Report No. 11 to the Storting

(2010–2011)

Report to the Storting

Evaluation of the 2006 Tax Reform

Recommendation of 1 April 2001, approved in the Council of State on the same date. (White paper from the Stoltenberg II Government)

Summary

1 Evaluation of the 2006 tax reform – main features

1.1 The tax reform – background and main elements

1.1.1 Purpose of the reform

The 2006 tax reform was implemented in the wake of a broad political process based primarily on the recommendations in NOU *[Official Norwegian Reports]* 2003: 9 *Skatteutvalget [The Tax Committee]*. The principal objective of the reform was to solve the growing problem that income from labour was being camouflaged as income from capital through tax-motivated adaptation to the split model. In the course of the 1990s, the split model had become so diluted that it was simple to make tax-motivated adaptations. Many self-employed persons did just that, and the amount of tax saved could be very substantial since labour income was taxed at a rate of up to 64.7 per cent (including employer's National Insurance contribution) whereas 28 per cent tax was levied on capital income. This tax loophole undermined real redistribution and threatened the legitimacy of the tax system.

The tax reform was also supposed to make the tax system more robust to increased globalisation. The reform was supposed to boost the general conditions for investing and working in Norway, so that tax bases and resources were not lost to other countries. Emphasis was also placed on fulfilling Norway's commitments under the EEA agreement. While work on the tax reform was in progress, there was some dispute as to whether the system for share taxation with RISK[1] and imputation in force at the time could continue, in view of developments in EU law.

Measures for strengthening the tax bases were also to be examined in the preparations for the tax reform. A broad tax base is conducive to a simpler taxation system and is important for keeping tax rates low and enabling a progressive rate structure to have the intended wealth redistribution effects. A broad tax base that reflects economic realities also strengthens the automatic stabilizers of the tax system. There is reason to believe that the design of the

[1] The RISK system was a technique for avoiding double taxation of gains trough an adjustment of the acquisition price of a share with already taxed retentions.

Norwegian tax system has enabled the Norwegian economy to handle the financial crisis better than most other countries.

It was important to the present Government, when it took over in autumn 2005, that the reform should strengthen redistribution through the tax system. In addition to the introduction of tax on dividends, wealth tax was therefore also emphasised as an important distribution policy instrument. In contrast to the Bondevik II Government, which aimed to dismantle wealth tax, the present Government has entrenched wealth tax by boosting the distribution profile and aiming for more equal treatment.

According to the mandate of the Tax Committee, the reform was to be rooted in the fundamental principles for an effective tax system that were laid down through the 1992 reform, including principles for equal treatment and a broad tax base combined with relatively low tax rates. To ensure effective use of resources and high value added, it is crucial that corporate and wealth taxation be designed to foster socio-economically profitable investment. This is contingent on predictability, stable rules and a high level of equality in the fiscal treatment of different industries and investments. For a more detailed account of key principles for an effective taxation system, see section 2.1. of Proposition no. 1 (2010-2011) to the Storting (the Budget Bill).

Box 1.1 The work that culminated in the tax reform of 2006

In National Budget 2002, the Stoltenberg I Government announced that it had been agreed in the budget agreement between the Labour Party and the centre parties to submit a proposal for restructuring business and wealth taxation. A report was to be presented to the Storting in the autumn of 2002.

Following the change in government in October 2001, the Bondevik II Government appointed a committee of experts through a Royal Decree of 11 January 2002. The committee, which was chaired by former minister of finance Arne Skauge, was to consider changes in income and wealth taxation. The committee submitted its recommendation – NOU 2003: 9 *Skatteutvalget* (The Tax Committee) to the Ministry of Finance on 6 February 2003. The recommendation was then circulated widely for comments.

On 26 March, 2004, the Bondevik II Government submitted a report to the Storting on tax reform – Report no. 29 (2003 – 2004) to the Storting: The Government Tax Reform Proposal. On the basis of the Storting's deliberations on Report no. 29 to the Storting, cf. Recommendation no. 232 (2003 - 2004) to the Storting, a draft act was submitted as

Proposition no. 1 (2004-2005) to the Odelsting together with the Fiscal Budget for 2005. The majority of the amendments associated with the tax reform were then adopted in autumn 2004.

In addition, a government committee was appointed on 8 September 2004 to study whether taxation of owners of sole proprietorships and partnerships (general partnerships, limited partnerships etc.) should be linked to withdrawal of profit from the enterprise. The committee, which was chaired by Advocate Marianne Iversen, submitted its recommendation – NOU 2005: 2 *Uttaksutvalget* (The Withdrawal Committee) – to the Ministry of Finance on 12 January 2005. The Withdrawal Committee recommended introducing extra taxation in connection with profit distributions from partnerships to personal partners, while advising against taxation on withdrawals from sole proprietorships. The committee's proposals were followed up by the Ministry in Proposition no. 92 to the Odelsting (2004-2005), and amendments were adopted in the spring of 2005.

Key changes in rates for income taxation were adopted in the budgets for 2005 and 2006.

1.1.2 Main features of the reform

Since the 1992 reform, the Norwegian income tax system has been based on a two-tier structure (the dual income tax). Distribution was to be provided for through progressive taxation of gross labour and pension income, while the objective of efficient use of resources was to be the principle behind the taxation of capital income earned by personal tax payers. This income, like corporate profits, was subject to a flat tax rate of 28 per cent. The split model was to function as a bridge between these two parts of the tax system, by dividing income from own activities into two portions, taxable as capital income and labour income, respectively. Since the 1992 reform, however, the split model has been changed several times with the result that it no longer functioned in a satisfactory manner. In the 2006 reform, a system that did not involve a split model was therefore chosen. Rather than being based on rules designed to eliminate the *possibility* of tax-motivated adaptations, the aim was to remove the *motive* for adaptations by evening out the highest tax rates on ownership income (from self-employment, partnerships or companies) and wage income.

The intention of introducing the *aksjonærmodellen* (shareholder model), the *deltakermodellen* (partnership model) and the *foretaksmodellen* (self-employed model) was to ensure a high marginal tax on ownership income, irrespective of whether the income was earned through a limited company, a partnership or a sole proprietorship. Ownership income in excess of a

computed risk-free return on capital invested is taxed either as personal income (the self-employed model) or as ordinary income when it is disbursed to corporate owners (the shareholder model and the partnership model). This risk-free return allowance was intended to prevent tax on dividends from undermining enterprises' access to fresh, Norwegian equity, and to pave the way for investment and business start-ups in Norway. Table 1.1 provides an overview of the principal systemic changes in the tax reform.

Table 1.1 The main systemic changes brought about by the tax reform of 2006

Previous rules	New rules
Share income earned by Norwegian personal shareholders	
Share dividends from Norwegian companies: in principle taxable, but full imputation means that in practice dividends are not taxed in the hands of the shareholder. Share dividend from foreign company: fully taxable, deduction in Norwegian tax for tax at source on dividends paid to the state in which the company is resident. Active shareholders are additionally taxed according to the split income model, with progressive tax (National Insurance contributions and surtax) on an estimated share of the company's profit attributable to labour, irrespective of whether the profit was distributed as dividend or not. Capital gains on shares are always taxable income, and losses on shares are deductible. When gain or loss on shares is calculated, income that was taxed in the company during the shareholder's ownership period is credited	**The shareholder model:** Share dividends in excess of the allowance for a computed risk-free return are taxable. The imputation rules are abolished. The shareholder model applies only to dividends from companies resident in Norway or another EEA country. Dividends from companies resident in non-EEA countries will be taxable as before, i.e. fully taxable, but with deduction in Norwegian tax for taxation at source. The split income model is abolished for active shareholders. The new rules do not distinguish between active and passive shareholders. *Entry into force:* 1 January 2006. A transitional rule for 2005 introduced the same right to imputation for dividends from companies in EEA countries as for dividends from Norwegian limited companies. Capital gain on shares is always taxable, and

<table>
<tr><td>to the shareholder through the RISK rules (opening value adjustment). This adjustment ensures that the portion of the gains that is due to retained profits is not taxed. RISK is only applied to shares in Norwegian companies.</td><td>loss on shares is always deductible.

The RISK rules are abolished. Unused risk-free return allowance reduces capital gains, but cannot be used to increase a loss.</td></tr>
<tr><td colspan="2">Share income accrued by Norwegian limited companies</td></tr>
<tr><td>Dividends, capital gains and losses are treated as described above for personal shareholders.</td><td>The exemption method: Share dividend and capital gains on shares are exempt from tax. Conversely, losses on shares are not deductible.

The exemption method does not apply to:

– shares in companies in low-tax non-EEA countries

– portfolio shares (i.e. in cases of a less than 10 per cent holding) in companies in non-EEA countries

For these shares, dividends and capital gain on shares are still taxable and losses on shares are deductible.

Entry into force: 1 January 2004 for dividends and 26 March 2004 for capital gains and losses on shares.</td></tr>
<tr><td colspan="2">Share dividends from Norwegian limited companies to foreign shareholders</td></tr>
</table>

Obligation to pay tax at source to Norway on dividends. The tax rate is 25 per cent at the outset, but has been reduced in a number of tax agreements into which Norway has entered with other states.	If the foreign shareholder is a limited company resident in an EEA country, the exemption method applies. *Entry into force:* 1 January 2004. Personal shareholders resident in another EEA country are taxed according to the shareholder model in the same way as Norwegian personal shareholders. For shareholders outside the EEA (both personal and corporate) the tax at source rules apply as previously. *Entry into force:* 1 January 2004. Under a transitional rule, these shareholders were exempt from tax at source in 2005.
General partnerships, limited partnerships and other partnerships	
The company's profits are taxed on an accrual basis as ordinary income in the hands of partners. Active partners are additionally taxed according to the split income model, with progressive tax (National Insurance contributions and surtax) on an estimated share of the company's profit attributable to labour, regardless of whether the profit was distributed to partners or not.	The company's profits are taxed on an accrual basis as ordinary income in the hands of partners. **The partnership model:** When corporate profits are distributed to personal partners, the part that exceeds a computed risk-free return on the investment is additionally taxed as ordinary income. The split income model is abolished for active partners. *Entry into force:* 1 January 2006
Self-employed (sole proprietorships)	

The profits are taxed on an accrual basis as ordinary income in the hands of the owner. Active owners are additionally taxed according to the split income model with a progressive tax (National Insurance contributions and surtax) on a computed share of the company's profits attributable to labour.	The profits are taxed on an accrual basis as ordinary income in the hands of the owner. **The self-employed model**: The owner is additionally subject to a progressive tax (National Insurance contributions and surtax) on accrued profits after deduction of a computed risk-free return on the capital. *Entry into force:* 1 January 2006

Source: Ministry of Finance

Share dividends and capital gains on shares to personal shareholders are taxed according to the *shareholder model*, while the *partnership model* determines the taxation of distributed profits from partnerships (general partnerships, limited partnerships etc.) to the individual partner. Limited companies and partnerships differ in that the profits of limited companies are taxed in the companies (28 per cent), whereas the profits of partnerships are distributed among and taxed in the hands of the partners (28 per cent). However, the withdrawal taxation itself is the same. Personal shareholders and partners pay 28 per cent tax on the non-exempt portion of dividend/withdrawal from the companies. Added to the general tax of 28 per cent on company earnings, this therefore raises the maximum marginal tax on ownership income from 28 per cent before the reform to 48.16[2] per cent after the reform. All in all, the tax systems for personal partners and personal shareholders correspond to a large extent. There is not a distinction between the business economy and private economy of the self-employed as there is between shareholder and limited company. The shareholder model could therefore not be used for sole proprietorships. Instead, the *self-employed model* was introduced. Like the earlier split model, the self-employed model means that tax is levied on computed personal income at the progressive rates that apply to labour income (National Insurance contributions and surtax). To ensure that treatment is as similar as possible to the shareholder model and the partnership model, personal income is determined by deducting a computed risk-free return on capital from self-employment income. The calculated personal income accordingly captures both any high return on capital in the sole proprietorship and the return on labour.

[2] $0.28 + 0.28\ (1 - 0.28) = 0.4816$

At the same time as dividend tax was introduced, surtax rates were reduced to 9 per cent and 12 per cent, respectively, and the additional employer's social security contribution on wage income over 16 G (where G is the basic amount in the National Insurance system) was abolished. The highest marginal tax on wage income (including employer's social security contribution) was thereby reduced from 64.7 per cent in 2004 to 54.3 per cent in 2006, and has remained unchanged since then. The rate reductions combined with dividend tax evened out the difference between the marginal tax rates on ownership income and labour income so much that the profitability of income shifting was substantially reduced (see Figure 1.1). Consequently, the split income model could be abolished.

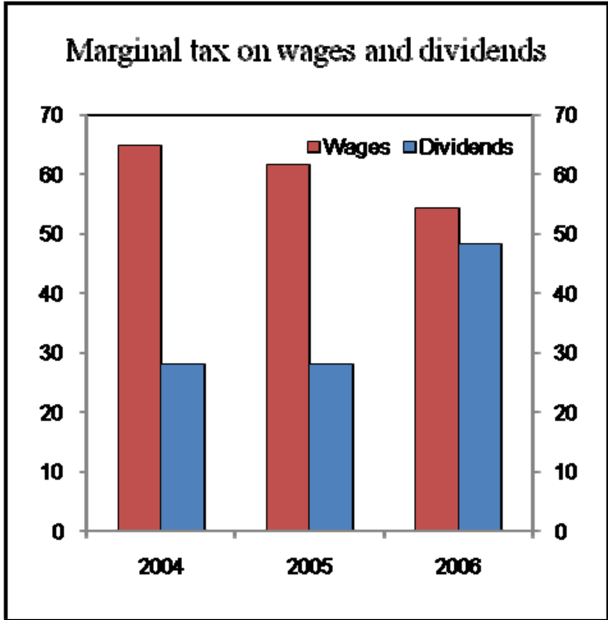

Figure 1.1 Marginal tax on wages and dividends (incl. corporate tax) 2004 - 2006. Including highest rate for employer's social security contribution. Per cent

Source: Ministry of Finance

Central to the reform was the exemption from tax, other than ordinary income tax of 28 per cent, of a return equivalent to the risk-free interest. This allowance was intended to prevent tax on dividends from raising the costs of funding Norwegian equity. The allowance was regarded as particularly important for start-ups and small companies that cannot fund new investment with retained profits, or which have limited access to credit markets or international capital markets. Large companies that can fund their investments through the international capital market are only affected to a limited extent by Norwegian tax on dividends.

The annual risk-free rate of return allowance for shareholders/partners (RRA) is computed as the exemption rate multiplied by the sum of the cost price of the share/holding and any unused allowance from previous years. Unused allowance is then carried over to the next year with interest and can be deducted from future dividends and capital gains associated with the same share/holding. The RRA for shareholders and partners is the average interest rate on three-month Treasury bills in the year for which the allowance is to be calculated. The same RRA forms the basis for calculating the allowance for a sole proprietorship.

In addition to finding a solution to the problem of income shifting, there was a need to change the taxation of share income, which was uncertain with respect to compliance with the EEA agreement. The imputation and RISK rules, which were supposed to prevent double taxation of corporate profits, treated Norwegian and cross-border share income differently. For personal shareholders, these regulations became superfluous with the introduction of the shareholder model. For companies, the RISK and imputation rules were replaced by the exemption method, whereby dividends and capital gains to corporate shareholders were exempt from taxation. Share income is thus only taxed on withdrawal from the corporate sector (shareholder model). The exemption method applies to both domestic and cross-border share income in the EEA area, and should thereby ensure compliance with Norway’s obligations pursuant to the EEA agreement. The method also covers companies that are partners in partnerships. It was possible to abolish both the imputation and RISK system for personal and corporate taxpayers when the tax reform was introduced.

1.1.3 The Ministry’s approach to evaluating the reform

The work of evaluating the tax reform has been broad-based and has been under way in the Ministry for a long period. The Ministry has considered the economic aspects of the rate of return allowance models, equal treatment of different types of income and activity, distribution effects of the reform, effects on the labour supply and administrative consequences. However, it has not been possible for a number of reasons to evaluate all the effects of the reform equally thoroughly. First, it is difficult to distinguish the effects of the reform from other factors that influence economic developments. Second, a relatively short period of time has elapsed since the reform was implemented. This means that knowledge of the effects of the reform will grow as more data become available. Third, the data that are available reflect adaptations to the tax reform.

The Ministry involved a number of external contributors in the evaluation process, outsourcing three assignments designed to reveal the economic and administrative effects of the reform:

- Statistics Norway was assigned to evaluate the practical and theoretical aspects of the shareholder model, and the significance of any weaknesses for the neutrality of the model.
- Statistics Norway was assigned to evaluate the distribution effects of the tax reform.
- Rambøll Management Consulting AS was assigned to study the administrative costs for companies, personal taxpayers and the tax administration.

Two seminars were held with researchers and tax experts from Norway and abroad. The Ministry has also maintained close contact with research communities in the course of the work. The economic aspects of the shareholder model in particular, and the need for and design of the computed risk-free return allowance were the subjects of this dialogue.

Two meetings were held with a contact group consisting of a broad selection of key players in Norwegian business and society. The Ministry received a good deal of input from this group which was discussed thoroughly in connection with the evaluation. The Ministry has also considered other proposals relating to the tax reform that have been presented in various connections, for example through Storting members' bills and input the Ministry has received from various organisations.

1.2 Main results and evaluations

In the view of the Ministry, the evaluation presented here depicts a very positive picture of the effects of the reform. The adaptation possibilities inherent in the old system have been very largely eliminated. The amount paid in tax now depends far less on how labour income is earned or how businesses are organised. As a result of dividend tax coupled with wealth tax, the most affluent pay considerably more tax than before, and lower tax on labour has boosted value added through an increased labour supply. The administrative costs are moderate, and dividend tax does not appear to have had a negative effect on the supply of capital. The tax system appears more unified than before the reform.

At the same time, the evaluation shows that there is room for improvement, first and foremost to prevent tax avoidance and to simplify the rules. The Ministry will also continue to work on measures both to strength the distribution profile and to improve the framework conditions for business. Wealth tax will remain central to ensuring a good balance between the objective of

wealth redistribution on the one hand and business interests on the other, as set out in the Soria Moria II declaration. The Ministry will return to this point in the annual budgets.

1.2.1 Continued high growth and prosperity and effective use of resources

Through the 1992 reform, the tax system was founded on the principles of equal treatment, a broad tax base and low rates. These principles remained in place in the tax reform of 2006 and have contributed to maintaining the beneficial effects of effective capital and corporate taxation.

The abolition by the 1992 reform of various allocation schemes and streamlining of the depreciation rules was particularly important for ensuring that the investments with the highest profitability before tax were also preferred after tax. As a result, resources have increasingly been used for socio-economically profitable projects, thereby increasing the average return on investments. This is also evident in a sharp increase since 1992 in revenue from corporate sector taxation, measured in relation to gross domestic product (cf. figure 1.2). Developments in tax revenue reflect positive developments in the Norwegian economy, a sound return on investments and a tax base that corresponds to real corporate sector income.

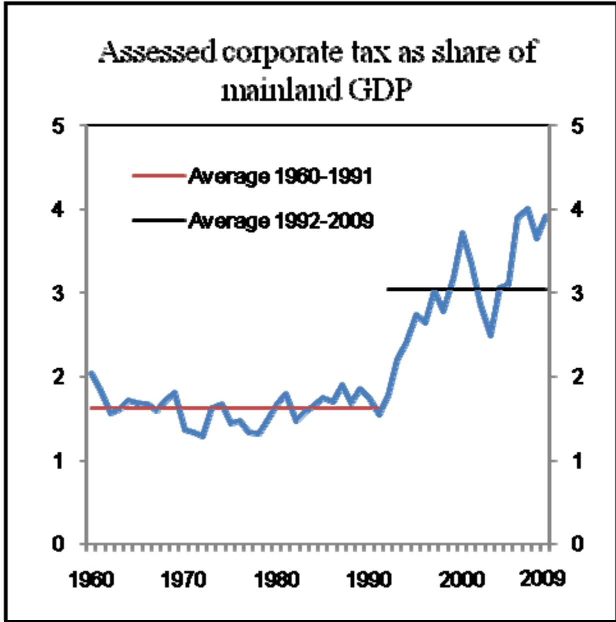

Figure 1.2 Assessed corporate tax as a share of mainland GDP. Per cent

Source: Ministry of Finance

The Norwegian corporate tax rate of 28 per cent has remained unchanged since the 1992 reform. A number of countries have implemented corporate tax reforms similar to that

introduced by Norway in 1992. This has had the effect of reducing the average formal tax rate for EU countries and the OECD area, and Norway now has a somewhat higher formal tax rate than these averages. The relatively sharp fall in average formal tax rates in the EU and OECD areas is also partly attributable to some of the smaller countries cutting corporate tax in order to attract investment.

The average effective tax rate provides a better basis for comparing the tax burdens in the different countries than the formal rates. The average effective tax rate in Norway is somewhat higher than in neighbouring countries, but lower than in the large economies such as France, Germany and the USA. Since the financial crisis, there has been great uncertainty regarding how the need of the OECD countries to handle high government debt may affect tax levels generally and corporate tax in particular.

The Ministry is of the opinion that the overall tax conditions for businesses wanting to establish themselves in Norway are good. Good infrastructure, a supply of well qualified labour, smoothly functioning financial markets and stable and predictable rules and regulations also contribute substantially to good overall framework conditions for business in Norway.

An adequate supply of capital is crucial for the execution of profitable projects. Large Norwegian enterprises with ready access to the global capital market are generally able to secure funding for their investments, irrespective of the Norwegian tax on dividends. The risk-free rate of return allowance in dividend taxation is therefore particularly important for small, newly established companies that are dependent on Norwegian equity. The evaluation indicates that it is precisely start-up companies with low earnings that are dependent on new share capital. With time, funding requirements are met to a greater extent by accrued equity and debt.

The Ministry wishes to stress that available statistics show no sign of changes in companies' funding structure that cannot be explained by the expected adaptations immediately before and after the reform or by general economic developments. This indicates that investors and companies perceive the tax system as neutral, also after the 2006 tax reform. There is therefore reason to believe that the risk-free return allowance has functioned according to intention, with the result that dividend tax has not had negative effects on the supply of capital, investment or how investments are financed.

When the 2006 tax reform was implemented, it was stressed that the reform was intended to boost incentives to work. There is reason to believe that the reform has had a positive effect on the labour supply. According to analyses performed by Statistics Norway, the reduction in surtax rates and increase in the basic allowance has increased the labour supply, first and foremost among married and cohabiting women. Statistics Norway has estimated that there will be compensation for about 20 per cent of the wage tax cuts over time in the form of increased tax income as a result of a larger labour supply.

The tax reform has merged the disparate elements of the tax system more closely together now than before the reform. For example, the level of the highest marginal tax rates on labour income cannot be appreciably higher than the marginal tax on share income if one wishes to avoid serious tax-motivated adaptations and weaker real redistribution. Moreover, taxation of ownership income is based on a common method irrespective of whether the income stems from sole proprietorships, partnerships or limited companies. If the tax rules for one type of enterprise change, this will normally entail changing the others too. The Ministry is of the view that the strong interconnection between different parts of the tax system strengthens the stability of the tax system. Stable tax rules increase confidence that investing and operating businesses in Norway will remain attractive in the future.

1.2.2 Less tax adaptations and more equal treatment of different types of enterprise

The reform has led to a reduction in tax adaptations. The problem that many taxpayers could achieve major tax savings through simple measures to camouflage labour income as capital income has been sharply reduced. The residual difference between the taxation on labour and share income now amounts to a maximum of 6.1 percentage points. For owners with a high return on labour (higher than surtax bracket 2) the difference in rates may have a bearing on the choice between organising an activity as a sole proprietorship or as a limited company with the opportunity to extract dividend. But the possibility of achieving major tax savings by having labour income taxed as share income is substantially reduced.

For a shareholder who works in his or her own company, the rate differential will influence the choice between wages and dividend. At the margin where tax on dividend is 48.2 per cent, (i.e. any risk-free rate of return allowance is used up) it will pay to extract wages up to surtax bracket 1 (NOK 471 200 in 2011) in most cases. For those fully covered by the new pension earning rules in the National Insurance scheme, it will normally pay to extract wages up to 7.1 G (NOK 547 760 based on the estimated average G for 2011) in order to earn a higher

pension. The rate differential between wages at level 1 and dividend is 3.4 per cent, while pension earnings, which are taxed at the time of disbursement, are 18.1 per cent of wage income. At levels higher than 7.1 G it will pay irrespective to extract dividend rather than wages.

The Ministry wishes to stress the importance of maintaining marginal taxes on share income, computed personal income and wages at approximately the same level. This is crucial to prevent income shifting again becoming profitable. In the view of the Ministry, there is a high risk associated with increasing the rate differential. A case in point is the split income model, which functioned well when it was introduced, but which gradually lost its ability to prevent income shifting because the model became further and further removed from the underlying principle.

The Ministry has placed emphasis on evaluating the extent to which the tax system gives equal treatment to different types of enterprise. In order to make a real comparison of sole proprietorships and limited companies, the overall tax rules have to be considered, and not differences between individual elements. The Ministry has therefore carried out a number of calculations of average tax for different types of enterprise. They are based on the same premises concerning level and return on real capital, return on labour, operating expenses etc. for the different types of enterprise, so that the comparison is limited to the significance of the difference in taxation rules.

The general conclusion drawn from these calculations is that the average tax rate varied quite substantially between the different types of activity before the reform, but that treatment has subsequently become equal in the main, if one disregards the special tax benefits enjoyed by the primary industries (including a farmer's allowance of up to NOK 142 000 and a fishermen's allowance of up to NOK 150 000). In some cases the average tax for active shareholders may be somewhat lower than for sole proprietorships with the same income. This applies primarily to low and moderate return on labour, and is due to active shareholders having the option of withdrawing labour income and thereby qualifying for the basic allowance.

1.2.3 More redistribution

The reform has led to the levying of more similar tax on the same incomes, and to a substantial strengthening of redistribution of wealth through the taxation system. The increased redistribution is a robust result that has been confirmed by a number of different

analyses using different methods conducted by Statistics Norway. Statistics Norway estimates that redistribution, measured by the Reynold-Smolensky index of redistribution, increased by more than 10 per cent from 2005 to 2008.

Dividend tax and improvements in wealth tax have contributed most to increasing redistribution. In particular, the abolition of the discount on shares and the special rule about reduction of wealth tax for persons with very high wealth and low income (the 80 per cent rule) have made the tax system considerably tighter for the wealthiest portion of the population, whose income largely derives from substantial shareholdings.

Figure 1.3. shows the average tax for each decile of taxpayers when they are distributed according to income. For the majority of taxpayers, average tax increases with income. In the two lowest income groups, taxation in the period 2000-2009 became somewhat more progressive, with lower tax on the lowest income levels. The tax burden for the great majority underwent little change. For the decile with the highest income, however, there were major variations in the tax burden in the course of the period. Before the reform, average tax fell with increasing income at the highest income levels. Since the reform, the progressivity of the tax system has been clearly strengthened in that average tax also increases for those with the highest income.

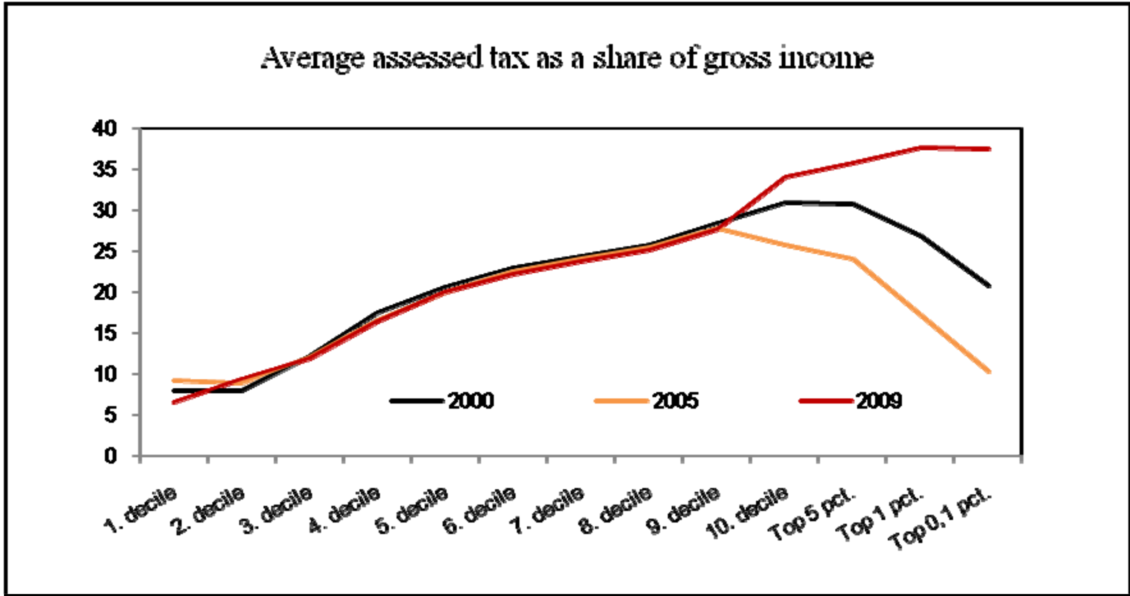

Figure 1.3 Average assessed tax[1] as a share of gross income. Residents aged 17 and over, ranked according to rising income and then divided into ten groups of equal size (deciles). Per cent 2000 – 2009

[1]Comprises National Insurance contributions, tax on ordinary income (with dividends), surtax and wealth tax.
Statistics Norway (Tax statistics for personal taxpayers).

Source: Ministry of Finance

The reduction in surtax rates and abolition of the extra employer's social security contribution on wage income of over 16 G has curbed the formal progression in the taxation of labour income. However, these cuts appear to have contributed far less to the overall effects on redistribution than dividend tax and the changes in wealth tax. Nor could the increase in value added tax from 24 per cent to 25 per cent, which helped to finance the reform and which is weakly regressive with respect to gross income, be expected to change the situation.

1.2.4 Moderate administrative costs

Determining the administrative costs associated with the reform for companies, personal taxpayers and the tax administration has been demanding. First, it has been difficult in many cases to quantify administrative costs, and how these change as a result of a reform. Second, it is difficult to quantify any corresponding gains, for example in the form of higher assessment quality and more equal treatment of taxpayers. The Ministry is nevertheless of the view that, on balance, the cost estimates, assessments and analyses obtained by the Ministry provide grounds for concluding that the administrative costs have been moderate.

The 2006 tax reform offered some special challenges of an administrative nature, particularly in connection with the shareholder model. When deduction of a risk-free return on shares takes place for the individual shareholder, a cost price must be fixed at the time when the shares are acquired, to enable correct calculation of the individual shareholder's risk-free return allowance for the year. When the reform was introduced, it was also necessary to obtain and register the cost prices of all shares owned by personal shareholders.

The shareholder model was introduced after weighing the objective of achieving the goals of the reform against the considerations of the tax authorities' collection costs and the taxpayers' compliance costs. The register of shareholders played a central part in this evaluation. The Ministry believed that a well functioning shareholder register would mean that the administrative costs of the reform were acceptable. The Ministry also stressed that a shareholder register with imputation of cost prices etc. would be easy for the tax authorities to monitor, and that the tax assessment quality would be better.

In the view of the Ministry, it is essential to distinguish between transitional costs associated with the introduction of the reform and the more lasting changes in administrative costs. There were some transitional problems with the introduction, in particular in connection with the shareholder register, which was to handle all information associated with the new share taxation. Problems due to errors and deficiencies in the shareholder register created extra work for the tax administration, companies and shareholders. Start-up problems associated with the shareholder register cannot be ascribed to the reform alone, however, because the register also fulfils an important function in the ordinary taxation of capital gains on shares.

The shareholder register is now functioning satisfactorily on the whole and helping to raise the quality of taxpayers' self-assessment and to reduce the risk of errors. The administrative costs of operating the shareholder register are relatively moderate.

Information from the shareholder register may be perceived by personal shareholders as difficult to check, and hence more time-consuming. On the other hand, shareholders are sent all the necessary information about shares that are registered in the shareholder register to enable them to calculate gains and losses on realisation. This implies a simplification for the shareholders compared with the system before the register was established.

The partnership model has probably led to somewhat higher administrative costs, associated in particular with the rules for quarterly determination of deposits. The Ministry is therefore working on simplifications to reduce the administrative costs.

The method of calculating personal income for sole proprietorships remained largely unchanged from the split model. This means that the tax reform has not brought about major changes in the work load or administrative costs for this group.

The administrative costs of the reform for the tax administration have been largely associated with the establishment and development of the shareholder register. Besides the actual development costs, the transition to new rules and commissioning of the register implied an extra burden on the administration. These are transitional costs that have now been phased out.

1.2.5 More about the different taxation models

The shareholder model:

The Ministry believes that the rate of return allowance should remain firmly in place. Abolishing this allowance would involve a considerable risk of financial distortions and of the overall tax burden on shares being to high.

The Ministry believes that it is crucial that the rules for the RRA are rooted in clear principles. If limits are introduced, the allowance will very largely lose its function. The Ministry has looked at the possibility of introducing an upper limit for the allowance, or of limiting it to shares in non-listed companies, but cannot recommend any such solution. Any significant restrictions on the allowance would be contrary to the fundamental principle of shareholder and corporate taxation to the effect that the tax rules must not influence the scope of investments and how they are financed. Any such restrictions would also strengthen motives and possibilities for tax-reduction adaptations and present major practical challenges.

The allowance is currently linked to the individual share, and any unutilised allowance after realisation is lost. The Ministry has considered the possibility of making share taxation more neutral in practice by allowing residual unused allowance after realisation to be coordinated with other share income or all ordinary income and carried forward. Allowing such coordination without applying countermeasures would provide opportunities for arbitrage that would form the basis for a market for sale of shares around year-ends. This is because the allowance for the whole income year is given to the owner of the share on 31 December. Personal taxpayers would be able, for insignificant cost and risk, to "buy" risk-free return allowances from corporate shareholders who do not benefit from the allowance, and thereby reduce the tax on other income. There are feasible, but administratively complex solutions for preventing such adaptations, including requirements relating to ownership time or basing the rate of return allowance pro rata on ownership time in the course of the year. However, the Ministry has concluded that in such cases the objective of increased symmetry is not important enough to justify higher administrative costs and far more complicated rules.

The correction income rule shall ensure that all income that forms the basis for dividend payment is taxed in the hands of the company. The rule concerning calculation of correction income was not changed in connection with the tax reform. The rule is relevant in cases where the surplus for accounting purposes is larger than the surplus for tax-related purposes, and primarily affects the time for levying tax. Except in cases of bankruptcies, the untaxed surplus will be taxed regardless at a later time. In practice, companies tend to wait to pay a dividend based on untaxed capital in order to avoid correction income (i.e.corporate tax levied on dividends paid from previously untaxed capital (korreksjonsskattereglene)). Since the

introduction of the shareholder model, this means that government income from dividend tax is also deferred. In view of this situation, and because the rules are very complicated, the Ministry has concluded that the rule about correction income should be discontinued.

The Ministry has considered a proposal from the Shareholders' Association and others to introduce a share savings account that results in deferred tax also for persons who own shares directly, as long as the investment remains in an escrow account. The measure is primarily aimed at persons who invest a substantial amount in shares, but not so much that they feel that it pays to establish an investment company.

The Ministry holds the view that the grounds for proposing a share saving account with deferred taxation for personal shareholders are weak. The objective of the exemption method is to avoid chain taxation within the corporate sector and is relevant for investment companies but not for personal shareholders. The possibility of deferring dividend tax that is offered by investment companies does not result in any tax savings over time that might dictate that those who own shares directly should have the same possibility. However, ownership through an investment company gives investors an advantage in that gains and losses on different shares can be coordinated at company level. The RRA for income from investment companies is linked to the deposit in the investment company, while the RRA in direct share ownership is linked to the individual share. Introducing a share saving account would not have very much purpose if the object was to increase coordination possibilities for personal shareholders.

There are also other problems associated with the proposal of a share saving account. First, the scheme would complicate the regulations and require clarification of their relationship with the EEA rules. Second, the scheme would complicate the relationship between investors and the market. Investors must choose between tax rules that apparently result in different tax, but which have approximately the same economic results. The scheme could be an added element of expense between the personal shareholder and the securities market. Third, the initial loss of revenue could be substantial, and at the same time large latent tax commitments would be built up. Opportunities for adaptations through year-end transactions could also result in considerable permanent loss of revenue.

The partnership model

The Ministry believes that the partnership model gives satisfactorily equal treatment of partners and shareholders and recommends that the main features of the partnership model

should be retained. At the same time, there are special features in the taxation system for partnerships that make it more complicated than the system for shareholders and limited companies. It must be borne in mind that the assessment must be carried out for each and every partner. The system also raises the question of the distribution of the tax base among municipalities. These are to a large extent challenges that also existed before the partnership model was introduced in 2006.

Calculating the partners' deposits in the partnership is also administratively demanding for taxpayers and the tax administration. Moreover, there are some technical problems associated with calculating deduction limits for partners in limited partnerships. The Ministry will continue work on possible simplifications and improvements, in these areas among others. The Ministry aims to circulate amendments for comments in the course of 2011.

The self-employed model:

The Ministry is of the opinion that the self-employed model has functioned well in light of the reform's objective of more equal taxation treatment. The introduction of the enterprise, shareholder and partnership models has led to more equal taxation of wage-earners and self-employed persons who operate either through a company or as a sole proprietorship.

The Ministry stresses that it must be attractive to invest and run a business in Norway, irrespective of whether the business is operated as a sole proprietorship or as a company. The taxation rules should not be an obstacle to organising the activity in the manner that is most appropriate from a commercial point of view. The Ministry is therefore of the view that the self-employed model should remain largely in its current form, and the exemption rate and risk-free return allowance for sole proprietorships should continue to be determined the way they are at present. At the same time, the Ministry wishes to point out that there are no well-founded reasons for a salary allowance in the new tax system, and that it gives sole proprietorships with employees an advantage compared with similar operations organised as limited companies.

Sole proprietorships are taxed on an accrual basis for personal income, whereas shareholders can choose to defer taxation by deferring a dividend. This has led to a proposal to introduce an allocation scheme for sole proprietorships that will make it possible for sole proprietorships to defer the tax on some or all of their personal income. The grounds usually given for the proposal are that accrual taxation of sole proprietorships may cause liquidity problems for some enterprises. Sole proprietorships that operate at a profit may have

somewhat less disposable assets available in the enterprise than limited companies that do not distribute a dividend.

However, the possibility of liquidity problems for sole proprietorships cannot justify a general allocation scheme that is costly and complicated and that will demand close follow-up through accounting and auditing and a closer watch by the tax authorities for concealed profit distributions. Nor can the liquidity argument be strongest for those enterprises that operate at a profit and have money to allocate. An allocation scheme would also imply a certain discrimination in favour of sole proprietorships. This is because sole proprietorships, which face a progressive rate structure, could reduce their overall tax by evening out their income over time. On the other hand shareholders, who face a flat tax rate (28 per cent), do not benefit similarly from evening out their income. Nor can wage-earners choose to defer their income in order to reduce their tax over time.

An allocation scheme could contribute to the locking in of capital if tax-payers perceive it to be an advantage to defer their taxes. Abolition of schemes that locked in capital was an important measure in the 1992 reform designed to ensure better capital flow and a higher return on capital. In the view of the Ministry, schemes that build up large latent tax commitments are also undesirable.

The exemption method:

The exemption method is intended to prevent income in chains of companies being taxed repeatedly. The combined effect of the shareholder model and exemption method is that income is taxed once only in the corporate sector, and that share income in excess of the RRA is taxed when it is extracted from the corporate sector. In the view of the Ministry, the exemption method has largely functioned in line with expectations. The Ministry therefore proposes that the main features of the exemption method remain unchanged. However, the Ministry will work further on some changes to prevent opportunities for adaptations or contribute to simplification.

Companies can use certain adaptations to exploit the differences between the special rules for taxation of share income in companies and the general tax rules. For example, a company can make investments through a subsidiary that is established with little equity and a loan from the parent company. If the subsidiary does not prosper, the parent company can claim deductions for a large portion of the investment as loss on receivables. If the company prospers, on the other hand, the return will be tax-free share income. This argues for

disallowing deductions for loss on receivables between closely associated companies. The Ministry will continue work on a proposal for a rule of this nature.

Similarly, the exemption method creates incentives for adapting the form of the transfer, depending on whether the taxpayers are in a gain or loss position. In the event of losses, it may pay to sell the assets in a company so as to obtain a deduction, whereas in the event of a gain it may pay to sell the shares in order to be covered by the exemption method. Possible countermeasures were considered in connection with the introduction of the exemption method, but were not proposed. Nor is the Ministry in favour now of special measures in this area.

The three per cent rule in the exemption method is a standard rule that requires companies to take to income three per cent of income that is tax-free according to the exemption method to compensate for costs associated with the tax-free income being deductible. The Ministry is in favour of changing the three per cent rule to cover only dividend. This will simplify the rules considerably, because companies will then avoid having to calculate gain or loss on realisation of shares. The Ministry will also consider the need for some adjustments in the area to which the three per cent rule applies.

In order for the exemption method to apply when a company realises a holding in a partnership, at least 90 per cent of the shareholding in the partnership must qualify under the exemption method. This standard rule opens the way for tax-motivated adaptations. The Ministry will consider changes in rules to reduce the scope for such adaptations.

The exemption method has been criticised because it does not stipulate requirements regarding the size of the holding for investments in Norway and other EEA states. The Ministry has considered whether such a restriction should be introduced in the exemption method. The Ministry has concluded that the objective of avoiding chain taxation is also relevant for portfolio investments, and that an ownership requirement of this nature that would complicate the system and open the way for adaptations should therefore not be introduced.

The Ministry has also considered some legal issues associated with the application of the exemption method to cross-border investments, including the conditions for when income that stems from or is received by companies resident abroad qualifies under the exemption method. The review shows that the EEA agreement and associated EU/EEA practice places constraints on the restrictions that can be made in the application of the exemption method to

companies resident in the EEA. However, the Ministry will consider new legal developments and adapt the rules if this should be viewed as advisable.

1.2.6 Wealth tax

Wealth tax was considered in connection with both the 1992 and the 2006 reforms. The Aarbakke Committee (NOU 1989: 14) recommended retaining wealth tax for individuals, in the interests of both distribution and effective use of resources. However, the Tax Committee (NOU 2003: 9) was of the view that the trend of greater capital mobility and stronger tax competition among countries implied that wealth tax should be gradually reduced and replaced by increased tax on real property. The Bondevik II Government followed up the Tax Committee's proposal to reduce wealth tax with a view to phasing it out, but not the proposal that this should be compensated for by increased tax on real property.

From the time it took over in autumn 2005, however, the Government has been concerned with strengthening the distribution profile of the tax system, and that wealth tax should play an important part in this respect. In the Government's follow-up of the tax reform, wealth tax has therefore been a much stronger distribution policy supplement to income tax than it was previously. Wealth tax ensures that the tax system functions progressively also at the highest income levels (see Figure 1.4).

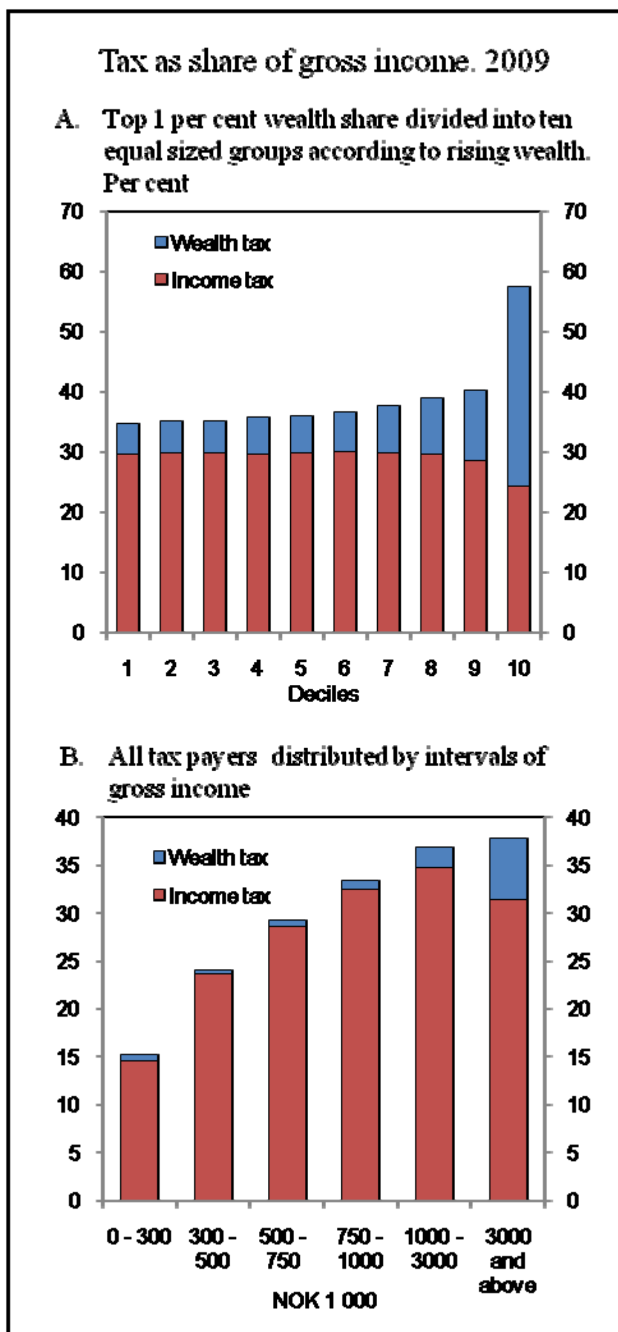

Figure 1.4 Tax on income and wealth in 2009 as a share of gross income for different intervals of gross income. Per cent

Sources: Statistics Norway and the Ministry of Finance

The overall tax on capital, consisting of both wealth tax and income tax, influences both saving and investment. A high combined tax on capital reduces the profitability of saving and hence the profitability of investing for Norwegian investors. But wealth tax does not at the outset make investment in Norway less interesting than investment abroad for Norwegian investors. However, wealth tax can to some extent limit the supply of capital to enterprises

that are obliged to resort to the Norwegian capital market. Differences in wealth valuation favour property investment, and can therefore to some extent shift investment away from equities. This may reduce the overall socio-economic return on the capital.

All in all, wealth tax provides a balance between the objectives of wealth redistribution and catering for business interests. The Government intends to retain wealth tax, but to work on changes that contribute to a fairer distribution and better framework conditions for Norwegian business, in line with the political platform in the Soria Moria II declaration. The Ministry will return to this point in the annual budgets.

Introducing exemption from wealth tax on working capital, as advocated by the Confederation of Norwegian Enterprise, among others, does not provide a good balance between distribution and business interests. Exemption for the whole or some of the "working" capital comes strongly into conflict with the objective of equal treatment of different types of enterprise and capital, has poor distribution effects, will lead to major administrative problems for the tax authorities, and provides new possibilities for tax adaptations. The Government is therefore not in favour of introducing such exemption.