AN IN-DEPTH ARTICLE FROM WIERSHOLM

Limitation of interest deduction on intra-group loans

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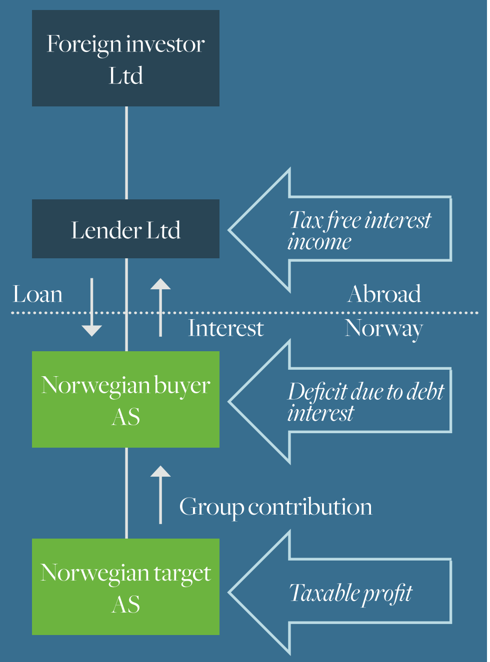


1. BACKGROUND

Provisions to limit the deductibility of interest paid between taxpayers that are related parties (internal interest) were introduced and entered into force from 1 January 2014.

The interest limitation rule is motivated by the desire to prevent multinational groups from deducting interest costs in Norway, while sourcing the interest income to low-tax jurisdictions.

Many OECD countries have also tightened their interest deduction rules, including Denmark, Sweden and Finland. However, the interest deduction limitation rules vary significantly from country to country. Under the interest limitation rule, the lender (if taxable in Norway) will be taxed for its interest income even though the borrower's right to deduct interest costs will be limited under the rule.

Note that external loans can be regarded as internal loans in a number of contexts. If, for instance, a related party has provided security for the debt, the borrowing company's external loan is to be reclassified/categorized as an internal loan.

2. MAIN ASPECTS

The main aspects of the interest limitation rule are as follows:

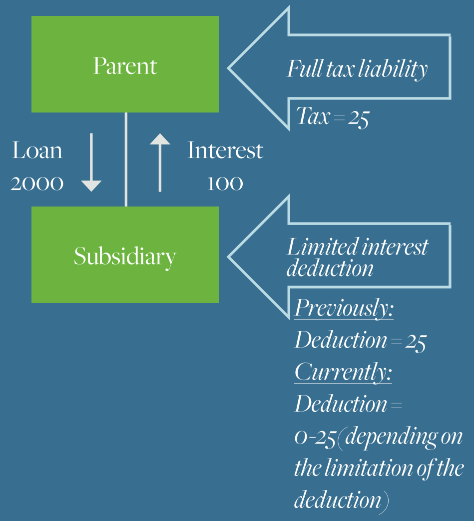
- The basic principle is that the interest limitation rule applies to loans between related parties, i.e. internal loans. In order to be regarded as a related party, ownership or control of at least 50 percent at some point during the income year is required.
- The rule allows for the provision of security, letters of comfort, and back-to-back agreements to imply that an external loan might be reclassified/categorized as an internal loan.
- Deduction of interest expenses exceeding 25 percent of the amount of a specifically defined result, is denied. (For the income year 2015 the percentage was 30).
- When calculating the interest deduction limit, the tax result before interest deduction limitation, is used as a basis. Net interest expenses and tax depreciations are to be re-allocated in such a basis.
- If the net interest costs exceed NOK 5 million, the interest deduction limitation is to apply in full.
- Denied interest deduction may be brought forward and deducted in the next ten income years.
- Below you find a detailed review of the rules.

3. NOK 5 MILLION THRESHOLD

The rules regarding the limitation of deductible interest is found in section 6-41 of the Norwegian Tax Act. The limitation only applies to companies that have net interest costs exceeding NOK 5 million. In that case, the limitation of deductibility of interest expenses apply from NOK 1. Companies having lower net interest costs are, thus, still entitled to deduct these costs without limitation. Net interest costs include both external and internal interest costs, reduced by interest income. The threshold amount (NOK 5 million) applies per company.

4. GENERALISED RULE – NO CASE-BY-CASE THIN CAPITALISATION RULE

A generalised rule is introduced for calculating the deductible interest costs. Hence, the rule is not a classical thin-capitalisation rule, under which the borrower's borrowing capacity and right to interest deductions on intra-group loans are assessed on a case-by-case basis. The maximum deductible interest will be calculated on the basis of a generally applicable interest deduction limit.

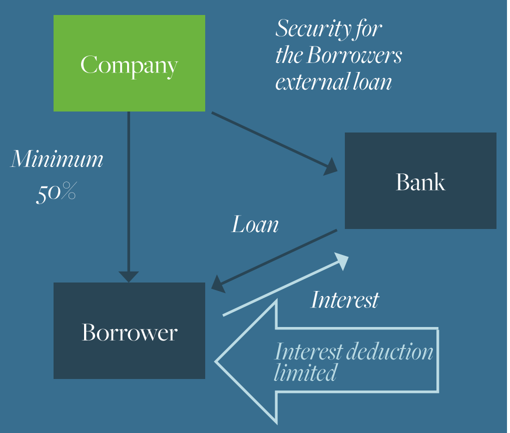


5. MAIN PURPOSE; THE RULES ARE APPLICABLE TO INTRA-GROUP LOANS

The interest limitation rule applies to loans between related parties. The interest deduction limitation shall not exceed the total amount of net intra-group interest costs. Hence, the rule is not intended to limit the right to deduct interest on loans obtained from unrelated lenders such as e.g. banks and financial institutions. However, interest paid to unrelated lenders is included when calculating the interest deduction limit. Therefore, if the borrower has high interest costs on external loans this will significantly reduce the amount of interest on intra-group loans it will be entitled to deduct. External interest will displace internal interest within the interest deductibility limit.

Group account schemes will normally entail that the interest deduction is limited by the interest limitation rules. For group account schemes with a credit facility and joint collateral from the companies, the parent company's interest on debt to the bank is regarded as external interest. But; the rules also applies to external loans as external loans can be reclassified to internal loans.

It is signaled from the Ministry of Finance that it may be appropriate to extend the interest limitation rule so that interest to independent (external) lenders also is included in the interest limitation. However, the Ministry of Finance states that there is no reason to include external debt in actual loans where there is no risk of profit shifting, and will investigate alternative solutions to prevent actual loans to be affected.



5.1 Reclassification if security from a related party is provided

External loans may be regarded as internal loans in a number of contexts. If, for instance, a related party has provided security for the debt, the borrowing company's external loan is to be reclassified/categorized as an internal loan.

Both the wording of the act as well as its legislative background allow for the provision of security and letters of comfort to imply that an external loan might be reclassified as an internal loan.

Group account schemes with cross guarantees between subsidiaries do not cause any limitation of interest deduction since they neither increase the parent company's borrowing capacity nor give the lender increased security. The same should apply if the subsidiaries are jointly liable for the parent company's obligation.

Cross guarantees between subsidiaries for the subsidiaries' loans could, however, cause a limitation of interest deduction.

5.2 Indemnity, "all guarantors' liabilities" etc will not lead to reclassification

A general security from related parties, such as indemnity, costs in connection with loans not used etc., which is not related to the debt forming the basis of the interest cost, will not lead to a re-classification of the interest on the loan.

5.3 Letter of comfort

The ministry expresses in an interpretive ruling dated 10 June 2014 the view that a re-classification of external debt to internal debt does not just cover legally binding provision of security, but also cases of informal provision of security. An example of such informal provision of security would be a declaration from the parent company concerning financial support (letter of comfort) vis-à-vis the lenders of the company's subsidiary.

It appears from the preparatory works that it depends on the interpretation in each individual case whether or not such informal provision of security should be considered covered, and there is a requirement that the provision of security has affected the borrowing opportunity of the subsidiary as compared to what would be achievable in the market without such provision of security.

5.4 Subordinated loans

Subordinated loans are not mentioned in the preparatory works. In our opinion, subordination of a loan in favour of a related party should not be considered as collateral and lead to reclassification. However, it cannot be excluded that the tax authorities find a declaration from a related company concerning subordination of its loan vis-à-vis the lenders of the borrowing company, that is covered and will lead to reclassification of the external loan to an internal loan. As mentioned above regarding the authorities' view of the letter of comfort, we assume that the subordination in that case will affect the borrowing company's loan capacity.

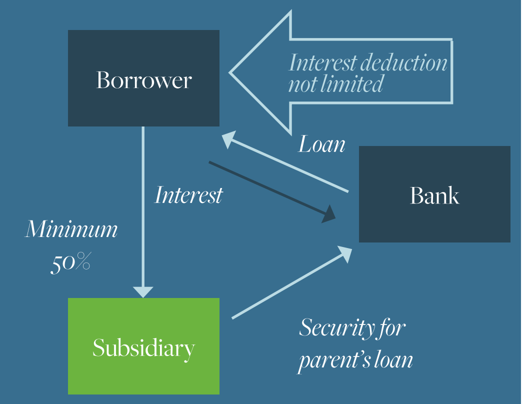
5.5 Equity guarantee

The preparatory works do not address whether an equity guarantee is covered by the interest deduction limitation rule. In our opinion, an equity guarantee should not cause any interest deduction limitation since the guarantee is not for the debt. An equity guarantee will normally be given to the lenders of the borrowing company, and it cannot be excluded that the tax authorities will find that this is covered by the interest limitation rules. We assume that the equity guarantee in that case will affect the borrowing company's loan capacity.

5.6 Exceptions in regulation

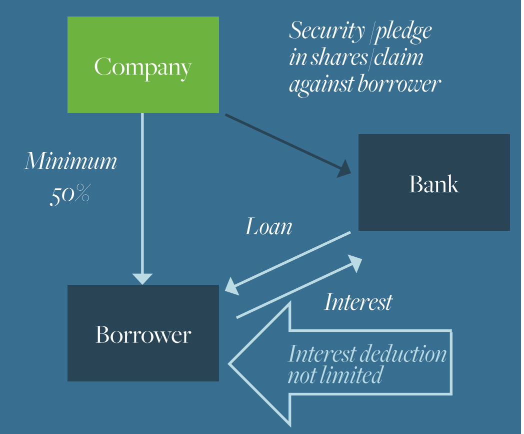
5.6.1 Security provided by underlying company

In the regulations, determined on 24 April 2014, an exception is provided for cases in which the security is provided by an underlying company of which the borrowing company directly or indirectly owns or controls at least 50 percent.



5.6.2 Related party provided shares as security for the borrowing company

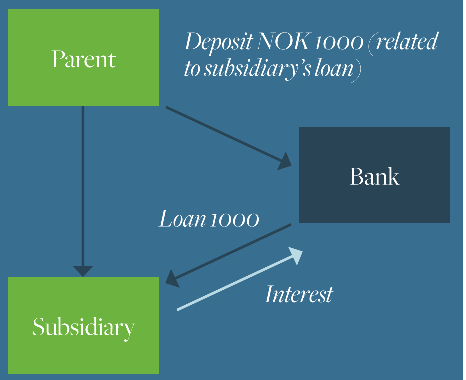
Also subject to an exception are cases in which a related party has provided shares in the borrowing company or a claim against the borrowing company as security.



5.6.3 Negative pledges are not to be regarded as security

Negative pledges are not to be regarded as security. This also applies to other types of pledges, such as a ban on sales, a ban against raising new loans and a ban against shutting down activities.

5.7 Back-to-back loans



A loan between related parties that is granted indirectly through an independent party (a so-called "back-to-back" loan) will also be regarded as an internal loan. For instance, a company may raise a loan in an independent bank. At the same time, the parent company of the company deposits an equivalent amount in the bank. In such a situation, the loan to the bank is to be regarded as an internal loan under the interest limitation rule. However, this does not apply if there is no connection between the lending and the borrowing, meaning that a third-party loan does in fact exist.

It is assumed that a specific assessment must be made as to whether there is an adequate "link" between the parent company's deposit in the bank and the bank's lending to the subsidiary.

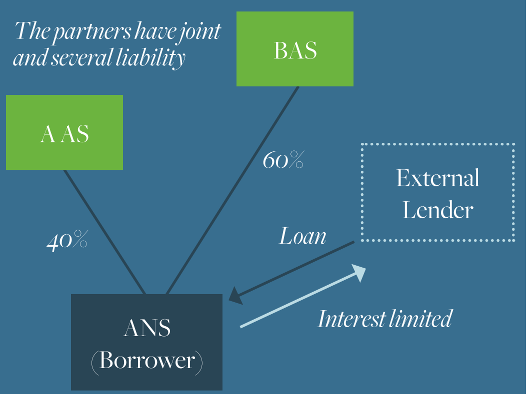
5.8 Security for parts of a loan or part of a year

If security has been provided for parts of a loan, the re-classification of external interest to internal interest is to be limited to a corresponding part of the interest amount.

The ministry states in an interpretive ruling dated 10 June 2014 that if the requirements for having interest regarded as internal interest are fulfilled only for parts of a year, then only the interest relating to this period should be regarded as internal interest.

5.9 Loans in tax-transparent partnerships

In general partnerships (Norwegian company types ANS or DA), the partners have either a joint and several (ANS) or a pro-rata (DA) liability in respect of the liabilities of the partnership. In its ruling dated 10 June 2014 and 4 July 2014, the ministry expresses the view that the liability resulting from a partnership may be regarded as security. The ministry alleges that there is no basis in the rules on the limitation of the deductibility of interest for considering the liability resulting from a partnership as exempted from the rule concerning the re-classification of external interest to internal interest. In the view of the ministry, the purpose behind the rules on the limitation of the deductibility of interest indicates that such security/liability is comprised by the rule.



This, then, implies that external loans raised by a general partnership (ANS) with a partner holding an ownership share of 50 per cent or more may be reclassified/categorized as an internal rather than external loan and as such be covered by the rules on the limitation of the deductibility of interest.

For general partnerships with a joint and several liability (ANS) the ministry's interpretation of the law has very unfortunate implications and can have a considerable impact on the right to make interest deductions. The Directorate of taxes has in a binding advanced ruling considered whether participants in a general partnership (ANS) should be deemed to have provided security for the company's debt in relation to the interest limitation rule. The Directorate concluded that the signing of an agreement for limitation of liability between a partnership, the participants and lender meant that the participants were no longer considered to have provided security for the partnership/company's debt after the interest limitation rule.

On the basis of the directorates ruling it must be sufficient that there is an agreement between the relevant parties on the restriction of the participants' responsibility to avoid that the participants are considered haven provided security. It cannot be a requirement that the limitation of liability explicitly shall appear in the partnership agreement. The same applies to other partnerships, such as partnerships with shared liability (DA), limited partnerships (KS) and internal companies (indre selskaper). From the way in which the ruling is phrased, it appears as if general partnerships with a pro-rata liability (DA), in which the individual partners are only liable for their pro-rata share of the partnership's liabilities, will not be subject to such a risk of re-classification of external loans. The ministry's has in a ruling 4 July 2014 stated this. In order to remedy any negative consequences of the ministry's interpretation, one option would be to make the change from joint and several liability (ANS) to pro-rata liability (DA). Implementing such a change will generally not trigger tax liability or stamp duty (stamp duty applies in a sale of property).

5.10 A duty to inspect in respect of bond loans

In the case of a bond loan issue the lender is not necessarily known to the borrower / issuer of the bonds. It is stated in the Ministry of Finance ruling dated 10 June 2014 that if the taxpayer is unaware that the lender in a bond loan is a related party and the taxpayer in a careful and loyal manner has fulfilled the requirements of the Tax Assessment Act concerning the duty of disclosure, then the two-year deadline applies for the performance of reassessments.

The ruling does not indicate what kind of inspections must be made to find out who the owners of the bonds are or what kind of information must be given to the tax office in order to fulfil the requirements of carefulness and loyalty.

6. CALCULATION OF INTEREST DEDUCTION LIMIT

The maximum limit for deduction of interest costs is stipulated to 25 percent of a deduction limit.

6.1 The calculation

The deduction limit is calculated as follows:
Ordinary income before interest limitation

+ Interest costs
+ Fiscal depreciations
- Interest income
= Basis for the deduction limit

According to the Ministry of Finance, the calculation is intended to be a fiscal approach to EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), which is regarded as an indicator of the cash flow, and thus also the ability to pay interest on debt. However, the fiscal concept proposed by the Ministry might deviate substantially from EBITDA based on accounting rules, e.g. since share income (capital gains on shares, dividends, etc.) taxed under the participation exemption method will not form part of the taxpayer's ordinary income. This means that for companies with substantial tax-exempted capital gains and dividends, the deduction limit might be strongly limited. This will also be the situation if the borrower has carry-forward losses recognised for fiscal purposes. Group contributions received will form part of the ordinary income and thus also the basis for calculation of the deduction limit.

The interest deductibility limitation applies to each company, even if the company is part of a group.

It appears from the rules that no deduction is granted for additional carryforwards or group contribution after the limitation of interest deductibility. It is thus not possible to compensate for higher taxes (due to the limitation of interest) in the adjusted ordinary income, with the use of group contribution or loss carryforward.

Limitation of interest deductibility may lead to an additional general income, which in turn may lead to (more) tax payable. The borrower may in certain circumstances be served by not claiming a deduction for internal interest rather than getting an extra income that cannot be offset against losses.

6.2 What is regarded as net interest costs?

All costs falling under section 6-40 of the Norwegian Tax Act (the general rule on deductibility of interest costs) qualify as interest costs under the provision. Other categories of income/costs that will qualify as interest under the rule are:

- Discounts and premiums received/paid upon borrowing
- Profits and losses on "hybrid bonds" (e.g. convertible bonds) that are not to be separated into a bond-element and a derivative-element for tax purposes

By contrast, the following categories of income/costs shall not qualify as interest under the rule:

- Interest- and currency derivatives
- Currency exchange gains/losses (agio/disagio) related to loans

6.3 To which taxpayers shall the interest limitation rule apply?

The rule shall apply to companies taxed as separate tax entities (private limited companies (AS), public limited companies (ASA), co-operatives etc.), partnerships, Norwegian controlled foreign companies in low-tax countries (NOKUS/CFC), and certain companies and establishments with a limited tax liability to Norway. The rule shall not apply to individuals (physical persons). Limited liability companies owned by municipalities and funded through loans from their municipality-owner are also covered by the rule.

The interest deduction limitation is calculated for each separate company even though the company is part of a fiscal group of companies (i.e. a group of companies with more than 90 per cent common ownership).

The interest deduction limitation rule shall apply for the purpose of calculating the basis for ordinary corporation tax imposed on hydroelectric power companies.

For companies taxed under the shipping tax regime, section 6-41 (9) provides that the interest deduction limitation does not apply to companies that are covered by the Petroleum Taxation Act section 3 d. It is, however, indicated that the ministry will come back with proposals for rules regarding limitation also for the shipping tax regime.

According to the provision, financial institutions shall be exempt from the interest deduction limitation rule.

6.4 Which taxpayers are regarded as related parties?

As a general rule, only the right to deduct interest on intra-group loans is to be limited by the interest limitation rule. Such intra-group interest is defined as interest paid to a related person, company or establishment.

The provision is to include both direct and indirect ownership. When considering whether the borrower and lender qualify as related parties, the criteria found in section 4-12 of the Norwegian Tax Assessment Act (containing the Norwegian transfer pricing documentation rules) are to be applied. This implies that a wide range of related parties will be regarded as related parties under the rule. A person, company or establishment is regarded as a company's related party if there is at least 50 percent direct or indirect common ownership between them. It is sufficient that the criteria of "50 per cent ownership or control" are met at some point during the income year

6.5 Carry-forward of non-deducted intra-group interest

Interest which, as a result of the interest deduction limitation rule, cannot be deducted in the year it is incurred, can be carried forward and deducted for ten years (extended from five years in earlier proposals). Carry-forward interest can only be deducted in a future income year insofar it lies within the lender's interest deduction limit for the relevant financial year.

It is not possible to carry forward unused deduction limit or tax EBITDA to subsequent years.

6.6 Taxation of the lender's interest income

Under Norwegian domestic law, the lender's interest income will be taxed in its entirety, even if the borrower's right to deduct interest costs is wholly or partly limited under the interest deduction limitation rule. Thus, under Norwegian domestic law there will be no symmetrical treatment of the borrower's right to deduct interest costs and the lender's obligation to pay tax on interest income.

If the lender's interest income is not subject to tax in Norway, this asymmetry may be reduced or eliminated (depending on the lender's level of taxation).