A comparison of the Allowance for Corporate Equity system and the Comprehensive Business Income Tax system in a Norwegian setting

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I examine distortions in the Norwegian tax system and find that the current Norwegian system discriminates equity, as the cost of debt is deducted in a firm's tax account while the cost of equity is not. I also find that the treatment of depreciations is non-neutral as there is an inequality between true economic depreciations and depreciations for tax purposes. Comparing ACE – the Allowance for Corporate Equity system and CBIT – the Comprehensive Business Income Tax system, I find that only ACE ensures correct depreciations. Only CBIT, however, is completely neutral with respect to the choice between debt and equity, as CBIT removes the possibility of deducting the cost of debt. This offsets the possibility of thin capitalization strategies by multinational companies. Neither CBIT, nor ACE will remove the incentive to shift profits to low tax countries. This makes it desirable to reduce the tax rate, and I find that this is best accommodated if introducing a CBIT tax system. The CBIT system will increase the cost of capital and thus decrease investments, but a reduced tax rate will offset this. As a conclusion, I recommend implementing a CBIT system, and agree in this respect with the Swedish tax commission that just delivered their proposal.

Increased globalization, with more integrated markets and thus greater mobility of tax bases has increased the importance of taxes in investment decisions. Different tax rates between countries provide adaptability for multinational companies which use deduction possibilities and transfer pricing to shift profits from high-tax countries to low-tax countries. This has led to an international trend towards lower corporate tax rates, with intention to prevent undesirable adjustments across borders in terms of transfer pricing and thin capitalization. The Norwegian corporate tax rate has remained unchanged since 1992[1]. At the same time the average corporate tax rate within the EU has fallen from 36,6 % in 1995 to 25,1 % in 2013. Moreover the corporate tax base is changing. Many countries have shifted their tax burden

[1] After I started to work on my thesis the Norwegian government changed the tax rate from 28 % to 27 %.

from income taxes to consumption taxes. The change in the international conditions raises the need to consider the Norwegian tax system.

March 15th 2013, the Norwegian government appointed a tax-commission to consider the Norwegian corporate taxation in light of the international development. Among other topics, the commission is to consider if the corporate tax rate should be changed, analyze possibilities of moving income and deductions between countries in order to save taxes, and examine the possibility of protecting Norwegian corporate taxation by treating debt and equity equally. An important guiding principle is that the commission's proposal should be approximately revenue-neutral.

The consideration of treating debt and equity equally involves a fundamental tax reform in Norway, either by implementing the Allowance for Corporate Equity system or the Comprehensive Business Income Tax system.

In the first part of my thesis, I examine distortions in the current Norwegian system. I find that the Norwegian tax system discriminates equity, as cost of debt is deducted in a firm's tax account while cost of equity is not. Further, I find that the treatment of depreciations is non-neutral, as there is an inequality between true economic depreciations and depreciations for tax purposes. With regards to the current Norwegian system, I also include an analysis on multinational companies' behavior and its affection on the Norwegian tax base. I show that MNCs shift profits out of Norway, which results in reduced government tax revenues. Thus, I suggest a reduction in the Norwegian tax rate. This is in accordance with the OECD-trend.

The tax-commission's mandate involves an examination of two fundamental tax reforms, the Allowance for Corporate Equity and the Comprehensive Business Income Tax systems. I have examined these systems with regards to investment behavior, tax-treatment of debt and equity and tax-treatment of depreciations. I find that both systems are more neutral, and thus less distortive, than the current Norwegian tax system.

	Current system	**ACE**	**CBIT**
Investment behavior	*Not analyzed*	Increased investments	Decreased investments
Debt and equity	Non-neutral treatment	Non-neutral treatment	Neutral treatment
Depreciations	Non-neutral treatment	Neutral treatment	Non-neutral treatment

Table: The table highlights main findings of neutrality properties in the current system, ACE and CBIT.

I find that ACE solves the problem with incorrect depreciations. Moreover ACE will reduce a firm's cost of capital. This will increase investments in Norway and in Norwegian affiliates. However, I find that ACE is not completely neutral regarding tax-treatment of debt and equity. Cost of debt is fully deductible, but as cost of equity is not likely to be fully deductible, equity is still discriminated under an ACE regime. Despite this, ACE is more neutral than the current system, as at least a fraction of equity is tax-deductible. CBIT ensures symmetric tax-treatment of debt and equity, as neither cost of equity nor debt is tax deductible. However, I find that CBIT does not ensure correct depreciations. Moreover, CBIT decreases investments, as the cost of capital is raised.

When the tax rate-decline and the tax base-impact are taken into consideration, the picture becomes more complex. The Norwegian government requested the tax-commission's proposal to be approximately revenue neutral. The tax base is already pressured by my suggestion of a reduced tax rate. Implementing the ACE system would pressure the tax base further. Implementing ACE without reducing the tax-rate would not be beneficial, as a high tax rate will maintain MNCs' motivation for profit shifting.

As a suggested decline in the tax rate will reduce the Norwegian tax revenues, implementing CBIT is a better fit. Ceteris paribus, CBIT will increase tax revenues. This allows for a decline in the tax rate and still secures a revenue-neutral impact.

The tax-commission is to consider the possibility of protecting corporate taxation by treating debt and equity equally in order to reduce problems related to MNCs' tax strategies. I find that CBIT does treat debt and equity equally, while ACE does not. This is thus an argument in favor of CBIT. As CBIT removes the possibility of deducting the cost of debt, the possibility of thin capitalization strategies from MNCs will be offset. Under an ACE system debt shifting will still be possible. However, none of the tax systems prevent profit shifting with regards to the tax rate. This suggests for a decline in the tax rate, which is best accompanied by a CBIT system.

Based on a welfare-discussion, I understand CBIT to increase welfare, and ACE to reduce welfare, in an open economy with a large multinational sector and high tax rates. The CBIT system will ensure equal tax-treatment between debt and equity, and impose greater leeway in the financial policy. This is in accordance with my recommendation of a reduction in the tax rate to cope with profit shifting problems incurred by MNCs. The CBIT system will increase the cost of capital and thus decrease investments, but as the tax rate is reduced, this effect will be accommodated. As a conclusion I recommend an implementation of the CBIT system.