



LUNDS UNIVERSITET
Ekonomihögskolan

Thin Cap and Iceland

What can happen in the absence of thin capitalization rules ?

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Jon Bjarni Steinsson

Email: jonb.steinsson@gmail.com

Phone: 0703649711

Supervisor: Axel Hilling

Examiner: Mats Tjernberg

Course: HARN60

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List of Abbreviations

art.	article
Ch	chapter
CL	Icelandic Corporations Law
EBITDA	Earning Before Interest, Taxes, Depreciation and Amortization
ECJ	European Court of Justice
EEA	European Economic Area
EFTA	European Free Trade Association
e.g.	For example
EU	European Union
GAAP	Generally Accepted Accounting Principle
HRD	Icelandic Supreme Court
IMF	International Monetary Fund
ITC	Icelandic Income Tax Code
M	Million
No.	Number
Nsp	Numbered Sub Paragraph
OECD	Organization for Economic Co-Operation and Development
P.	Page
PLCL	Icelandic Private Limited Company Laws
Thin cap	Thin Capitalization
Vol.	Volume
YSKN	Icelandic Internal Revenue Board (tax court)

Foreword

During the 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'. Especially since I knew that in my home country, Iceland, that area of tax law was almost unheard of. When deciding on a master thesis topic I was thinking about how I could make use of this interest. In the middle of that consideration, I saw a news report from Iceland regarding these aluminium plants and their owners. How they seemed to be taking an advantage of the lack of any rules regarding thin capitalization to avoid paying any income tax and instead paid huge amounts of tax-free interests to their parent and sister companies in Luxembourg and the Netherlands. I contacted the reporter, he was kind enough to provide me with some of his findings, and during our talks, the topic of this examination was formulated. I would like to thank Helgi Seljan for providing me with data I would have otherwise had trouble getting myself and for giving me an idea for this thesis. I would also like to thank my tutor, Axel Hilling, for his help during the working process.

Jón Bjarni Steinsson

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Abstract

An examination of how thin capitalization of companies works, rules put in place to counter such behaviour, their affects and how or if such rules might help in a situation in Iceland where multinational corporations seem to be taking an advantage of such rules to avoid paying any income tax.

Keywords: Thin capitalization, Interest deduction limitations rules, tax avoidance, tax planning, Iceland, Germany, Denmark.

1. Introduction

Question: Is it possible to solve problems associated with multinational corporations taking advantage of the lack of Thin Capitalization rules in Iceland with current legislation or by implementing new rules?

1.1. Background

In Iceland, there are no thin capitalization provisions although the Supreme Court has held, with a reference to the main principle behind article 57(1) of the Income Tax Law (general anti avoidance rule based on the arm's length principle, that a transaction may be disregarded if its purpose is only to circumvent tax legislation. According to a report from the IMF, that has ever since the collapse of 2008 monitored and looked closely into the tax environment in Iceland, taxation of corporate profits in Iceland is a classical system that is generally in accordance with the systems found in other European countries. A consistent and efficient tax system does not require major changes. There are specific aspects, however, where the current economic situation has brought to the surface some shortcomings related to the treatment of holding gains and losses, debt forgiveness, complex financial operations, and excessive leverage.¹ The corporate tax introduces a bias in favour of debt opposed to equity financing. This is because in the hands of the corporation, profits are taxable while interest payments are deductible. The tax authorities consider that there are indications of excessive debt financing, often motivated by tax avoidance objectives. At present, the tax authorities' only possibility to confront these practices is by using either the arm's length provision (article 57 ITA) or the anti-avoidance concept developed in case law. Neither of these approaches seems to be effectively applicable in Iceland and the authorities consider that their capacity to challenge and prevent thin capitalization practices should be strengthened.²

1.2. Subject and Purpose

A committee report on tax evasion in Iceland from 2004 stated that it was necessary to impose a tax on interest payments out of the country since the lack of such legislation would encourage tax evasion where companies would set up groups of companies where a foreign group provides a resident company with a loan. The profit of the Icelandic company is transferred offshore in the form of high interest payments, considered as deductible expenses.

¹ International Monetary Fund - *Improving the Equity and Revenue Productivity of the Icelandic Tax System*, p. 18

² International Monetary Fund - *Improving the Equity and Revenue Productivity of the Icelandic Tax System*, p. 21

The interest payments themselves not taxed when going out of the country to the foreign company. The report added that the fact that interest payments were not taxed leaving the country was in accordance with the basic tax procedure of taxing dividends, sales and operational profits.³ In an article about the economic impact of heavy industry in Iceland the ex head of the Icelandic tax authority, Indriði H. Þorláksson, discusses the need to tax the interest paid out of the country to foreign entities.⁴ These interest payments are income originating in Iceland, income where the state feels the need to ensure its share of the revenue. Indriði also suggests that to not tax the interest paid out of the country increases the likelihood of tax avoidance because the companies are able to use these payments of company profits go out of the country without it ever being taxed. Indriði also mentions the fact that interest costs are considered deductible operating expenses that decrease the tax base so by these measures dividends are being disguised as interest to avoid paying taxes.⁵

The purpose of this examination is to look at the lack of thin cap rules situation in Iceland with the example of the aluminium plants in mind. By analyzing and then comparing Icelandic laws with Danish and German laws in relevant areas of corporate taxation the plan is to provide some useful guidance as to which steps would be the best to take in order to counter these sorts of tax avoiding behaviours now or when implanting regulations in Iceland regarding thin capitalization.

1.3 Method and Material

This thesis will conduct a traditional comparative law analysis, first by identifying a real life problem regarding thin capitalization of certain multinational corporations operating in Iceland, then by studying how possible tax planning relating to such financing is resolved in two different countries with interest deduction limitation rules. The two countries chosen are Germany and Denmark. Denmark is chosen mainly because Danish legislation was originally the basis for Icelandic laws so there are many similarities, Germany was chosen because its interest deduction limitation rules are relatively new and for the fact that in a recent report the IMF recommended that Iceland implemented rules similar to the German ones if they decided to adopt such rules. The starting point for this paper will be the relevant domestic law provisions with comparison to the other chosen jurisdictions, the OECD Model convention and other material found relevant by the author. The thesis will analyse domestic sources of

³ I Þorláksson, *Skýrsla starfshóps um umfang skattsvika á Íslandi*, p. 35.

⁴ I Þorláksson: „Efnahagsleg áhrif stóriðju á Íslandi“,

⁵ I Þorláksson: „Efnahagsleg áhrif stóriðju á Íslandi“,

law, such as preparatory work and scholars' articles, devoted to the topic in order to assess the compatibility of the rules and enable a critical comparison. It should be noted that this project was undertaken partly because this is a very current issue in Iceland and is intended mostly for Icelandic readers, hopefully as means to provide possible solutions. Therefore, some of the sources used are Icelandic since in many cases no sources of information existed in any other language. Moreover, some of the sources used are in English but are not available outside of Iceland or on the internet; those will be made available through a file provided for in a link at the end of the bibliography. It is the hope of the author this alternative approach will be forgiven.

1.4 Delimitations

In the course of the research for this paper it became obvious that in parts, especially when it came to thin capitalization in general or the different approaches taken in various jurisdictions many articles and papers have been published and very often authors of such publications do not agree. It would in the authors mind not have lead to the desired results if all material published had been considered in this paper; instead an attempt was made to include the ones relevant to the research question. Originally, the plan was to include the Swedish and Dutch systems along with the German and Danish ones; it however soon became clear that Swedish authorities have almost identical problems as the Icelandic do. The Dutch system also did not seem very helpful have since the Dutch system of thin cap rules was abolished and replaced by a new system very recently.

Although thin capitalization rules are in fact different from interest deduction limitation rules, they are a response to the same problem. Therefore, for the purpose of this paper, the term 'thin capitalization rules' will also cover interest deduction limitation rules where relevant.

Finally, the reader should be aware that some sources necessary for the purpose of research on the matter were not available in any other language then Icelandic, where needed this author translated to English. The goal of this examination is as mentioned above to provide some guidance to the situation in Iceland; therefore, Icelandic sources need to be relied upon.

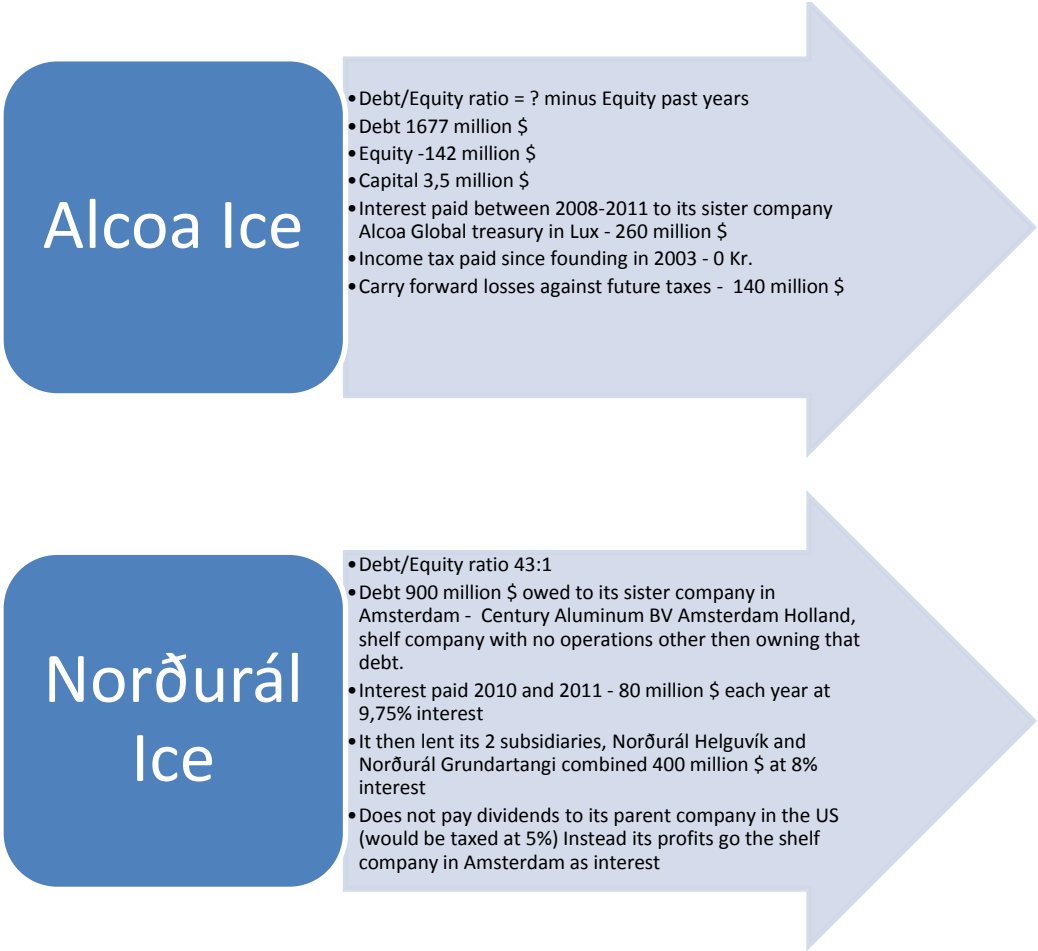
1.5. Outline

In line with the comparative legal method, following the introduction and the presentation of the problem in chapter 2, an explanation of the subject (thin capitalization) the relevant national law provisions of Denmark and Germany and Iceland will be presented in Chapters 3

and 4. Following this, Chapter 5 will discuss possible solutions, while the conclusions of the author will be put forth in Chapter 6.

2. Is There a Problem?

In Iceland there are a few big aluminium smelters with one more at least is on the drawing board. Recently an Icelandic investigative reporter pointed out that the owners of two of the largest ones 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 Ms US\$ in interest every year. Below is a picture that roughly shows how this is set up.



This in itself does not necessarily need to be a problem from the government’s point of view; these smelters generate a lot of revenue for the state by other means than direct income tax. Such as the income taxes of its workers and the purchase of goods and services. However, when before mentioned reporter asked members of government they did indeed see this as a

⁶ Annual reports of Alcoa and Norðurál

problem. When interviewed Steingrímur J. Sigfusson, Minister of Industry and Innovation said:

„Well, it is very difficult to come to another conclusion than that the companies are 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. Which causes their returns here domestically in our tax environment completely different from what one would feel it should be. This must of course be dealt with, that is obvious. This is of course a certain method to increase profits. This is compatible to over-pricing supplies into the factories. Moreover, I believe this gives full cause for the tax authorities, the Commissioner of the Inland Revenue or the Inspector of Taxes, to look into these cases, including the terms of these loans and there are certain clauses in tax law, which could be looked into in this regards. In addition, of course right should be right. One feels it is normal that these companies are making good profits, e.g. because they have access to low electric energy prices.“⁷

Therefore, it is obvious that it is not the intent of the government that this kind of tax planning schemes be possible. The government wants a solution that enables the tax authorities to tax that income at its source in Iceland, rather than to have the profits shipped out of the country tax free in the form of interest. The simplest way would probably be to introduce some sort of interest deduction rules, but there Icelandic authorities run into another problem. It seems as if the Aluminium plants might have been made “immune” to any future legislation regarding limitations on interest deductions. In laws regarding the governments authorization to make investment contracts⁸, for an aluminium smelter in Reyðarfjörður⁹. And in similar acts regarding plants in Grundartangi¹⁰ and Helguvík¹¹, it is provided that the agreements can contain an exemption from any provisions of ITC regarding deductions of interests in such a way that as the aluminium plants are concerned, they shall remain unchanged during the maturity of those agreements. With such an agreement, the plants seem to have ensured that in the event that the legislature decides to make rules that limit the deductibility of interest or rules regarding thin capitalization, those provisions would not apply to the smelters. As an example the agreement regarding the smelter in **Reyðarfjörður** says: “*The deductibility of interest expense shall remain unchanged during the Initial Term as it is under Act No.*

⁷ H Seljan, *interview in Kastljós*, 21/13 2013– link to english transcript available in reference list.

⁸ 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

⁹ Art. 16(11), act no. 12/2003

¹⁰ Art. 6(12), act no. 62/1997

¹¹ Art. 4(7) (act no. 51/2009)

75/1981 on Income Tax and Net Worth Tax, as amended, on the date of the signing of this agreement.”¹² another one regarding the one in **Helguvík** says that: “After 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 on Arm’s Length Principles and Transfer Pricing“.¹³ The agreement regarding Grundartangi originally contained no such provision, but it was added in 2008.

On those laws and contracts, Steingrímur J. Sigfusson said in the same interview as quoted above:

„But our problem is that the old agreements were made in such an atrocious manner that the companies are very well guarded and ensured, to some extent indefinitely into the future, with the exception that certain types of taxes can be imposed here. This is unfortunately how things were done in the case of Alcoa Reyðarfjörður. In that case, a special clause was put into the agreement that the company is protected against changes to being allowed to take these huge interest payments due to enormous loans which the companies here are made to carry and pay instalments to their associate- or parent companies abroad. Therefore, we saw that we would not be able to cut this off, even though we were to impose rules about minimal owners’ capital, unless it would be possible to prove that the terms of these loans are off the charts.“¹⁴

How these contract provisions possibly affect any future legislation regarding interest deduction limits in Iceland remains completely unclear, what little this author has seen on the matter seems to indicate that most believe that nothing can be done. This will be discussed further in later chapters.

Steingrímur then added that to counter the problems the legislator started with so-called CFC-rules, preventing Icelandic parent companies from transferring their dividends to subsidiaries in tax havens and therefore forcing them to take up group taxation. The next step decided was the adoption of so-called Thin Capitalisation Rules, and that preparations for these rules had been in full motion within the Ministry of Finance since his time there.¹⁵ [Around 2009]

Conclusion: It is the view of members of government that there is a problem. Large corporations with source income in Iceland are not paying any income taxes related to the

¹² Investment agreement for Aluminum smelter in Reyðarfjörður.

¹³ Investment agreement for Aluminum smelter in Helguvík.

¹⁴ H Seljan, *interview in Kastljós*, 21/13 2013– link to english transcript available in refrence list

¹⁵ H Seljan, *interview in Kastljós*, 21/13 2013– link to english transcript available in refrence list

profits associated with that income. Seeing as Iceland is an OECD member, and the fact that its guidelines are even mentioned in one of the investment agreements, art. 7 of the OECD model convention should be kept in mind, as it stipulates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment.¹⁶ Para. 2 of that article then contains the central directive on which the attribution of profits to a permanent establishment is intended to be based. The paragraph incorporates the view that the profits that should be attributed to a permanent establishment are those, which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the “arm’s length principle” of article 9 in the convention.¹⁷ The will of the government is to tax that income while Icelandic tax laws seem to lack any provisions that could allow such taxation. In the works are new laws whose aim is to give authorities tools to counter this sort of tax planning schemes, there are however some difficulties and questions that might need to be answered in order to apply such legislation efficiently. The following chapter will examine thin capitalization, the purpose of thin cap rules and how they work.

3. Thin Capitalization

In this chapter, the aim is to look at what it exactly means when said that a corporation is thinly capitalized, why that is often considered negative from the tax authorities’ point of view, and finally how that “problem” has or can be addressed.

A firm can increase its value by using debt finance instead of equity finance, making use of interest deductions. A firm's capital structure choice, however, involves not only the debt-equity decision. Some companies also have the choice between internal and external debt finance. In the context of multinational firms, this choice entails complex issues of international tax planning.¹⁸

A company is said to be ‘thinly capitalized’ when it has a high proportion of debt capital in relation to its equity capital. The significant differences that apply in most countries to the tax treatment of debt on one hand, and equity on the other, have made thin capitalization a

¹⁶ OECD Model Tax Convention

¹⁷ Revised commentary on Article 7

¹⁸ G Wamser, ‘The Impact of Thin-Capitalization Rules on External Debt usage’, p. 1

popular method of international tax planning.¹⁹ In recent years, thin capitalization and international debt shifting has been the subject of attention among both policy makers and scholars. The standard effect of thin capitalization replacing equity by tax-preferred external debt has been well known for decades. With the integration of formerly national financial markets and the growing share of multinational companies in world trade, the international component, known as international debt shifting, has become more and more worrisome. Multinationals use international debt shifting to save tax payments by utilizing differences in national tax rates and preferential tax rules. For external debt shifting, evidence shows that multinationals excessively load those affiliates generating high net tax savings with external debt. On the other hand, to keep overall bankruptcy costs in check, the use of external debt in affiliates with low tax savings is reduced, allowing for higher tax savings than in comparable domestic firms. For internal debt shifting (borrowing and lending among related affiliates), the aim of this game is to deduct interest in high-tax countries while earning interest in low-tax countries in such a way that the tax savings in the high-tax countries exceeds the increased tax liability in low-tax countries. Setting up internal banks in the lowest-taxed affiliate maximizes the debt tax shield, which provides all other affiliates with internal debt. In particular, non-regulated internal debt shifting can be used as a money machine generating tax-arbitrage profits as long as there is positive taxable income.²⁰

The main purpose of thin cap rules is to curb excessive debt financing and tax-revenue losses from international debt shifting. Two approaches have been said viable in achieving that goal, using either specific or nonspecific thin cap rules. Specific thin cap rules directly tackle the use of internal debt from related parties while non-specific thin cap rules do not focus on internal debt alone, but in most cases restrict the use of debt in general and have similar effects to specific thin cap rules. The most well known example of non-specific rules are the US earnings-stripping rules that restrict the deductibility of domestic interest expenses. The US denies deductibility of ‘extreme’ interest expenses beyond 50% of a company’s EBITDA, if the debt-to-asset ratio lies above a safe harbour of 1.5:1 and if (excessive) interest is paid to a related party outside the scope of the US income tax. Since 1993, third-party debt guaranteed by a parent company is also treated as restricted internal debt. In 2008, Germany followed and extended the US example, denying deductibility of ‘excessive interest expenses above 30% of a company’s EBITDA, skipping the safe-harbour clause. Italy followed the

¹⁹ A Duorado and R de la Feria, ‘Thin Capitalization Rules in the context of the CCCTB’, p. 1

²⁰ D Schindler and M Ruf, ‘Debt Shifting and Thin-Capitalization Rules’, p. 2

German example later in 2008. Use of specific thin cap rules is more common. The majority of countries with thin cap rules directly restrict tax deductibility of internal debt and define safe harbour ratios where thin cap rules do not apply as long as the internal debt-to-asset ratio remains within the safe-harbour ratio, such rules deny interest deductibility for excessive internal debt coming from shareholders with significant influence on the management. Generally, exemptions for financial institutions apply. Until 2004 most thin cap rules were only targeted to foreign investment and did not apply to internal finance by domestic investors. In December 2002, however, the ECJ decided in *Lankhorst-Hohorst* that the German thin cap rules at the time violated the principle of ‘freedom of establishment’. Because the old rules were only targeted to inbound investors and did not apply to German investors that resulted in discrimination against German companies’ loan agreements with non-resident affiliated companies or shareholders relative to loan agreements with resident affiliated companies or shareholders. This ruling forced nearly all EU countries to reform their thin cap rules. One way to deal with with the ruling was to exclude companies residing in other EU countries from the application of any thin cap rules. This direction was adopted by for example Spain and Portugal. The other avenue, for instance taken by Germany, was to apply thin cap rules to both resident and non-resident companies.²¹

3.1. Denmark

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.²²
- (3) EBIT limitation: this provides for a limitation based on annual profits: net financing expenses must not exceed 80% of EBIT.²³ 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

²¹ D Schindler and M Ruf, ‘Debt Shifting and Thin-Capitalization Rules’, p. 5-6.

²² N Bjornhol and I Thiersen - ‘New Danish Limitations on Interest Deductions’, p. 589.

²³ N Bjornhol and I Thiersen - ‘New Danish Limitations on Interest Deductions’, p. 589

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.²⁴

Danish tax law does not contain any general definition of the concepts of “debt” and “equity” So most funding instruments need to be qualified under the general rules of Danish tax law. When the funding instrument issuer is a Danish limited liability company the qualification of the instrument for tax purposes may very well be based on the fundamental distinction between a contribution and a loan, with a contribution being comparable to an addition to equity. Even though the concept of contribution is not defined clearly in Danish tax regulations, legal usage, and administrative practice, do provide guidance towards a more detailed definition of the concept that relates to transfers of assets (money or assets) to a limited liability company in particular, without this company paying a consideration of the same value. Therefore, under Danish tax law a contribution may be deemed to exist even though the substance of the underlying circumstance is entirely different under civil law. For instance, Danish practice shows that in cases where, 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.²⁵

The Danish tax authorities have attempted to extend the area for tax reclassification of transactions well defined by civil or company law, the Supreme Court has rejected such reclassifications despite the motivation for the transactions in said cases clearly relating to tax savings and the transactions not displaying any noticeable commercial substance.²⁶

Unwanted tax consequences of a given classification are usually countered through anti-avoidance rules or rules that prescribe a given tax treatment of specific types of income, deduction and gains/losses. Add to this the more general restrictions resulting from the right of deduction for interest expenses, capital losses, etc. being limited under the provisions on thin capitalisation laid down in section 11 of the Danish Corporation Tax Act, the provisions on the interest deduction ceiling in section 11B and the EBIT provision in section 11C. In recent years, this strategy has led to the adoption of a number of complicated anti-avoidance rules, which have given rise to considerable interpretation challenges, and which often are not consistent.²⁷ According to section 2B of the Danish Corporation Tax Act, a Danish company’s

²⁴ J Hansen and N Vinther, ‘Denmark’, *IFA Cahier – The Debt Equity Conundrum* , p. 240

²⁵ J Hansen and N Vinther, ‘Denmark’, *IFA Cahier – The Debt Equity Conundrum* , p. 240

²⁶ J Hansen and N Vinther, ‘Denmark’, *IFA Cahier – The Debt Equity Conundrum* , p. 246

²⁷ J Hansen and N Vinther, ‘Denmark’, *IFA Cahier – The Debt Equity Conundrum* , p. 247

debt e.g. to foreign individuals or companies should be considered equity if the debt claim is regarded as contributed capital under foreign tax rules. According to the wording of the provision, reclassification does not result in capital gains on debt being considered an equity transaction, and capital gains should therefore still be subject to taxation even if the debt is reclassified as contributed capital (equity).²⁸

3.2. Germany

Interest relating to a business activity is tax deductible as a business expense. The deductibility of interest is most notably limited by the interest deduction ceiling rule (Zinsschranke).²⁹ Since interest is, in principle, tax-deductible tax treatment of debt can be more favourable. However, the interest deduction ceiling rule has made debt investments less attractive.³⁰ Loans granted by a shareholder to a corporation are qualified as debt in the balance sheet. However, interest payments to a shareholder of a corporation that are not arm's length are not deductible but are treated as dividend payments. Tax groups are treated as "one" business for purposes of the interest deduction ceiling rule which can have positive effects regarding the deductibility of interest.³¹ German tax law assumes an equity treatment of an instrument if a contributable asset has been transferred by the shareholder to the entity, which has led to an increase of the entity's capital. Whereby this capital (a) is not subject to free retransfer to the shareholder (e.g. by termination of a loan agreement, etc.) and (b) is subject to fulfilling the entity's liabilities in an insolvency scenario prior to a retransfer to the shareholder. Whether or not these criteria are fulfilled has to be decided under the foreign civil law applicable to the issued instrument.³²

In general, the commercial treatment according to German GAAP is decisive also for tax purposes. This is due to the legal principle that tax accounting should be based on commercial accounting. This principle was historically established in order to ensure that tax authorities could easily determine the accurate and true taxable profit.³³ The German GAAP treatment of an instrument as debt or equity follows the characterization under German commercial law. Thus, financing instruments, which assume liability towards the companies' creditors, should be treated as equity, all other instruments as debt. The debt treatment also applies with respect

²⁸ J Hansen and N Vinther, 'Denmark', *IFA Cahier – The Debt Equity Conundrum*, p. 247-28

²⁹ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 310-311

³⁰ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 314

³¹ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 315

³² Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 315-316

³³ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 315-316

to loans, in particular shareholder loans, which are subordinated³⁴ and are therefore treated as equity under German insolvency laws.³⁵

Following the Federal Tax Court decision, the prevailing method used is the amendment of the taxable results e.g. by thin capitalization rules and no longer the reclassification of financing instruments as such. The mutual agreement provisions in the double taxation treaties are predominantly based on article 25 of the OECD model convention. Thus, there are no specific rules dealing with the characterization of an instrument as either debt or equity in cross-border taxation issues. Mutual agreements are not published, which is, however, not surprising as such agreements concern a specific case and tax secrecy must be observed. If a mutual agreement is reached in favour of the German taxpayer, the respective tax assessments have to be changed accordingly³⁶.³⁷

Business expenses can generally be deducted from the income earned for determining the income tax base. However, as regards interest expenses, certain restrictions under the German interest deduction ceiling rule may apply. The deductibility of net interest expense by a business is limited to 30 per cent of the current year tax EBITDA and, if applicable, of the tax EBITDA of the previous years, unless certain exceptions apply. It applies not only to interest on shareholder loans but also to all kinds of remuneration for the provision of capital including interest to be paid on ordinary third party bank financing. There is no arm's length test, which would provide relief from this limitation. The rule ultimately causes double taxation, as interest earned is taxable at creditor level, while the interest expense may not be fully deductible at borrower level. Any non-deductible amount of interest exceeding the 30 per cent EBITDA cap can only be carried forward and may be deductible in future years.³⁸

In order not to be affected by the limitation on interest deduction, certain exceptions can be applied:

(a) The limitation does not apply if the net interest expenses are below 3 M euro.

³⁴ Subordinate debt is a debt where the providers (the lenders) have subordinate status in relationship to the normal debt. A typical example for this would be when a promoter of a company invests 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—assuming there are assets to distribute after all other liabilities and debts have been paid.

³⁵ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 316-317

³⁶ section 175a General Tax Code

³⁷ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 318-319

³⁸ Fischer,Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 319-320

(b) Further, the limitation does not apply if the relevant interest paying business is not a member of a group of companies, i.e. if it is a stand-alone entity.

(c) Thirdly, in case of a group of companies, the interest paying business must demonstrate that its equity ratio is equal to (with a tolerance of 2 percentage points) or higher than the relevant group's equity ratio as at the last balance sheet date of the previous fiscal year.

Furthermore in addition to the exceptions (b) and (c), neither the borrower nor any other entity belonging to the same group of companies, if any, should owe, up to a certain threshold, interest on loans granted by direct or indirect shareholders of the interest paying entity holding more than 25 per cent of the share capital in the borrower. The same applies with regard to interest on loans granted by related parties of such shareholders or loans granted by third parties who have a harmful recourse to such shareholders or related parties. The threshold for such interests caused by shareholder debt financing is 10% of net interest expenses. Finally, such interest on shareholder debt financing is only regarded as harmful if the respective lender and the debtor entity are not members of the same group of companies. This is because in such a scenario the interest-owing entity will already be unable to meet the requirements of the equity ratio comparison due to the shareholder loan.³⁹

The interest deduction ceiling rule as described above can be considered a major tax impediment to achieving the desired tax effects of debt financing. As the definition of interest under this rule is very broad there are no (hybrid) financial instruments as such that could achieve payments that are tax deductible but do not fall within the scope of the interest deduction ceiling rule. However, hybrid instruments, which qualify as equity under German commercial law, may be used to improve the debt–equity ratio of German enterprises in order to avoid the application of the interest deduction ceiling rule. Similarly, a number of other models have been developed which try to avoid the application of this rule. For example, tax groups are formed to improve the EBITDA of the controlling enterprise or to achieve the deductibility of interest paid to other group members. Businesses formerly owned by only one corporation or partnership are being segregated in order to be able to use the threshold of 3 M euro several times and loans have partly been replaced by leasing, licensing or similar contracts. However, it must be noted that structuring aimed at avoiding the application of the interest deduction ceiling rule is frequently not opted for, since the outcome is often uncertain and the transaction costs are too high compared to the impact of a limited interest deduction.

³⁹ Fischer, Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 319-320

Under the interest deduction ceiling rule, interest paid on loans granted by shareholders are fully deductible, if (a) the threshold of 3 M euro is not reached or (b) there is sufficient EBITDA. Thus, if these conditions are met bank loans and equity can be replaced by shareholder loans. The interest earned by the shareholders will be taxed in accordance with the compensation tax regime if the shareholder owns less than 10 per cent of the shares of the corporation.⁴⁰

3.3. Criticism of German/Danish rules

The German *Zinsschranke* has been strongly criticized by German tax practitioners. Some of the main arguments raised against it include its high level of complexity; the infringement of the net principle, meaning the full deductibility of all expenses related to the business income; the regulation of companies exempt from its application; the low level of deductible interest expenses, the lack of suitability of the escape clause; and the failure to consider R&D expenses incurred for purposes of determining taxable EBITDA.⁴¹ The Danish provisions has also been criticised, Bjornhol and Thiersen are of the opinion that the asset limitation rate of 6.5% seems too low and does not reflect that arm's length interest rates may exceed 6.5%. They also failed to understand why the fair market value at the year-end is applied, 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. They pointed out that while Germany replaced its existing thin capitalization rules with an EBIT limitation that option was sadly not debated in Denmark, since the Bill was rushed through the parliament.⁴²

Conclusion: 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 interest as dividends. This chapter set its sights on two systems that had been recognized being amongst the best in dealing with the problem of thin capitalization, the German rules had even been recommended as benchmark for future Icelandic legislation by the IMF.⁴³ As pointed out though in ch. 3.3 above those systems have been criticized and are

⁴⁰ Fischer, Lohbeck - 'Germany', *IFA Cahier – The Debt Equity Conundrum*, p. 325-326

⁴¹ K von Brocke and E G Perez, 'Group Financing: From Thin Capitalization to Interest Deduction Limitation Rules' p. 34

⁴² N Bjornhol and I Thiersen - 'New Danish Limitations on Interest Deductions' p. 591

⁴³ Monetary Fund - *Improving the Equity and Revenue Productivity of the Icelandic Tax System*, p. 22

considered complex with many ways to circumvent them. However, as mentioned in ch. 3.2, loans granted by a shareholder to a corporation are under German rules qualified as debt in the balance sheet while interest payments on such loans to a shareholder of a corporation that are not arm's length are not deductible but are treated as dividend payments. In the case of the owners of the aluminium plants such rules might in the current situation lead to those interest payments being treated as dividends and therefore made taxable.

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 will be discussed in ch. 5.

4. Icelandic Laws

This chapter will provide an overview of those parts of Icelandic laws that would be relevant in any future legislation regarding thin capitalization. The basic principles of tax law will be explained, the concept of a consolidated company defined along with some definition of the terms costs, interest and dividends in regards to the deductibility of such expenses from the tax base of corporations as well as comparing them to similar terms in other jurisdictions and international agreements.

In the statutory interpretation of Icelandic tax laws, the literal meaning of the words is to be applied, that is, to interpret them literally and according to the preparatory work, that was the basis of said legislation.⁴⁴ The taxation right of the Icelandic authorities on the duty of Iceland's natural and legal persons to pay tax on all their income is found art. 1 and art. 2 ITC.

According to the Constitution, the Parliament makes all decisions regarding financial management of the state, and it is the only competent authority to decide by general law which taxes shall be imposed, cf. art. 40, art. 77 and para. 2, art. 78 of The Constitution of Iceland, laws no. 33/1944 (hereinafter "The Constitution") which provides for the states taxation authority. These provisions of the Constitution give the government and Parliament the power to make certain groups, individuals, or legal entities pay money by ways of general and applicable standards and without a disclosed unconsolidated consideration.⁴⁵

Since the rules relating to thin capitalization of companies focus on company groups it is necessary to define the term „consolidated company,, in Icelandic law. When defining the

⁴⁴ H V Jónsson, „Frádráttur frá tekjum við ákvörðun tekjuskattstofns“, p. 322-323

⁴⁵ G G Schram: *Stjórnskipunarréttur*, p. 556-557

concept a reference to the definition used in corporate law is needed since the term is not defined in tax law. According to corporate law, a company is any independent legal entity that controls its own affairs. However, companies can be connected in such a way that they are dependent on each other. If such a relationship exists, it is considered to be a consolidated company group, that is, when the structure is in a way where one company has such a holding in another company, or other companies, that it controls a majority of the votes in, or if for any other reason takes effective control of it.⁴⁶As previously stated the income tax code does not contain any definitions of company groups, we therefore need to take a look at laws on corporations, the Act no. 2/1995 on Corporations (hereinafter CL.) and the Act on Private Limited Companies no. 138/1994 (hereinafter PLC.) contain provisions relating to consolidated companies. Under the acts, they shall be limited to a group when a corporation is in fact controlled by a limited company, the higher one is called the parent and the others subsidiary companies, together they form the consolidated company⁴⁷. In art. 2 CL it is noted that the scope of the act covers only Icelandic companies and should therefore apply only to corporations, which are established in Iceland. This obviously causes problems when dealing with tax measures in cross-border trading within international consolidated companies since by that wording the laws seem to leave out multinational corporations. With no definition in the tax law, this creates a legal vacuum when it comes to taxing such entities.

When considering a consolidated group of companies, each company within the group is considered an independent legal entity, both in financial and tax sense, as long as the individual meets the legal criteria in Article 2 of the income tax code (hereinafter ITC) on independent taxation. When evaluating the legal status of a company within the group, we assume that each company is a separate legal entity, although it is part of a consolidated group.⁴⁸

As established in the above, the concept of group or consolidated group is not defined in the tax law. However, art. 55 ITC, an article that provides authorization for joint taxation of limited liability companies, uses the concepts of parent and subsidiary companies. Companies that are considered highly dependent on each other may be jointly taxed, but the condition is that the parent cannot own less than 90% if joint taxations, is to be allowed.⁴⁹ Article 55 ITC provides a variety of additional conditions for the authorization of joint taxation, including

⁴⁶ S M Stefánsson: *Samstæður hlutafélaga*, p. 15-19

⁴⁷ Art. 2, para. 4 CL, art. 2. PLCL

⁴⁸ Á K Guðmundsson: „Milliverðlagning“, p. 255.

⁴⁹ Para. 1, nsp. 2, art. 55 ITC

utilization of the tax losses of companies. The benefit of group taxation is the option to utilize company's operating loss against the profits of other units within the group. When jointly taxed based on art. 55 ITC, the jointly taxed companies are jointly liable for tax payments even if the income tax on joint income is levied on the parent company. There are certain restrictions on the use of loss of joint taxation, it is for example, not possible to use the losses that accrued before the joint taxation against profits of other companies in the consolidated taxation after the group became jointly taxed under paragraph of art. 55 ITC.

It is the duty of any natural or legal persons to pay taxes on all of their income.⁵⁰ Corporate income tax base is the income provided for in ch. II of ITC, minus deductible operating expenses as authorized by art. 31 ITC.⁵¹ Furthermore, all legal persons subject to tax in the country should be subject to tax under the tax code, unless specifically exempted.⁵² Legal person's income tax is to be calculated on net income, which means that from the total income can be deducted the total sum of that year's expenses accrued to earn the income, ensuring and withholding it.⁵³ It is a legal person's obligation to declare all income, wherever it is earned, but expenses they may only deduct if permitted by law.⁵⁴ The permission to deduct operating costs is provided for in paragraph 1 of article 31 ITC and is an exception from the main principle laid down in art 2 ITC requiring the payment of tax on all of income. Exceptions to the main principle of tax law must be provided for in a clear and predetermined manner of law, as it is expressly provided for in the Constitution that it is not allowed to levy taxes, change, or remove them except by law⁵⁵.

The rule on worldwide taxation is provided for in ITCs provision on unlimited tax liability. The rule regarding persons with unlimited tax liability in Iceland says that persons, be that legal or natural, should pay taxes where they are domiciled or in the case of legal entities where they are registered, regardless of the source of that income.⁵⁶ Persons who are not residents of Iceland are required to pay income tax on all income that has its source in Iceland and with an added wealth on its assets in the country.⁵⁷ Limited tax shall those individuals and legal entities bear which do not meet the requirement on residence or registration in Iceland.⁵⁸

⁵⁰ Art. 1, art. 2 ITC.

⁵¹ Art. 2 ITC.

⁵² Art. 7 ITC.

⁵³ Para. 1, nsp 1, art. 31 ITC.

⁵⁴ Part B, art. 7 ITC.

⁵⁵ Art. 40, Art. 77 The Constitution.

⁵⁶ Art. 1, art. 2 ITC.

⁵⁷ Art. 3 ITC.

⁵⁸ Art. 3 ITC.

Foreign companies, organizations, and institutions that do not have a permanent establishment in Iceland or are there legally registered, carry based on the provision limited tax liability.⁵⁹

The tax code does not contain provisions that provide that shareholders may not provide loans for corporations they own share in. However, art. 107 CL and art. 79 PLCL, prohibit that corporation lend money to shareholders. A shareholder can achieve tax efficiency by lending money to a corporation instead providing additional capital because the total corporation tax on profits is higher than the tax on capital gains.⁶⁰ If the interest rate is higher than is customary in comparable loans in the private market, the tax authorities may look the loan as equity contribution and tax authorities bear the burden of proof in such cases.

4.1. Costs

From income tax and the income of persons arising from commercial or independent activities or related to such operations can be drawn: Operating costs, i.e. charges during the year for the purpose of earning income, securing and keeping it, including premiums to acquire pension rights of employees in pension funds on the basis of mandatory pension insurance and pension funds, interest on debt, discounts, currency losses, amortization and depreciation of assets, as further provided in the act, and what is devoted to the insurance and upkeep on property which returns profits to the operation. There is the strict condition that in order for an expense to be deductible, it has for that year, have had the purposes of earning the income.⁶¹

It is then a regulation that further provides what costs can be considered as deductible expenses⁶². From a ruling by the internal revenue board, which is court of first instance in matters relating to taxes, it can be assumed that the burden of proof on the deductibility of operating expenses in each case lies with the person who intends to make use of such subtractions. As proof of the deductibility of certain expenses taxable, persons can submit invoices or other documents relevant to their case. In that particular case, the court said that the taxable person had to be the one to blame when not able to provide the court with sufficient accounting to prove the legitimacy of his deducted expenses.⁶³

⁵⁹ Art. 3 ITC.

⁶⁰ Á G Vilhjálmsson: *Skattur á fyrirtæki*, p. 586.

⁶¹ Para. 1, art. 31 ITC.

⁶² Regulation no. 483/1994 on the deduction from income from commercial and independent activities

⁶³ YSKN 502/1999

4.2 Interests

The term “interest” as used in article 11 of the OECD Model means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article. In *Denmark*, the concept of interests is strictly limited and according to well-established Danish tax practice includes a regular, periodic payment to the creditor, calculated as a certain percentage of the amount owed at the time, for making capital available.⁶⁴ Under the German *Zinsschranke*, debt capital includes all cash contributions to capital recorded as a liabilities that do not belong to equity from a tax perspective. According to a letter of the German tax authorities, in addition to interest based on a fixed or floating interest rate, participations in profits or sales, disgios (prepaid interest), early termination costs and other fees paid to the lender are also included in the definition of the term “interest”.⁶⁵ In the Nordic multilateral convention for the avoidance of double taxation with respect to taxes on income and on capital,⁶⁶ the term “interest” is defined in Art. 11(3) as meaning remuneration on money lent. A payment from a debtor, which is determined according to the function of time, the rate of return and the principal, is interest, regardless of what the payment is called or when it is made.⁶⁷ That definition differs from the definition in Art. 11(3) of the OECD Model in that it does not expressly say that income from a debt-claim is interest whether or not it carries a right to participate in the debtor’s profits. Art. 11(2) of the Nordic Convention says that income from a debt-claim is interest, provided it is not a dividend covered by Art. 10(6), meaning that if an item seems to qualify as both interest and a dividend, the item should be treated as a dividend.⁶⁸

When defining the concept of interest in Icelandic tax law art. 8 ITC should be considered with art. 49. art. 50. art. ITC, under general law parlances interest are considered periodic payments for a loan of money or deferral of payment, determined in advance for a specific period, based on a certain percentage of the loan amount or remaining balance at each time.⁶⁹ The interest concept is broadly defined in the tax code and covers in addition to interests a

⁶⁴ J Hansen and N Vinther, ‘Denmark’, *IFA Cahier – The Debt Equity Conundrum*, p.244

⁶⁵ K von Brocke and E G Perez, ‘Group Financing: From Thin Capitalization to Interest Deduction Limitation Rules’, p.31-32

⁶⁶The Nordic Convention

⁶⁷Helminen, *Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention*, pg. 59

⁶⁸Helminen, *Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention*, pg.59

⁶⁹ Á G Vilhjálmsson: *Skattur á fyrirtæki*, p. 266

variety of other charges related to interest claims, it allows the deduction of interests on debt, discounts, and currency losses.⁷⁰ Full list of deductible interest related expenses is as follows:

1. Interest on fixed and flexible debt, including defaulting interests. As interest, you may consider costs of borrowing, annual, or temporary fixed costs, fees, stamp duty and registration costs. As interest in this context are accrued indexation of principal and interest.⁷¹
2. Mortality of sold securities, bills and any other debt instruments provided that the buyer of the securities is known. Discounts shall be calculated by the relative amount deducted each year after the instalment period. If the debt is taken over or if the obligation to pay falls down before the maturity of the debt, the remaining amortization is not deductible from income. A debt taken over in connection with the sale of assets, the seller can reduce the sale price of the property that amounts to the remaining discounts, if the seller was the original debtor of the overtaken debt.⁷²
3. Currency losses in regards to any liabilities in foreign currencies in the year that rate change occurs, depending on the sale price of the foreign currency at the year's end are deductible.⁷³

As before mentioned (in ch. 4.1) it is one of the main principles of the income tax code that for costs to be deductible from taxable income it needs to meet the criteria of having the purpose of earning income securing it and keep it. Thus, we need interest liabilities that are associated with the operation in a way that they are imposed on business or incurred with a view of buying properties that are used to gain revenues in its operation. In a recent ruling by the Supreme Court, regarding the deductibility of interest of loans taken out to finance leveraged takeovers the court said that the general rule set forth in art. 31(1) ITC, regarding operating expenses that are deductible from income, is that they should be connected to the income that operating year, cf. reference to the Supreme Court ruling in case Hrd. 247/1993 and in case Hrd. 321/2005. The Court then continued and said that the second para. art. 49 ITC also stated, with regards to operating expenses, that they were only to be deductible in full if they were linked to business operations' or independent business activities. Interest

⁷⁰ Para. 1, nsp.1, art. 31 ITC

⁷¹ Para. 1, nsp 1, art. 49 ITC.

⁷² Para. 1, nsp 2, art. 49 ITC.

⁷³ Para. 1, nsp 3, art. 49 ITC.

rates, discounts and currency losses that did not meet that criteria, were not deductible expenses within the meaning of the aforementioned provisions.⁷⁴

For interest costs to be charged as deductible operating expenses the condition that they are related to either a loan or a debt is set out in ITC. However, the deductibility of interest is not subject to the condition that the interest is paid regularly so that the payment of interest can take place at the beginning or at the end. When the assessment is made whether a loan and the claim associated to it are real, whether or not a written contract is in place is important, what is the maturity of the loan, what are the insurances for the repayment of the loan, interest and so on. The stronger the connection is between the creditor and the debtor, the greater the requirements get. If the parties are closely related and the above conditions are not fulfilled the tax authorities can deny interest deductions and ignore the loan or look at it as equity, not a loan.⁷⁵

4.3. Dividends

According to article 10 of the OECD Model, the term “dividends” is generally meant as distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies. Under the laws of the OECD Member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders. On this point, they differ from partnerships insofar as the latter do not have juridical personality in most countries.⁷⁶ In Danish law the concept of dividends is broadly defined and according to section 16A(2)(i) of the Danish Tax Assessment Act dividends generally refers to “anything distributed by the company to existing shareholders. In Germany a dividend is a part of the profit that a stock company distributes to its shareholders or that what a cooperative society distributed to its members. The German legislature does however not use the term dividend, it only refers to it in, § 174 Section 2 No. 2 German Stock Companies Act, as „*distributable amount*“. According to art. 10(6) of the Nordic Convention, the term “dividends” means any income from shares or certificates, income from other rights, not being debt-claims, participating in profits and other income derived from a company which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the

⁷⁴ Hrd. 555/2012

⁷⁵ Á G Vilhjálmsón: *Skattur á fyrirtæki*, p 269.

⁷⁶ Commentary to the OECD Model Tax Convention

distribution is a resident.⁷⁷ The last part of that definition covers any income from a company that is taxed in the source state the same way as income from shares, a definition that is broader than the definition in Art. 10(3) of the OECD Model, which refers only to income from corporate rights. Not requiring the existence of corporate rights reduces the danger of unresolved classification conflicts, as compared to the OECD Model. A classification conflict cannot be based on the disagreement of the contracting states regarding the existence of corporate rights as it can under the OECD Model. For example, income from hybrid financial instruments or interest in a thin capitalization situation may qualify as a dividend if the source state treats the payment as a dividend, even though the instrument cannot be regarded to be a corporate right.⁷⁸ Following many years of negotiations, the new Germany-Netherlands Income Tax Treaty and protocol was signed on 12 April 2012.⁷⁹ The dividend definition in that treaty follows that of the OECD Model, while also including income from distributions concerning certificates of a German investment fund (*Investmentvermögen*) and applying to all financial instruments providing for profit-participating payments that are deductible from the payer's tax base. Provisions of the treaty do not apply to convertible bonds or to any income associated with rights or debt claims that do not carry a right to participate in profits. This provision is in line with German treaty policy and identical wording can be found in almost all of Germany's tax treaties.⁸⁰

In Icelandic tax law income as dividends is every delivery of considerable valuables from a corporation to its shareholders that can be considered as revenues connected to the share of their holdings in the company.⁸¹ According to CL and PLCL, when organizations that own shares in limited and private limited companies receive dividends from the companies they are involved in, when their activities are profitable, such payments are with a narrow interpretation called dividends⁸². However, in ITC dividends are defined more broadly, that is, it is said to be the transfer of values from a corporation that a shareholder has shares in.⁸³ Companies can when receiving dividends deduct from their income an amount equal to the dividends received when certain conditions are fulfilled⁸⁴. It should be pointed out though that the definition of deductible amounts under art. 31(9) ITC does not fully coincide with the

⁷⁷ Helminen, *Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention*, pg.55

⁷⁸ Helminen, *Dividends, Interest and Royalties under the Nordic Multilateral Double Taxation Convention*, pg.55

⁷⁹ Andreas Perdelwitz* and René Offermanns *The New Germany-Netherlands Income Tax Treaty*, pg. 115

⁸⁰ Andreas Perdelwitz, René Offermanns *The New Germany-Netherlands Income Tax Treaty*, pg. 116

⁸¹ Para. 1, art. 11 ITC

⁸² Art. 99 CL, art. 74 PLCL

⁸³ Art. 11 ITC

⁸⁴ Nsp. 9, art. 31 ITC

dividends definition of art. 11 ITC and can therefore create circumstances where the payment received is deemed as dividends under art. 11, without having the same right to deduction as is available under art. 31(9). This is because the deduction authorization refers to CL, while art. 11 ITC includes a broader definition of the dividends term.

Since tax authorities can, subject to certain conditions, consider interest payments as dividends in the cases of loans between related parties, you need to look at how tax authorities assess whether a transactions is dividends or an interest payment. The binding opinion of the head of tax Revenue from 20th of March 2001 says which factors should be considered when assessing whether a loan should be regarded as a contribution of equity or debt and whether it is permissible to consider the capital cost of the loan as deductible expenses, cf. para. 1(1), art. 31 ITC, the opinion states that the general distinctions between loans on the one hand and equity contribution on the other is that the claimant of a loan is entitled to its repayment at maturity, i.e. at a predetermined time. On the other hand, the shareholder (or the owner a capital contribution) does not have a claim for repayment of his contribution while the company is still in operation. Capital contribution therefore is a permanent investment that is intended for use by the company that has been invested in, while the loan is inherently temporary investment for a pre-determined time. To distinguish between an equity contribution and a loan the permanency and the potential repayment are normally important factors for consideration. It is nevertheless recognized that in the case of hybrid securities it is to some extent unclear whether the investment is considered as a loan or capital a contribution. The opinion then says that when comparing art. 8 and art. 9 ITC it is evident that the definition of interest is much broader than the definition of dividends. Art. 8 ITC covers interests on bills, bonds and all other financial instruments bearing dividends or interests while art. 9 ITC on the other hand according to its wording only applies to “objects and shares” and the income from "partial ownerships". Thus, it appears that art. 9 assumes that dividends can only be present in the case of an ownership of a company through shares, and that those shares are the base for which there can be any distribution of dividends. Therefore, a claim against a company will not be considered capital in that context, only actual ownership, i.e. shares that give rights in accordance with CL.⁸⁵ From the opinion, it can be concluded that for a transaction to be considered as dividends the one receiving said dividends needs to own actual asset stocks in the company that gives him certain rights under the company laws. Having a claim against a company is not to be considered in the meaning of

⁸⁵ Binding opinion of The Head of Tax Revenue 2/2001

art. 9 ITC payments to the claimants and should therefore be considered interest and not dividends.

Conclusion: The Icelandic tax code is rather simple; most parts of relevant articles relating to corporation taxation have been covered here. Concerning any future legislation regarding thin capitalization the obvious problems are unclear definitions, a definition for company groups needs to be added to the income tax code instead of this “crossover” into Corporation laws. Also, as described in ch. 4.3 on dividends this crossover between the tax code and corporation law, creates legal uncertainty that needs to be ratified. A part from this the tax codes definitions seem to be similar to definitions in other jurisdictions and international agreements. Adjusting the code for any future thin cap legislation should therefore not cause many problems. In regards to Aluminium plants discussed it seems as the interest they are paying to their parent and or sister companies are within the definition of interests of the ITC. As regards to dividends and the possibility to reclassify those interest as dividends it seems to be the opinion of the tax revenue itself that any such reclassification is not within the current scope of the tax law.

5. Possible solutions

In an interview regarding the tax avoidance schemes of the Aluminium plants in March 2013, Katrin Juliusdottir, then Minister of Finance and Economic Affairs said that it was of course not good if someone was not taxed in Iceland on income that had its source in the country. She mentioned that a taskforce had been appointed which handed in conclusions last summer (2012) about imposing rules on loans between parent companies and subsidiaries or connected parties. Katrin also noted that the Icelandic income tax laws already contained a rule, which enabled the tax authorities to monitor if there were any unnatural happenings taking place, unnatural transactions, or loans between connected parties. For example, those parties could take out loans from its parent companies with unnaturally high interests and if the tax authorities demonstrate that it was so, then transactions could be changed or altered to tax them anyway. Katrin then said that if there were any unnatural loans involved she assumed that tax authorities should be able to do something about such arrangements.⁸⁶ In that interview, the Minister identifies two possible solutions, firstly using the tax avoidance provision in the current tax law and secondly to implement some kind of thin cap legislation. In this chapter, author will attempt to take a closer look at the problem itself and then analyze

⁸⁶H Seljan, *interview in Kastljós*, 21/13 2013– link to english transcript available in reference list.

those solutions in two separate chapters with some conclusion at the end of each one. Due to an almost complete lack of any Icelandic literature or case law, regarding cross border tax planning or excessive debt financing this will mostly be this author's speculation.

As before mentioned two of the major players in the Icelandic thin cap "scheme" are Alcoa and Norðurál. Unfortunately it was not possible to get a more recent copy of the annual report for Alcoa Iceland than the one from 2009, that did not cause this author much concern as from looking at the ones from the years before it seems the EBITDA has stayed ca. the same each year. Another problem was that for some reason the annual reports of Norðurál did not contain sufficient information to calculate the EBITDA.

Norðurál 2011:

Profits before financial revenue and expenses was approx. 2,7 M US\$, assuming the company had no operational expenses we can try and use that number as a "fake" EBITDA for calculations sake.

EBITDA: 2,7 M US\$

Debt/Equity ratio = 43:1

Long term liabilities:

Subordinated Loan = 897 M US\$

Liability to related party = 1,4 M US\$

Interest expenses = 96 M US\$

Income tax paid = 0⁸⁷

Alcoa 2009:

EBITDA = - 52.64 M US\$

Debt/Equity ratio = ? In all the annual reports the author has its hands on the equity has been in minus, therefore there is no way to calculate the ratio

Loans from related parties = US\$ 1.601.309 M US\$

Interest expenses = 90 M US\$

Income tax paid: 0⁸⁸

From this and the picture shown in ch. 2 it seems clear that what these companies are doing is simple, they are highly leveraged with debt from related parties, they pay high interests to

⁸⁷ Norðurál (2011), Annual Report

⁸⁸ Alcoa(2009), Annual Report

related parties and no income tax, losses, and carry forward taxable deductions to be used against any future profits.

5.1. Implementing Thin Cap rules

In her interview, Katrin mentioned the works of a taskforce from last summer (2012); the suggestion put forth in its conclusions was that if implementing any rules regarding limitations of the deductibility of interest, earning test approach like the EBITDA rules in Germany, should be the benchmark for consideration.⁸⁹ The earnings test limits the amount of deductible interest expense as a percentage of earnings before interest costs and tax (EBIT) or earnings before interest costs, tax, depreciation, and amortization (EBITDA). This approach normally allows first the reduction of interest expenses up to the interest income received in the same year. In addition, any net interest expense—i.e., the excess interest expense over the interest received in the same year—is deductible up to a percentage of the EBIT. Often, the latitude for net interest expenses broadens by using the EBITDA. Any non-deductible net interest expenses can be carried forward indefinitely. To prevent administrative difficulties and avoidance, the ratio of allowed interest to earnings is the same across industries. This method could create difficulties in businesses with unusually volatile profits, which would see some legitimate interest costs disallowed in low-profit years and would be well below their allowed cap in good-profit years. A sufficiently generous EBITDA limit and the carry-forward provision, however, would mitigate this shortcoming. On the other hand, the allowable interest deduction ceiling is more uncertain ex ante than a debt-to-equity test, as it is known only after profit realization and the income statement is drawn.⁹⁰ The conclusions of the task force suggested implementing a rule that adds a paragraph to art. 57 ITC saying that deductible interest of loans from affiliated companies to be limited at 30% of EBITDA, exempt from the limitations would be companies with EBITDA lower than approx. 1 M Euro and interest cost on loans whose interest proven to be close to what could be agreed between unrelated parties.⁹¹ It is the opinion of this author that these kind of rules would not go far as to prevent or somehow give tools to counter behaviour such as that of Alcoa or Norðurál. They are holding companies, which by nature often have low taxable EBITDA. Moreover, the loans in question have interest in the range of 8 to 9,5% which could well be found to be within arm's length. If not, although not mentioned in the before mentioned suggestions and

⁸⁹ *Report of Ministry of Finance task force on implementing rules regarding thin capitalization*, p. 17

⁹⁰ International Monetary Fund - *Improving the Equity and Revenue Productivity of the Icelandic Tax System*, p.

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⁹¹ *Report of Ministry of Finance task force on implementing rules regarding thin capitalization*, p. 19-20

assuming that only the interest exceeding the arms length interest rate would be taxable, the increase in tax revenue would probably be minimal.

Conclusion: It is highly unlikely that implementing thin cap rules similar to those suggested by the Ministry task force or the IMF will provide any tools tax authorities' could use to increase the tax revenue regarding the aluminium plants in question. There are at least two reasons for that, first there is the fact that it seems that their owners are for the time being "immune" to any changes in law regarding the deductibility of interest. Second, the loans in question are probably within or close to the arms length limit, as pointed out in ch. 3.3 arms length interest can well exceed 6,5%. Seeing as the interest rates in question are 8 – 9,5% that does not leave much left for taxation, that is even ignoring the facts that the corporations in question could simply lower the interest rates to reach the arms length limit.

5.2. Using Current Tax Avoidance Provisions

Would it be as mentioned by the ex minister of Finance, possible to use the current Icelandic tax avoidance legislation to tax the payments made by the aluminium plants to their sisters and parents in other countries?

If tax persons in concluding financial agreements do so in a way that is significantly different from what is common in similar transactions on the open market, any valuables that without such an unusual agreement would have gone to either of the parties, but do not because of said agreement, shall be counted as taxable income for that person.⁹² The provision has a foundation in article 9 of the OECD model tax treaty as that article was at the time of legislation in 1971. That text is substantively identical to the original provision in the tax law, but 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 art. 9 of the Model Convention refers to the terms having to be "different"⁹³ According to this rule, the courts and tax authorities can look past transactions and agreements if their purpose was mainly to achieve a tax advantage, but not done for normal operational purposes. Transactions between related parties are then adjusted to conform to reality by assessing the actual financial and business aspects of the transactions.⁹⁴ The Reality Principle is not considered as having independent statutory authority, since it constitutes a prerequisite for the tax system, and gets its legal basis in the main principle of ITC, according to art. 1, 2, and 7

⁹² Para. 1, Art. 57 ITC

⁹³ OECD Model Tax Convention

⁹⁴ Jan Pedersen: *Skatteudnyttelse*, pg. 440-441.

ITC which prescribes what is to be considered taxable income and that taxable entities must pay taxes on all their income.⁹⁵ A Recent court ruling by an Icelandic court of first instance, confirms that assessment, the judgment stated that the so-called "reality principle" derived from art. 57 should not be applied in the case since that provisions only regarded transfer pricing rules between parties.⁹⁶ Furthermore, in a case appealed to the Supreme Court in 2006, the court held that in interpreting the provision one would need to look at the unwritten principles regarding tax avoidance on which the provision rested. From that it followed, that in no way did the provision allow for the taxation of legal transactions designed to reduce tax burden of a taxable person, even though these measures might not be customary and/or rare. 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 that has been 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 actually exist and can be used as base for taxation.⁹⁷

Conclusion: This overview of the rather limited tax avoidance provision of Icelandic tax law shows that there might be a way to tax the interest payments the aluminium plants are making to their sister and parent companies in other countries by redefining them as dividends. For this to be possible, the definition of dividends in tax law might have to be adjusted in the tax law, as mentioned at the end of ch. 4.3 having a claim against a company is not to be considered payments to the claimants and should therefore be considered interest and not dividends. In the light of complete lack of case law, this author can only guess that this might prove rather difficult. The "conclusion" must therefore be that in theory, this way might be possible under current Icelandic laws; with slight adjustments of the definition of dividends, those chances might even increase for future "interest" payments of the plants. This author hopes that Icelandic courts will get the chance to answer some of these questions in the future.

5.3. What About EU Law

Regardless of the aluminium plants discussed in this examination, it is likely that Iceland will in the near future implement some sort of interest deduction limitation or thin cap rules, members of government have voiced their opinions saying so and there is ongoing work

⁹⁵ K G Valdimarsson, „Skattasniðganga“, p. 237-238.

⁹⁶ Héraðsdómur E-4843/2010

⁹⁷ Hrd. 321/2005

within the Ministry of Finance preparing such legislation. Missing from the suggestions put forth so far is any mention of EU law, its case law, or possible infringements with EU law in any future legislation. Author can only guess that the reason for this is that the EEA Agreement specifically does not cover any EU rules or regulation regarding taxes. This was intended as the EFTA countries entering into the agreement wanted to keep all matters relating to taxes outside its scope. Iceland is however, according to the Supreme Court, in a case involving the supremacy of the EEA agreement, when it comes to legislation, Iceland is bound by the international obligations it has undertaken and the legislator must consider them when applying its powers of taxation.⁹⁸ Icelandic government has an obligation either to implement some provisions of international agreements into its laws or to harmonize national law and the provisions of international agreements. In addition, there are sometimes obligations on member states to interpret international laws in accordance with its international law obligations. Art. 3 of Act no. 2/1993 on the European Economic Area states that laws and regulations should be interpreted to an extent applicable, in accordance with the EEA Agreement and the rules on which the agreement is built upon. The EEA Agreement forms an integral part of the Community legal order, it has primacy, and direct effect in Community Member States, just as any EC legislation does. The EC 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 to be the same, as regards to, for example the free movement of capital. Denying benefits to EFTA nationals while granting them to Community nationals may be in breach of the EEA fundamental freedoms. This can happen if a Community member states national legislation is discriminatory or restricts market access. When EFTA state nationals objectively fulfil the requirement of being in comparable situation as nationals of EC member states, denying them the benefits of the legislations constitutes discrimination in breach of the EEA fundamental freedoms.⁹⁹ This is important as this indicates that a ruling such as the one in the before mentioned *Lankhorst-Hohorst* case, the then German rules regarding thin capitalization were found to be in breach of the freedom of establishment, would have affect on any laws or regulations regarding the same in Iceland. Therefore, the Icelandic legislator would need to have the case law of the ECJ in mind when making new tax rules regarding thin capitalization because of the EEA agreement, even if said agreement specifically excludes taxes from its scope. Even been suggested is that the German *Zinsschranke* causes unequal treatment and that it is not in line

⁹⁸ Hrd. 477/2002

⁹⁹ J Guðmundsson, „European Tax Law in Relations with EFTA Countries“p. 80-81

with the definition of profit under the parent-subsidiary directive and in breach of the freedom of establishment.¹⁰⁰ Other relevant ECJ judgements on the matter are C-196/04 Cadbury Schweppes, C-212/97 Centros, C- 231/05 OY AA, C-524/04 Thin Cap Group Litigation and others.

Conclusion: Even if taxes are excluded from the scope of the EEA agreement, EU law and its case law needs to be kept in mind in any legislation regarding limitations on interest deductions, the fundamental freedoms have been in question in many ECJ cases and as pointed out here Icelandic legislation can not violate those freedoms.

6. Conclusion

Obvious from the words of the *former* (changed 24/5 '13) ministers of finance and industry it is the will of the government to tax the income of the corporations in question in Iceland instead of them being able to “deliver” their profits to their parent and or sister companies in other tax jurisdictions in the form of interest. The legal question then is if that is possible, either with current legislation or by changing it. From the overview of Icelandic laws in ch. 4, the conclusion was that those interest payments were within the tax codes definitions of interests and are therefore “ok” in that respect. Ch. 5.2 discussed the possibility of using the current tax avoidance provisions of the tax code to somehow; with the conclusion that in theory, it could be possible but under the current legislation, it was unlikely to succeed. Some ruling from Icelandic courts on that matter would however be very much appreciated. The option of implementing some thin cap or interest deduction limitation rules was discussed in ch. 5.1 with the conclusion that legislation similar to the one already suggested by a task force set up by the Ministry of Finance would most likely not succeed in increasing any tax revenue from the corporations in question.

The answer to the question “*Is it possible to solve problems associated with multinational corporations taking advantage of the lack of Thin Capitalization rules in Iceland with current legislation or by implementing new rules?*” Must therefore be that it is unlikely that current legislations anti avoidance provisions can solve that problem and that the current ideas regarding new legislation are unlikely to succeed as well. It is the opinion of this author that the way most likely to succeed would be to implement provisions into the tax code that made it easier for tax authorities to make transactional changes to such interest payments and

¹⁰⁰ R Eicke and W Kessler, ‘New German Thin Cap Rules – Too Thin the Cap’, p. 266

redefine them as dividends. The problem however with such a solution is that one can easily circumvent it by simply going through a third party. In the case of the aluminium plants, for example, the foreign owners could put huge amounts of money into a bank account and agree with that bank that in return it would lend the Icelandic corporations the same amount charging a bit more interest on the loan than the pay in savings account. It is this author's opinion that in light of the problems with thin cap or interest limitation rules in other countries, implementing such rules is not necessarily the best solution for Iceland. It would not affect that many corporations, and the gain in tax revenue might be minimal. Instead, adding to the existing tax avoidance provision some clear rules allowing for transactional changes from interests to dividends when excessive interests are paid on loans to shareholders or affiliated companies without there being any obvious operational reasons for such loans. The business purpose test of the ITC might prove useful in such determination: "in order for an expense to be deductible, it has for that year, have had the purposes of earning the income".¹⁰¹ Loans taken out from shareholders or affiliated companies that failed that test would then be considered as equity contributions and not loans and all interest payments taxed as dividends.

In any case, the Icelandic Tax Code needs some overhaul; it needs clear definitions of interests, dividends, and consolidated company groups, clear rules regarding tax accounting standards would be a good addition as well. Moreover, the tax avoidance provision, regardless of future implementation of thin cap rules could use some makeover. As it is, it seems to be in the hands of the courts rather than the legislator how certain tax planning behaviours should be treated, this is not ideal; the courts need clear directions from law rather than having to make the laws up themselves.

Finally, and somewhat off topic the author would like to point out that empirical evidence has shown that thin cap or interest deduction limitation rules seem to reduce investments up to a point where that loss is more than any gain in tax revenue while at the same time increasing tax competition.¹⁰² This might be ok for larger countries like Germany but for smaller countries, increased tax competition may not be such a good thing. Before any steps are taken in restricting the deductibility of interests, the Icelandic legislator should consider all possible affects, not simply the possible increase in tax revenue.

¹⁰¹ Para. 1, art. 31 ITC.

¹⁰²R A de Mooj, *Tax Biases to Debt Finance -Assessing the Problem, Finding Solutions*. also T Buettner, M Overesch and others, *The Impact of Thin-Capitalization Rules on Multinationals*. Financing and Investment Decisions.

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