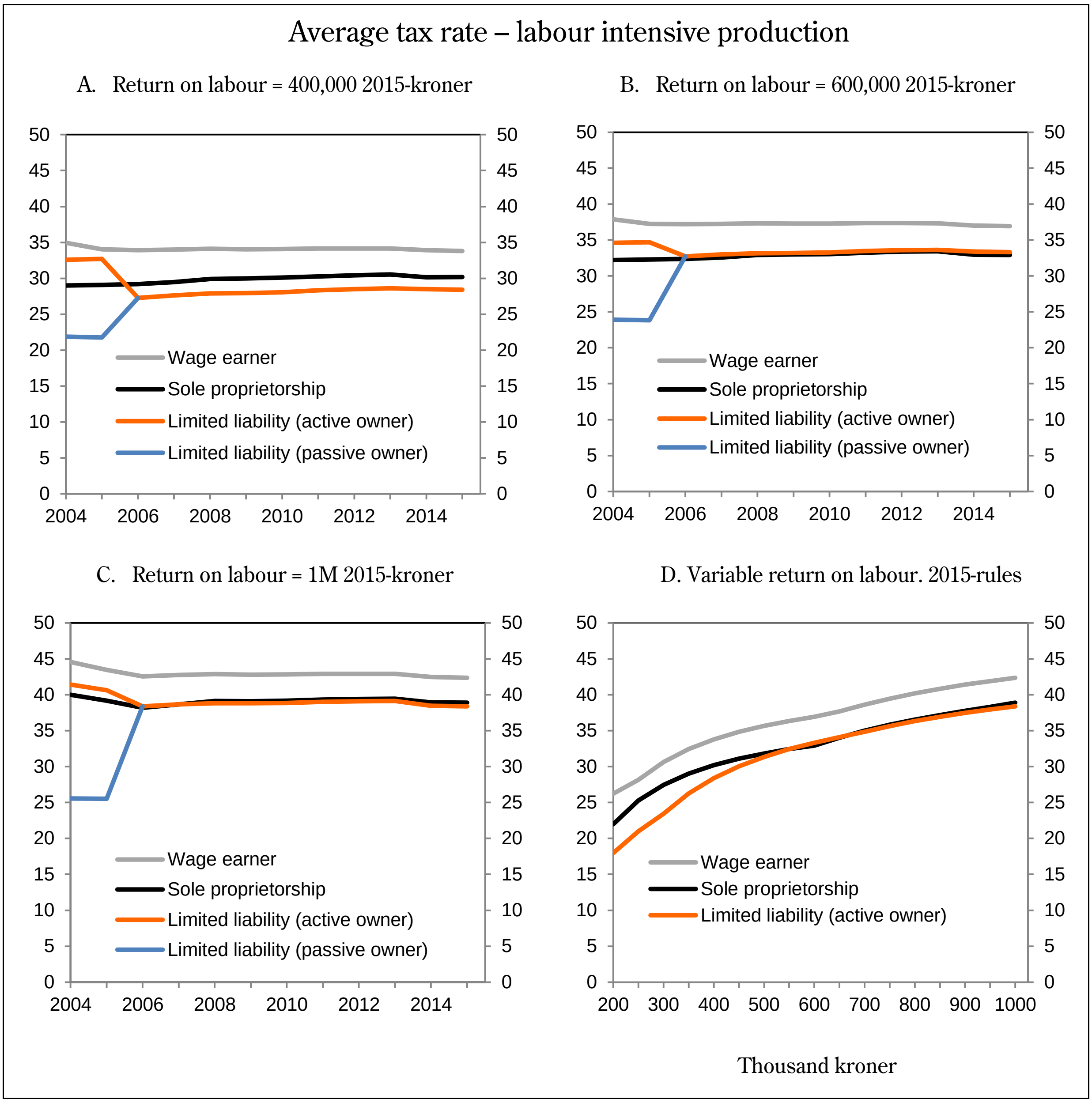

Figure 4 Estimated average tax rate for different business organisations. Labour intensive production without real capital and employees. Per cent

Source: Ministry of Finance.

1.3.4 Measures to counteract profit shifting

Multinational groups of companies can shift profits earned in Norway to countries with lower tax rates. This is typically done through incorrect pricing of cross-border transactions between group companies, for example interest deductions and payments for intellectual property rights. In principle, goods and services passing between companies in the same group must be priced on market terms, i.e. in accordance with the so-called arm's length principle that Norway generally applies both domestically and in Tax Treaties. In some contexts, however, the arm's length principle is difficult to apply correctly. The current application of the arm's length principle may also in itself offer opportunities for profit shifting in certain areas, for example through interest deductions.

Profit shifting was an important reason for the appointment of the Tax Commission. A lowering of the corporate tax rate will make profit shifting less profitable, but will not solve the problem entirely. Profit shifting erodes the tax base and reduces the central government's tax revenues. Moreover, profit shifting distorts competition to the disadvantage of national companies, who become subject to higher effective taxation than multinationals. Over time, this will weaken the legitimacy of corporate tax. The Government therefore considers it important to take steps to counter profit shifting wherever possible. Many of the Tax Commission's proposals in this area should therefore be implemented. However, the scope for introducing effective anti-profit shifting measures may be restricted by Norway's international obligations.

The Tax Commission proposes introducing a withholding tax on interest payments, payments for the use of intellectual property rights (royalties) and lease payments relating to certain tangible assets. The Ministry of Finance anticipates that levying withholding tax on such payments will be an effective means of preventing multinationals from transferring profits through disproportionately large loans or tax-motivated pricing of internal transactions. Norway is one of few countries that do not levy such withholding tax in domestic law. Most countries have national law and provisions in tax treaties to alleviate any double taxation that may arise. These may mean that withholding tax does not increase the overall tax burden, but simply allocates the taxing rights between the countries. The Government recommends the introduction of withholding tax on interest and royalty payments, and intends to circulate a proposal for consultation.

The majority of the Tax Commission also proposes that the opportunity for companies to make interest deductions should be restricted. Among other things, it has been proposed that the interest deduction limitation should cover all interest, i.e. also interest paid to independent lenders. The Government agrees with the Commission majority that the interest deduction limitation rule should be made stricter. In its 2016 budget, the Government has therefore proposed that the rule's deduction limit should be reduced from 30 per cent to 25 per cent. The Government also agrees with the Commission majority that, in principle, the rule should become stricter so that it also covers profit shifting through interest payments to independent lenders (external interest). This is conditional upon a satisfactory solution being found to prevent the elimination of a deduction in respect of real interest. This autumn, the OECD will publish recommendations on national interest deduction limitation rules. These recommendations are likely to provide for the exclusion of external interest, but simultaneously to provide that groups should be permitted to deduct their total (global) interest costs to independent third parties. Any global rule will require further study.

The Commission also proposes a number of other anti-profit shifting measures, including the introduction of a statutory general anti-avoidance rule that permits the authorities to set aside tax-motivated transactions that conflict with the purpose of the rules. The Ministry of Finance intends to follow up on this proposal, and has therefore launched an external study to examine it. In line with the Commission's recommendation, the Ministry also sees good reasons for tightening up the Tax Act's definition of «residence» with respect to companies. This will help to prevent companies from becoming "homeless" and thus avoiding full taxation in any country. The Ministry intends to circulate a proposal for consultation. The OECD countries have agreed to introduce country-by-country reporting by multinational groups to the tax authorities. The Ministry will follow up this agreement by circulating for consultation a proposal on implementation in Norwegian law.

1.3.5 Cross-border income from equity

The Tax Commission has discussed the need for a change in the taxation of cross-border income from equity. In this connection, it is pointed out that it is, in principle, desirable for the residence principle to be applied consistently. Consistent application of the residence principle when taxing income from equity would require the ongoing taxation of Norwegian shareholders in respect of revenues earned by foreign companies. Although this appears rather unrealistic, there may nevertheless be reason to consider changes in the taxation of cross-border income from equity to ensure more equal treatment of Norwegian owners' investments at home and abroad. The objectives of reducing opportunities for profit shifting and the erosion of the tax base also suggest that the rules should be made stricter. However, this must be weighed against administrative considerations. In addition, the scope for stricter rules is limited by Norway's international obligations, primarily under the EEA Agreement.

The Commission has proposed certain changes to the exemption method, the shareholder model and the NOKUS rules. As regards the exemption method, the Ministry of Finance agrees with the Commission that it is important to have rules to prevent income earned in low-tax countries from being channelled through companies in EEA countries. The Ministry therefore intends to monitor developments in EEA law and evaluate Norway's regulatory framework on an ongoing basis

The Ministry will also evaluate the NOKUS rules more thoroughly. This review will include an examination of whether the current distinction between active and passive income is appropriate.

The Commission also proposes repealing the rules on withholding tax on dividends distributed to shareholders resident in normal-tax countries. The reason given for the proposal is that it may have a positive effect on investment in Norway. However, in the Ministry of Finance's view it is important for Norway to have regulations to prevent, wherever possible, Norway from being used as a conduit country for profit shifting. The current rules governing withholding tax on dividends allow specific types of tax planning to be countered. The Ministry therefore considers that the current rules on withholding tax on dividends should be retained.

1.3.6 Depreciation

The depreciation rates for tax purposes applicable to businesses should generally correspond to the economic depreciation of the assets. Rates that depart significantly from economic depreciation will skew investment, both between different assets and between different industries. Although higher depreciation rates can improve post-tax profitability for those who benefit, excessively high depreciation rates will reduce the overall return and competitiveness of the economy.

The Government gave the Tax Commission a supplementary mandate asking it to review the system of depreciation for tax purposes. The Commission proposes retaining declining balance depreciation as the general rule for depreciation for tax purposes. The declining balance system is well established, and has significant administrative advantages over, for example, straight line depreciation.

The Commission points out that actual depreciation varies substantially between different types of assets. It is impossible to implement a system under which depreciation rates correspond to actual economic depreciation for every single asset. In practice, therefore, certain simplifications are necessary.

The information available on economic depreciation is deficient. It is also uncertain. The Commission considers empirical studies of economic life and certain other sources of information. Its review indicates that some depreciation rates in the Norwegian tax system are probably too high. Based on the available information, the Commission proposes, among other things, reversing the supplementary initial depreciation of 10 per cent for asset group d (machinery, etc.) and reducing the depreciation rate for asset group e (ships, rigs, etc.) from 14 per cent to 10 per cent.

Most of the parties that have submitted consultation comments support the basic principle that depreciation rates should be based on actual economic depreciation. However, views differ regarding the actual depreciation of different assets.

The Government wishes to reduce the level of taxes and strengthen the growth potential of the economy. Depreciation rates that deviate markedly from economic depreciation will result in bad investments. This will reduce the overall return on investment. High depreciation rates only benefit certain capital-intensive industries. Industries where enterprises have few depreciable assets will not benefit from high depreciation rates. Given that the aim is to strengthen the growth potential of the economy, tax reductions should take the form of general lower tax rates, rather than selective reliefs through depreciation rates.

Although great uncertainty attaches to estimates of economic depreciation, the Tax Commission finds that the difference between actual depreciation and the rates for certain groups is so large that changes should be made. The Government proposes the implementation of most of the Commission's suggested changes to depreciation rates. Among other things, the supplementary initial depreciation for machinery should be reversed in 2017, and the depreciation rate for ships and certain types of buildings should be reduced. However, the objectives of simplicity and feasibility may indicate that asset groups should not be split up. Not least for this reason, the Government proposes somewhat less detailed rules than suggested by the Tax Commission.

1.3.7 Taxation of the financial sector

In principle, the financial sector is taxed like any other business activity. One important exception is that financial services are exempt from value added tax. The revenue loss resulting from the exemption has been estimated on an uncertain basis at around NOK 8 billion in 2014. The Financial Crisis Commission pointed out that the value added tax exemption for financial services has several undesirable aspects; see Official Norwegian Report (NOU) 2011: 1 *Better positioned against financial crises*. The exemption contributes to an undesirable distortion of production and consumption towards financial services, and it breaches the neutrality principle of the value added tax system.

The Tax Commission concludes that the financial sector should generally be taxed in the same way as other industries. If the corporate tax is reduced, this reduction should also apply to the financial sector. On the other hand, the financial sector should not be taxed more lightly than other sectors. The Commission therefore takes the view that further efforts should be made to resolve the problems associated with the current value added tax exemption for financial services. The Commission proposes that the value added tax base should be expanded to encompass financial services provided in return for specific considerations in the form of fees, commission, etc., for example general insurance. Further, tax should also be levied on margin-based income in the financial sector, such as interest margins (the difference between lending and borrowing rates).

Like the Commission, the Government is of the opinion that the financial sector should in principle be taxed like other industries. As the Commission points out, the exemption of financial services from value added tax is undesirable in that it distorts production and consumption towards financial services, away from relatively more expensive, taxed goods and services. Moreover, in contrast to some other countries, the financial sector in Norway is not subject to any special taxes. Countries like France and Denmark have introduced additional taxes on wages or profits in financial undertakings. The reasons given for such additional taxation include the need to compensate for the value added tax exemption. Further, many EU member states levy special taxes on general insurance. Some countries tax financial transactions and 11 EU member states are cooperating with the aim of introducing a common financial transaction tax.

The Government considers that a tax should be introduced on the value added in financial service production. The value added tax based should be expanded to encompass financial services wherever practicable, i.e. to include financial services provided in return for specific considerations. A dedicated tax can be introduced for margin-based income. This tax should preserve as many of the neutrality characteristics of value added tax as possible. Neutral taxation demands a tax base that identifies the value added. This implies that, in principle, the tax base should only include the value added for private customers. Moreover, a neutral tax must allow for the exemption of exported financial services, whereas imports must in principle be taxed.

The Ministry of Finance has previously prepared a draft plan showing how as many as possible of these considerations can be safeguarded, see the bill and draft resolution on direct and indirect taxes and customs duties in 2014 (Prop. 1 LS (2013–2014)). However, a concrete proposal on legislation has yet to be drafted. This will be a difficult task. Although no completely neutral tax can be introduced in the short term, some of the NOK 8 billion tax expense should be recovered from the financial sector. When determining the level, consideration should be given to the scope for preserving neutrality characteristics. Value added tax on services on which fees are payable and a tax on margin-based income should be introduced simultaneously, and no earlier than 2017. A tax on margin-based income with good neutrality characteristics will be an international innovation, and the Ministry would emphasise that its development is demanding.

The Tax Commission states that capital gains and losses should generally be taxed upon realisation. However, in the case of the financial sector, the Commission has concluded that consideration should be given to whether gains and losses on financial instruments in banks should be crystallised annually on the basis of market value. In the Ministry's view, there are no grounds for introducing a special crystallisation principle for financial instruments in banks, etc. The Ministry therefore recommends that the realisation principle should remain the crystallisation rule for gains and losses on financial instruments.

1.3.8 Tax on net wealth and property

The Government gives priority to structuring the tax system so that it contributes to productive framework conditions for private ownership and stimulates innovation and investment in Norway. The net wealth tax has several weaknesses, as identified by the Tax Commission in its report. It undermines incentives to save, and saving is thus reduced. The skewed valuation of different assets plays a part in distorting investment away from business activity. This reduces the total return on savings. Norwegian owners have to pay net wealth tax on the value of their businesses even if these have not produced a return or profit in the tax year in question. This can present liquidity challenges. Net wealth tax may cause investors dependent on Norwegian equity funding to cancel projects that would otherwise be beneficial to society and create new jobs. Net wealth tax also makes it more difficult to keep businesses in Norwegian hands, since it is only levied on Norwegian owners.

The negative effects of the net wealth tax have been reduced by the changes made in the past two years, and will be reduced further through the proposals in the 2016 budget. The Government considers that the problematic aspects of net wealth tax imply that it should be cut further. The Government also intends to assess how reductions in the net wealth tax to a greater extent can benefit business capital.

The Tax Commission proposes a strong increase in the valuation of primary residences, from the current 25 per cent to 80 per cent. This would make net wealth tax payable on very many normal residential properties. The Government does not wish to increase taxes on people’s homes, and will therefore retain the current low valuation of primary residences.

1.3.9 Value added tax

The Tax Commission takes the view that the sole purpose of value added tax should be to generate revenue for the State. The Commission points out that the current value added tax system, with its reduced rates, exceptions and exemptions, influences the composition of production and consumption. Moreover, reduced rates, exceptions and exemptions create delimitations that impose substantial administrative costs on businesses and the tax authorities. The Commission has stated that the value added tax system is largely unsuited to safeguarding distributional preferences, supporting individual groups, influencing the composition of consumption, etc.

The Commission proposes a dual-rate value added tax system in which the standard rate of 25 per cent is retained but the current zero rate on domestic sales and the lowest rate of 8 per cent are increased to 15 per cent, corresponding to the current rate on food. The Government shares the Commission’s view that the purpose of value added tax should be to generate revenue for the State. The most effective way of achieving this at the lowest possible administrative cost is to have a simple system with as few exceptions as possible. The Government would point out that several processes are currently ongoing with respect to goods and services subject to the zero rate. These include electric cars, where ESA (EFTA Surveillance Authority) has approved the zero rate for electric cars, electric car batteries and electric car leasing agreements until 2017. Work is also continuing on the planned introduction of an exemption or reduced valued added tax rate for electronic news services. Accordingly, the Government does not wish to propose reversal of the zero rates at this time.

The reduced rate of 8 per cent applies to certain services such as passenger transport, accommodation, cinemas, public service broadcasting, museum entry, amusement parks and large sporting events. The low rate means that the taxpayer is only required to charge 8 per cent value added tax on sales, but still receives a deduction in respect of value added tax paid on purchases made for use in the business (generally 25 per cent). In other words, being subject to the low rate is highly beneficial. The 2016 budget proposes an increase of 2 percentage points in the rate, to 10 per cent.

An increase in the low rate may cause some increase in the price charged to consumers for the affected services. A price increase may reduce demand somewhat, and thus activity in the industries in question. However, an increased rate will not influence demand from businesses entitled to deduct value added tax. The same applies to demand from the municipal sector and the public administrative sector, which benefit from arrangements that neutralise value added tax. Overall, the Ministry of Finance is of the view that the negative impact on the affected parties will not be serious, particularly if the rate is escalated gradually.

In the public transport sector, compensation is paid so that price increases are largely avoided. Such compensation must comply with provisions in concluded agreements relating to the public purchase of passenger transport services. This applies to the purchase of passenger transport services from NSB AS (state owned railway company), local public transport (buses, boats and local trains), ferries linking major and minor roads, certain air routes and the purchase of sea transport services on the Bergen – Kirkenes line from Hurtigruten ASA.

The Ministry will also consider the possibility of including additional areas which are currently excluded from the value added tax system, as proposed by the Commission.

1.4 Economic and administrative consequences

In this white paper, the Government outlines a tax system that promotes economic growth, eases transformation and creates new jobs. The Government proposes that the corporate tax rate be reduced to 22 per cent over the three-year period 2016–2018, and that additional reductions be considered in light of developments in other countries. The Government proposes that the total marginal rate of tax on personal income to be reduced by at least 0.8 percentage points over this three-year period. Table 1 gives an overview over the outlined tax reform's effect on government revenue.

Reduced rates and more correct tax bases are the key to optimal use of resources. A broader, more correct tax base offers scope for cutting tax rates. Accordingly, the degree of willingness to expand the tax base and remove tax privileges determines how far the tax rate can be reduced.

Both the Tax Commission and the OECD argues that a shift from corporate taxes, taxes on savings and taxes on labour to other direct and indirect taxes promotes economic growth. The Government agrees that corporate tax as a whole should be reduced, but also sees several good reasons why some of the rate reduction should be funded within the corporate sector. Correspondingly, tax reductions should be granted to broad groups of personal taxpayers, but primarily in the form of cuts in the marginal tax on work and saving. Figure 5 illustrates the distributional effects of the tax reform.

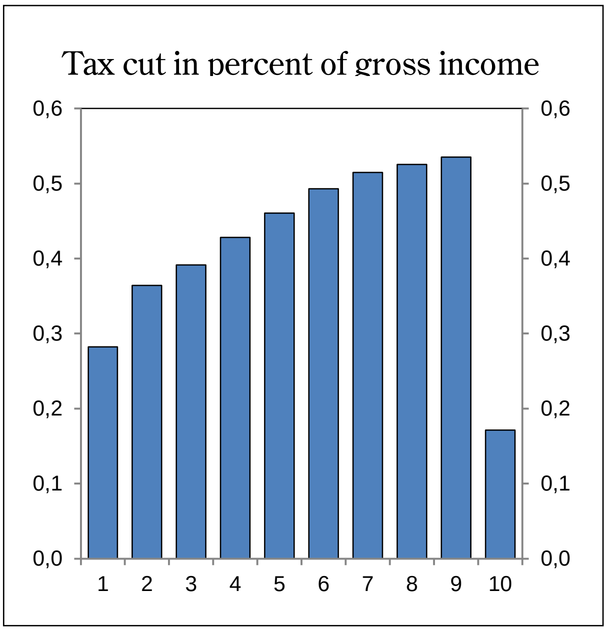

Figure 5. Tax reductions as percentage of gross income for different income brackets (deciles based on equivalent gross income). Personal taxation under the Solberg Government's outlined tax reform[1] compared to the benchmark system for 2016. Per cent

[1]Calculation accounts for lowering of the tax rate on general income for wage earners, raised dividend tax, a new tax on personal income (the bracket tax) and adjustment of tax allowances for pensioners.

Sources: The Norwegian Ministry of Finance and Statistics Norway

The Tax Commission's analyses show that the proposals may have large positive dynamic effects in the longer term. The Commission assumes that between 20 and 40 per cent of the initial revenue loss due to reductions in corporate and capital taxation will be compensated for by increased tax revenues in the longer term. This is because the restructuring is expected to boost investment, saving, and labour supply. The long-term effects of cutting tax on labour are also considerable. An uncertain estimate indicates a self-financing rate of 17 per cent for the Commission's proposed changes to taxation of labour income. This is linked to the anticipated increase in labour supply under the proposals.

The Government proposes that the main structure of the current tax system should be retained. Many of the proposals will therefore have minor administrative impacts.

Table 1 Outlined tax reform 2016–2018. Estimated effects on accrued tax revenue relative to the benchmark system for 2015. Million 2016-kroner

	Tax reform 2016 – 2018	Proposed in the 2016 budget
Reducing the corporate tax rate from 27 to 22 percent	-14,215	-6,115
Additional changes in corporate taxation (depreciation, interest deduction limitation and other measures to counter profit shifting)	3,500	240
Reducing tax on ordinary income for persons from 27 to 22 percent and raising tax on dividends	-53,200	-21,360
New tax on personal income (the bracket tax), which replaces the surtax	45,400	17,450
Increasing the low rate in the value added tax from 8 to 10 percent	650	650
New tax on financial services	3,500	0
Taxing loans from companies to personal shareholders as dividends	600	600
SUM	-13,765	-8,535

Source: The Norwegian Ministry of Finance and Statistics Norway.