Taxation of capital and wage income;

towards separated or more integrated personal tax system?

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1 INTRODUCTION TO THE PERSONAL TAX SYSTEM

1.1 Introduction

Lately, fundamental reforms of the personal income tax system have been high on the agenda in many countries, including Norway. The objective of the present national report is thus to describe the backdrop for the recent tax reform and the main features of the current personal tax system of Norway. Primary emphasis is given to the taxation of individuals` wage and capital income and an analysis of whether such taxation has become more integrated or separated.

As a point of departure, it may be mentioned that individuals resident in Norway are taxable for their world-wide income and assets, unless otherwise is provided for by domestic law or a tax treaty with the respective foreign country. Non-resident individuals are taxable for income from Norwegian sources and certain Norwegian property, including;

- income from employment
- income from business activity in Norway
- dividends from Norwegian companies
- certain forms of capital gains on property and shares.

The presentation will go no further into international issues in relation to the personal tax system.

The Norwegian personal tax system is relatively complex. To give a suitable exposition of the Norwegian system for taxation of individuals, including the connection between the taxation of wage income and capital income compared to the significance of the interaction of different taxation models, a more wide-ranging approach to the issue is requisite.

Against this background, the present paper reviews the development in Norway from a traditional dual income tax system to so-called semi-dual personal income taxation. As a starting point, the concept of general and personal income and the fundamental principles behind the personal tax system are discussed under section 1.2 and 2. The Norwegian experience with the dual income tax system under the tax reform of 1992 will be briefly reviewed under section 3. Subsequently, a more thorough examination of the recent tax reform of 2004-2006 and the consequences for the personal tax system, including taxation of wage- and capital income is provided under section 4. Alternative personal tax models will be presented under section 5. Finally, the concluding section 6 will sum up the different parts of the presentation and give a final assembled insight into where the Norwegian personal tax system stands today.

The presentation will not deal with procedural law in relation to the personal tax system. Problems of income transformation and tax evasion will be currently addressed.

1.2 General income and personal income in general

The Norwegian income tax system for individuals is based on a dual tax *base* system, i.e. it consists of two main groups of income; ***general income*** and ***personal income***. While companies may only have general income, individuals may fall within both of these bases of tax computation. The mentioned concepts of income are complex and compounded of several elements, but in ample terms, wage income may be said to constitute a part of both general and personal income, while capital income only constitute a part of general income (see figure 1 below).

As described in the following, the final tax burden imposed on individuals will be dependent on whether the income is general or personal income and whether the income is earned directly by the individual or through a sole proprietorship (self-employed), a partnership or a limited liability company.

General income is calculated for all taxpayers, both companies and individuals. It includes all taxable income from work, business and capital. It is a net income tax base and deductions are allowed for all expenses that have been incurred for the purpose of earning, securing or maintaining the taxpayer's income.[1]

However, individuals receiving wage (or pension) income may instead of the deduction for actual costs opt for a standard minimum deduction ("minstefradrag").[2] This is a blanket deduction supposed to cover the costs usually connected with employment. The deduction is 36 per cent of gross income, with a minimum allowance of NOK 4000 and a maximum of NOK 63 800. In addition to the standard minimum deduction, a number of additional deductions from taxable income are available, e.g. allowance for certain travel expenses, mortgage interest payments, trade union fees, gifts to voluntary organizations and documented expenses for child care etc. Finally, a standard personal allowance ("personfradrag") is granted for all individuals in general income. The amount differs for single taxpayers (class one)[3] and those with one or more dependents, e.g. single-income couples and single parents (class two).[4]

An example of how the general income is computed for individuals:

Wage income or pensions
\+ self-employment income and capital income (e.g. realised capital gains, rents, interests)
= Gross income
\- Deductions (e.g. interest expenses, family allowances, standard deductions)
= Net General income

The net general income is taxed at a flat rate of *28%*,[5] more precisely a county/municipal[6] tax of 16.2 per cent and a state tax of 11.8 per cent.

Personal income[7] is only calculated for individuals. It primarily includes:

[1] Cf. The Norwegian Tax Act (Skatteloven, sktl.) of 26 March 1999 no. 14 sect. 6-1.
[2] Employees may also opt for a special allowance ("særskilt fradrag i arbeidsinntekt") of NOK 31 800 if this is more favourable to them than the standard minimum deduction.
[3] NOK 37 000 in 2007.
[4] NOK 74 000 in 2007.
[5] In the county of Finmark and Nord-Troms the ordinary income tax rate is 23.5%.
[6] Norway is divided into 19 counties and subdivided into 431 municipalities.
[7] Cf. sktl. sec. 12-2.

- Wage and pension[8] income ("labour income").[9] These rules are dealt with under section 4.3.1.
- Personal income under the so-called "self-employed model" (foretaksmodellen). For self-employed, provisions exist which split business income into capital income and personal income ("imputed personal income"). These rules are discussed under section 4.3.2.

Income included in the personal income base, will also be included in the general income base. The concept of the personal income base is thus somewhat rooted in the notion of the general income base (see the example above). However, while the general income tax rate is proportional (28 per cent), the personal income tax rate is progressive. The progressive element in the personal income tax base is due to the income being subject to the calculation of:[10]

- social security contributions,[11] and
- surtax[12]

When an employee receives a salary from his employer (income from employment/wage income), the personal income is a gross income tax base from which no deductions are granted before the establishment of the tax. The highest marginal tax on wage income is currently 47.8 per cent (2007). However, in addition employers contribute up to 14.1 per cent (2007)[13] of paid wages to the Social Security Scheme (employer's national insurance contributions).[14] When including this tax burden, the marginal tax rate on wage income is 54.3 per cent (2007).

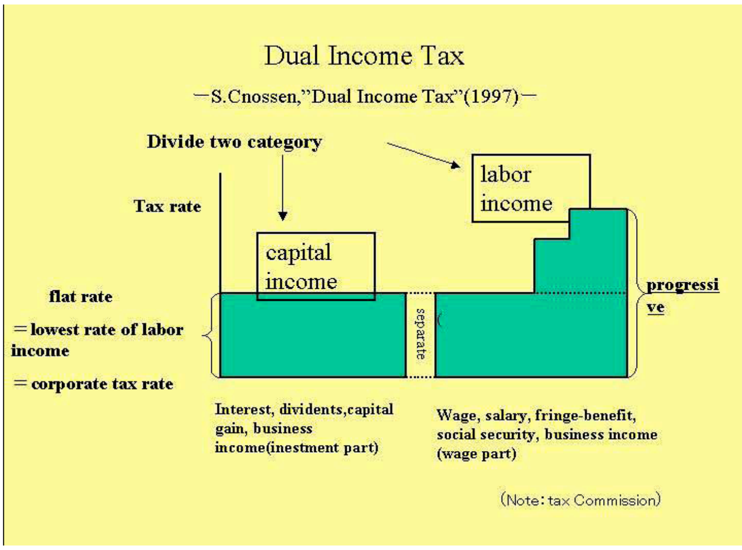
Also for self-employed, the personal income from self-employment is in principle a gross income tax base. However, the personal income from self-employment is in some respects computed differently from wage income (confer chapter 4.3.2). The marginal tax rate on self-employment income is 50.7 per cent (2007). The difference in the marginal tax rate on wage income and self-employment income is due to the sole-employed not paying employer's national insurance contributions on his remuneration. In addition, the tax rate on social security contributions for the sole-trader is 10.7 per cent[15] as opposed to 7.8 per cent for an employee.

Inasmuch as certain tax rules differentiate dependent on whether the tax payer is a self-employed or an employee, it is important to separate the two categories. Neither "employee" nor "self-employed" is defined in the Norwegian tax laws, and I will not go

[8] Taxation of pensions will not be addressed in the present paper.
[9] Income from partnership that is related to labour input, cf sec. 12-2(1)(f), will not be further addressed in the present report. For details see e.g. Lignings-ABC p. 809 et seq.
[10] In the following also referred to as *gross income taxes*.
[11] Cf. The Social Security Act (Folketrygdeloven, ftrl.) of 28 February no. 19, chapter 2, 3 and 23, especially sec. 23-3, and The Norwegian Parliament's resolution on social security tax.
[12] Cf. Sktl. sec. 12-1 and The Norwegian Parliament's tax resolution (Stortingets skattevedtak, SSV) sec. 3-1 and 3-5.
[13] The employer's national insurance contribution is geographical differentiated.
[14] Cf. ftrl. Sec. 23-3. The employer's national insurance contribution is deductible for the employer.
[15] Income from agriculture, forestry and fisheries is, however, subject to a rate of 7.8%.

further into the delimitation of theses concepts. However, I will briefly mention that according to the wording of the law and existing case law, an employee is characterised by being in a permanent or temporary contract of employment where he is placed under the employer's instruction authority and exercising the work for the employer's account and risk. A self-employed`s business activity on the other hand, is normally defined as "a sustained activity which is suitable to procure a net income and which is operated for the account and risk of the taxpayer." Such activity is often comprised of a combination of a work effort by the self-employed or others and of a capital input. The degree of work effort (activity) will determine whether he is making a "trading income" or "passive capital income". This delimitation will be of uppermost importance to the taxpayer, as the first mentioned is taxed at progressive rates as personal income and the last mentioned is taxed at a flat rate as capital income (confer section 4.3.2).

Figure 1. Dual Income Tax – the starting point for taxation of individuals in Norway:



2 FUNDAMENTAL PRINCIPLES OF THE PERSONAL TAX SYSTEM

The Norwegian tax system is in many ways similar to that observed in the other Nordic countries, owing to a stronger emphasis on income redistribution, a wider social safety net and a broader provision of social services as compared to most other countries. Reflecting the government spending as a share of GDP, the tax burden is among the highest among the industrialized countries. However, because taxation inevitably impinges on most aspects of economic activity, careful consideration must be given to the amount of taxes that are levied, and hence the level of expenditure, and to the design of the tax system. The main purposes behind the Norwegian tax system will be given a short description below.

Beside the principal purpose of providing *revenues* for the welfare state, it is considered extremely important that a personal tax system is able to create *fairness* (redistribution of income). Together with the social benefit system and a policy to ensure full employment, the tax system should contribute to a reduction of income differentials after tax. Both horizontal equity and vertical equity are important criteria in the evaluation of alternative personal income tax systems. Horizontal equity means that taxpayers in an equal situation should be taxed in an equal manner (better achieved by a more flat tax system), while vertical equity means that taxpayers with the better circumstances should bear a larger part of the tax burden as a proportion of their income (better achieved by a progressive income tax schedule). Vertical equity thus implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, or that the average tax rate should be increasing in income. This can be achieved by having a basic allowance, as is the case in the flat income tax system, but it will be achieved more accurately through a progressive tax rate schedule as in the comprehensive and dual personal income tax system. So the choice between progressive, semi-progressive and flat tax rate schedules from an equity perspective depends in part on how to strike the balance between horizontal and vertical equity.

Another element much emphasized in Norwegian tax law, is the tax system's possibility to ensure *efficiency* (neutrality). The different resources should be used as efficiently as possible. This implies tax neutrality across industries, different types of investment and forms of organization, and that capital income should be taxed independent of whether it is earned by companies or persons, and independently of how investments are financed. The effects of taxation on labour supply and demand should also be taken into account. The tax system should encourage productive activity and not tax planning taking into account the fact that the tax authorities have limited information about the taxpayers. Furthermore, emphasis should be placed on long-term consequences when designing tax rules contributing to more predictable and stable tax conditions. To achieve this, the tax system should be founded on general principles, with few exceptions and the tax code should be simple and transparent to keep administrative costs for the tax authorities and compliance costs for taxpayers as low as possible.

In general, a prerequisite for the tax system to be perceived as legitimate is that the principles underlying the tax system have a general support in the public. However, it is almost impossible to frame a tax system ensuring to the same extent all of these principles and some of the objectives may be completely or partially incompatible.

For example, the aim to pursue income distribution policy by means of the tax system may conflict with the aim of not (or as little as possible) letting the taxes influence on the manner of operation of the economy. The neutrality aim call for keeping the tax rate relatively low and equal for all taxpayers, while the distribution aim call for a progressive tax rate system with high marginal tax rates for high income.

The consequence may be more or less reasonable trade-offs. In addition, changes of governments, social development and changes in the public opinion in general, may result in shifts of which aims and principals are considered the most appropriate.

A consideration of how these objectives have been emphasised and reached or breached under the tax reform of 1992 and tax reform of 2004-2004, will be closer examined in the following.

3 KEY FEATURES OF THE TAX REFORM OF 1992

In 1992 Norway implemented a broad tax reform. Both the personal income taxation and the corporate taxation were reformed. The main goal was to reduce tax induced distortions to a minimum by lowering the tax rates and broadening the tax base. The reform also involved a significant step towards a more neutral tax system with respect to type of economic activity and the choice of organizational and financial structure of such activity.

3.1 The dual income tax (DIT)

Prior to the reform of 1992, labour and capital income of individuals were both taxed according to a progressive rate structure, with a top marginal rate for labour income of 57.8 per cent (62.7 per cent for self-employed), whereas corporate income was taxed at a flat rate of over 50 per cent. In 1992, Norway adopted considerable changes in its personal income tax system and introduced maybe the cleanest version of the dual income tax found so far.[16]

In its purest form, the dual income tax is characterized by a flat uniform personal tax on all forms of capital income, levied at a rate equal to the corporate income tax rate, full relief for the double taxation of corporate equity income and a basic tax rate on labour income equal to the capital income tax rate combined with a progressive surtax on high labour income and social security transfers.

Under the 1992 tax reform, two different concepts of income were introduced: *general income* and *personal income* (confer above, chapter 1.2), and a split rate model applied; while capital income earned by individual tax payers, regardless of how derived, was taxed as general income at a flat tax rate of *28 percent*, the income derived from labour and pensions was taxed progressively as personal income with a marginal tax rate *around 50 per cent*. The main idea behind the taxation of labour income at progressive rates was to ensure redistribution and fairness. For capital income, the aim was to obtain as neutral tax system as possible and through a relatively low proportional tax rate on capital, help prevent capital flight and induce investments in Norway.

However, the tax system did not remain neutral in one very important aspect, namely the taxation of wage and capital income. The wide difference in tax rates between capital and wage income gave incentives for individual taxpayers to attempt to transform their highly taxed wages into lower taxed capital income, mainly by distributing dividends or accumulating capital gains inside of their corporations.

[16] A similar system was introduced in the late 1980s in Denmark and in the early 1990s in Sweden and Finland, therefore the name "The Nordic Dual Tax system".

3.2 The "split model"

To bridge the gap between the tax rates of general and personal income and thus restore the pronounced aim of neutrality in choosing form of organisation, a so-called "split model" was introduced. The model applied to individuals combining income from labour and capital stemming from a single source, more precisely, self-employed individuals and active owners[17] of partnerships and limited companies. By definition, "active" owners were individuals who worked in their own business and owned at least two thirds of the shares of the firm or were entitled to at least two thirds of the firm's dividends.

Under the split-model a part of the taxable income of such individuals was deemed to be capital income by imputing a return[18] to the capital invested and thus subject to the 28 percent tax. The residual income[19] was treated as a reward for work effort and subject to the progressive tax rates as personal income, irrespective of whether this income was distributed as a dividend or not (i.e. a tax at source model).

However, this split model did not work as satisfactory as intended.[20] Over the years, the rate differential between taxes on general and personal income increased significantly. From a difference in 1992 of 28.1 percentage points it was 36.7 percentage points twelve years later.[21] This dramatically increased the incentive to transform such income for tax purposes. Moreover, in the decade following the tax reform the rules for income splitting were changed on several occasions and mainly in a more lenient direction. Consequently, it became easier to have labour income taxed as capital income through tax planning. For example, since most of the small and medium sized enterprises were in fact family businesses, the main owner could escape the personal income tax on business income by selling more than one third of the shares to family members or alternatively "switch ownership of shares" with friends with similar interests.[22] Thus, the splitting system failed to achieve its goal of securing an equal tax treatment of active owners and other groups of taxpayers. In addition, the widespread tax planning weakened the distributional effects of the tax system and the efficient use of resources. At the same time, to avoid loopholes, the split model became continuously more complicated and subsequently more difficult to comply with for the taxpayer and to supervise and control for the Tax Authorities.

[17] By definition, "active" owners work in their own business and own at least two thirds of the shares of the firm or are entitled to at least two thirds of the firm's dividends.

[18] The imputed capital income was calculated by multiplying the capital stock with an assumed rate of return on capital which was fixed annually by the Parliament on the basis of the average government bond rate, plus a risk premium.

[19] Personal income is computed by subtracting an imputed capital income, augmented by a fraction of salaries paid to employees, from total business income.

[20] For details, see White Paper of 26 March 2004 by the Bondevik II government (St.meld. nr. 29 (2003-2004)).

[21] This was due to increased surtax and the introduction of a supplementary employer's social security contribution on top wage earners. The marginal tax rate on wage reached the top in 2004 when it was 64.7 percent.

[22] E.g. between 1992 and 2000 the proportion of corporations subject to income splitting fell from 55 per cent to 32 per cent, indicating that a growing number of taxpayers were able to avoid income splitting by inviting "passive" owners into the company.

4 THE TAX REFORM OF 2004-2006 – "THE SEMI-DUAL INCOME TAX"

4.1 Background – bridging the gap between the taxation of wage and capital income

In light of the above mentioned challenges, an expert tax committee was appointed by the Norwegian government in 2002 to evaluate and possibly reforming or replacing the Norwegian tax system. An essential part of the committee's mandate was to consider reductions in the difference between the top marginal tax rates on wage income and capital income. Further, the committee was asked to compare the tax level and tax system in Norway with other countries and to consider whether the existing tax system was sufficiently adapted to the increasing mobility of capital and labour. A basic guideline for the committee was the desire to strengthen the principles of tax neutrality underlying the path breaking 1992 reform. The committee submitted its recommendations on 6th of February 2003 in the Green Paper NOU 2003: 9 "Skatteutvalget – forslag til endringer i skattesystemet" ("The Tax Committee – Proposed Changes to the Tax System"). Based on the tax committee's report and a hearing,[23] the Government presented its recommendations in a White Paper to the Parliament in early 2004.[24]

Primarily based on the Green Paper and White Paper, a multiparty agreement on a tax reform was entered into between the parties forming the Bondevik II coalition government (the Conservative Party, the Christian Democratic Party and the Liberals) and the Labour Party.[25] The new tax reform was followed up through the budgets for 2005 and 2006.

The main features of the tax reform were:

- Upholding the principles underpinning the 1992 tax reform, with a broad tax base, low tax rates, neutrality and fairness.

- Tax exemption (***"fritaksmetode"***)[26] for limited liability companies' income from shares (dividends and capital gains), in order to avoid chain taxation. Correspondingly, capital losses on shares are no longer deductible. To prevent tax avoidance arrangements the tax exemption will not be applicable to investments in foreign countries outside the EEA with low corporate taxation or to portfolio investments outside the EEA. There will be given no further review of the tax exemption method in this presentation.[27]

- Maintaining a flat 28 percent tax rate on undistributed company income and risk free capital income.

- Replacing the split model by a dividend taxation of individual shareholders, ***"the individual shareholder model"*** *(aksjonærmodellen)*,[28] and individual partners in partnership, ***"the individual partner model"*** (*deltakermodellen*),[29] whereby

[23] The report was sent on a public hearing in February-May 2003.
[24] White Paper of 26 March 2004 by the Bondevik II government (St.meld. nr. 29 (2003-2004)).
[25] The white paper was not directly accepted, but a tax compromise was reached.
[26] Cf. sktl. § 2-38.
[27] For details see e.g. Ot. prp. nr. 1 (2004-2005) chapter 6.
[28] Cf. Ot. prp. nr. 1 (2004-2005) chapter 5.
[29] Cf. Ot. prp. nr. 92 (2004-2005) chapter 1.

dividends/distributed profits and capital gains exceeding a computed risk-free return ("RFR") on the investment are subject to double taxation. A similar method is introduced for self-employed, ***"the self-employed model"*** (*foretaksmodellen*).[30] According to this method all business profits exceeding a risk-free return on the capital invested is taxed as personal income. The three models will in the following be collectively referred to as "the shielding model(s)". By introducing these models the tax system is aiming at taxing individual owners of companies in the same manner regardless of how the company/ownership is organized and regardless of whether the owners are active or passive.

- Reduction of the marginal tax rates of labour income (personal income), e.g. the surtax rates have been lowered, the standard minimum deduction increased and the separate employers' national insurance contributions on high income have been removed. The progressive rates have been made applicable also on profits exceeding risk free return in solely owned enterprises (self employed individuals).

The necessary amendments to The General Tax Act passed the Norwegian parliament (Stortinget) in the autumn of 2004 and in the spring of 2005, and came into force from 1st of January 2006.[31] The tax exemption for companies' income from shares came into force already from 2004. In addition, the tax rates for personal income (the surtax) have been reduced both for the fiscal year 2005 and for the fiscal year 2006.[32]

A central part of the tax reform may be assembled under the collective term of "harmonization of marginal tax rates". As a result of the above mentioned changes, the marginal tax rate on income exceeding RFR from limited liability companies and partnerships are per 2007 48.16 per cent, it is 47.8 per cent for wage income (54.3 including employers' national insurance contributions) and 50.5 per cent for income from self-employment.

The tax reform of 2004-2006 has thus helped bridge the gap between the taxation of individuals' general income (capital income) and personal income (wage income and income from self-employment), at least when it comes to capital income from investments in shares. At the same time, the reform has created a clear distinction between the taxation of income from shares owned by corporate entities and income from shares owned by individual shareholders.

A more detailed explanation of the most essential changes in the personal tax system and the consequences for the taxation of capital and wage income will be given in the following. A reform of personal income tax systems will also have impacts on the overall tax-benefit system, and can therefore not be evaluated in isolation of the rest of the tax system and public benefits (and in particular income-related benefits). Such linkages between personal income taxes and other taxes and benefits are obviously important, but it is outside the

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[30] Cf. Ot. prp. nr. 92 (2004-2005) chapter 2.
[31] For details, see the most essential travaux preparatoires; Ot. prp. nr. 1 (2004-2005) and Ot. prp. nr. 92 (2004-2005).
[32] By the new parliament majority of the Labour Party, the Centre Party and the Socialist Left Party.

scope of this paper to have any discussion of these issues except for the very few examples mentioned below.

4.2 General income – capital income

4.2.1 A brief description of the individual shareholder model

Under the reform of 1992 dividend was taxable as general income at a rate 28 per cent. However, the company would already (normally) have paid 28 percent tax on the income distributed as dividend. To avoid economic double taxation, shareholders receiving dividends from Norwegian limited companies were entitled to a full dividend imputation for the tax already paid ("*godtgjørelsesmetoden*"). Consequently dividends from Norwegian companies were in practice tax free on the hands of the shareholder, ensuring the same total taxation of 28 per cent upon income earned in a limited company as on other capital income.

Furthermore, to avoid economic double taxation of retained taxed profits in the company, the 1992 tax reform introduced a system where the shareholders were permitted to annually write up the basis of their shares by an amount equal to the taxed profit in the company ("*RISK-metoden*").[33] As a result, the capital income tax was levied only on capital gains in excess of retained profits that already had borne corporate tax.

The mentioned imputation and RISK method applied *both* to individual and corporate shareholders.

As mentioned above (confer chapter 3.2), in the case of companies where two-thirds or more were owned by active shareholders, a part of the income was taxed as personal income under the split model, irrespective of whether this income was distributed or not.

From January 1st 2006, both the imputation method, RISK method and the split model were replaced by the individual shareholder model.[34] The basic principle of this model is that the ordinary yield on investments is taxed only once (at the company level), whereas distributed profits exceeding the ordinary yield are also taxed at the shareholder level as general income at a flat rate of 28 per cent. In order to achieve the goal of such limited double taxation, the receiving individual is granted a so-called "computed risk-free return"/ "shielding deduction" (*skjermingsfradrag*), which reduces the taxable dividend/capital gain.

The shielding deduction is calculated for each share and equals the product of the individual's cost price of the share and a shielding interest rate that reflects an after-tax yield on a risk-free investment. This interest rate will be decided by the Ministry of Finance each year, and will correspond to the interest for three months Exchequer bills after taxes, which for 2006 amounted to 2.1%.[35]

When added to the 28 percent company taxation, this gives a total maximum marginal tax rate on dividends/capital gain of 48.16 per cent (28% corporate tax and 28% tax on the

[33] Or if a loss; to write down the basis of the shares.
[34] Cf. sktl. sect. 10-11 et seq. and sect. 10-30 et seq..
[35] See St.prp. nr. 1 Tillegg nr.1 (2005-2006).

distributed 72% of the profits). If the dividend for one year is less than the calculated risk-free return, the excess tax free amount can be carried forward to be offset against dividends distributed a later year, or against any capital gain from the alienation of the same share.[36] However, shielded income cannot be used to create or increase a capital loss.

The implementation of limited double taxation of dividends/capital gains derived by individual shareholders could give incentives for individual shareholders to debt finance companies. To avoid such tax planning and fortify neutrality, interest on loans from individuals to companies and partnerships will be taxed as distributed profits to the extent that the interest exceeds an "ordinary yield".[37]

The effect of the individual shareholder model is that dividends and capital gains exceeding a risk-free return on the investment is subject to economic double taxation and taxed at a total marginal rate which is roughly in line with the top marginal rate on labour income. There is no longer any taxation at source (only upon distribution/sale of shares), no part of the income is deemed to be personal income and the taxation of dividends and capital gains apply irrespective of whether the shareholders are active or passive.

4.2.2 A brief description of the individual partner model

Partnerships are not separate tax entities and are taxed on a transparency basis. The taxable income is calculated on a net assessment basis, as if the partnership was a taxable entity. Subsequently, the general income of the partners will be set to each partner’s share of the net taxable income or deductible loss. Whether the profit is distributed from the partnership or not, will not affect this taxation. The net income will be taxed as general income at a rate of 28 per cent.

Under the 1992 tax reform, according to the mentioned split model, a part of the income earned by partnerships that were owned two-thirds or more by active partners was treated as taxable personal income and was subject to progressive taxation. This taxation was carried out irrespective of whether such income was distributed to the partners or not.

In connection with the introduction of the individual shareholder model, a similar system for taxation of distributed profits of partnerships was implemented from 1st of January 2006.[38] The split model is thus replaced by additional taxation on distributed profit as general income. The receiving individual will be granted a "shielding deduction", which reduces the taxable distribution. For details of the shielding deduction, confer above under chapter 4.2.1. Such partnership taxation will ensure the same level of taxation on both retained and distributed profit as in limited companies, and the maximum marginal tax rate of distributed income will be 48.16 percent.

[36] For details, see e.g. Ot. prp. nr. 1 (2004-2005) chapter 5 and Lignings-ABC 2006 p. 7 et seq. and 25 et seq.

[37] Cf. sktl. sect. 5-22. The interest rate is determined by the Ministry of Finance every second month, and equals 2.1% for July and August 2006. This extra interest tax entered into force on 1 January 2006, and will apply to all lenders, even where they do not have any ownership in the company. However, holders of debentures are exempted.

[38] For details, see e.g. Ot. prp. nr. 92 (2004-2005) chapter 1 and “Skatterett” 2005 no. 3 p. 238.

4.2.3 Other capital income

The tax reform of 2004-2006 made no major changes concerning taxation of other types of capital income. Thus, capital income that individuals do not earn through limited liability companies and/or partnerships is normally taxed once as general income at a flat rate of 28 per cent. However, on the condition that the taxpayer has owned his dwelling for more than 1 year, and lived there for at least 1 year within the 2-year period prior to the disposal, gains derived from the disposal of dwellings (including farmhouses) are tax-free. The same exemption applies to gains on holiday houses provided the ownership has lasted for at least 5 years and that the taxpayer has used it for at least 5 years within an 8-year period prior to the disposal. In addition, from 2005 the benefit a taxpayer is deemed to derive from using his own dwelling also became exempt from tax.[39]

As a result, there is still a substantial difference in the tax rates of different types of capital income and between certain types of capital income and wage income.

4.3 Personal income

4.3.1 Taxation of wage income and wage-related income

4.3.1.1 Basis of computation

Wage income is a broad term and as a general rule all types of benefits derived from employment are taxable according to sec. 5-1(1) of the Tax Law. It is immaterial whether the benefit is paid in cash or in kind, whether it is paid as ordinary salary or as a gratuity, commission, fee, bonus, etc., and whether it is derived over a period of time or on one single occasion. The most important fringe benefits are the private use of the employer's car, free accommodation, free board and lodging and low interest rates on loans provided by the employer.

Employment income (including pensions, alimony, etc.) is taxable when the remuneration is paid to the taxpayer, unless the taxpayer has the opportunity to acquire the amount at an earlier date. Correspondingly, expenses incurred in connection with employment income are deductible at the time of payment.

Wage income is comprised in *both* general and personal income. Income from employment as personal income is a gross income tax base subject to social security contributions and surtax at progressive rates. Income from employment as general income is a net income base taxed at the flat rate of 28 per cent. Permissible deductions in the gross general income are lined-up above under chapter 1.2.

4.3.1.2 The rate structure

The progressivism of the wage income taxation is mainly due to the tax on gross earnings, namely the social security contributions and surtax. Additional elements of significance are the standard minimum deduction (“minstefradraget”) together with the employers' national insurance contributions.

[39] Cf. sktl. sect. 7-1.

For 2007 the premium for the National Insurance Scheme[40] (social security contribution) is 7.8 per cent of assessed income for wage earners, 3 per cent for pensioners, and 10.7 per cent for the self-employed. Personal income which is subject to a social security contribution of 7.8 per cent or 10.7 per cent is also pensionable earnings and forms the basis for the calculation of pension points.[41]

For 2007 surtax on personal income (which comprises labour, pension and self-employed income exceeding risk free return) is 9 per cent for income over the threshold of NOK 400 000 and until NOK 650 000 (bracket 1) and 12 per cent for income over the threshold of NOK 650 000 (bracket 2).

Employers' national insurance contribution is 14.1 per cent.[42]

The maximum marginal tax rate for wage income, including social security and pension premium, is consequently 47.8 per cent. The maximum marginal tax rate for wage income, including employers' national insurance contributions, is 54.3 per cent.

Reduction of the marginal tax rates of personal income was an important part of the work towards the approximation of taxation of capital income and labour income under the tax reform of 2004-2006. As a consequence, the tax rates for personal income (the surtax) have been reduced[43] both for the fiscal year 2005 and 2006.[44] In addition, to counteract the levelling of the distributing effect of the tax system, the standard minimum deduction has been increased. As it is the effective tax burden of labour income that determines whether the taxation of labour income is unequal to the taxation of capital income, also employers' national insurance contributions should be taken into consideration. For example, a shareholder working in the company may choose to receive dividends instead of wage income, and in that way avoid employers' national insurance contributions. Employers' national insurance contribution is neither imposed on income from self-employment. Consequently, to discourage tax planning, the supplementary employers' national insurance contribution on high wages was removed (e.g. in 2005, this amounted to 12.5 per cent for income over NOK 961 000).

4.3.2 The self-employed model

Under the 1992 tax reform, the net income of self-employed individuals was taxed as general income at a tax rate of 28 percent. In addition, the split model was applicable if the owner was participating actively in the enterprise (which would normally be the case). The purpose of the split model was to determine the part of the income which was attributable to the personal work of the owner, in order to tax this part (but this part only), as personal

[40] The scheme is financed by the individual's and employer's social security contributions in addition to grants from the state and the municipalities.
[41] Pension points form the basis for the pension income from the Norwegian Public Service Pension Fund.

[42] The rates of the employer's contribution vary depending on the geographical districts where the employees live and range from 0% to 14.1%.
[43] See St. prp. nr. 1 2005-2006 and St. prp. nr. 1 2005-2006 Tillegg.
[44] However, the new parliament majority of the Labour Party, the Centre Party and the Socialist Left Party also raised the tax rate in bracket 1 from 7 per cent to 9 per cent and lowered the income threshold in bracket 2 from NOK 750 000 to NOK 650 000, cf. St. prp. nr. 1 2006-2007.

income. The legislation regulating the splitting between deemed capital income (subject to 28 percent tax) and personal income (subject to progressive tax rates) was however quite favourable to the taxpayers.

From 2006, the split model for self-employed individuals was transformed into "the self-employed model".[45] The objective is no longer to identify the part of the income attributable to the owners' activity, but to tax *as personal income* all business profits exceeding a risk-free return on the capital invested. However, a condition for falling under the new model is that the enterprise is carrying on a "business" according to tax law.[46] Whether the business/activity is carried out by the self-employed/owner himself or others is no longer of any importance. On the other hand, a sheer passive capital investment is clearly not a "business". Another difference from the previous model is that more income items are included and less income items are deducted when computing the personal income. In addition, there is no longer an upper limit for calculating personal income.

The personal income from self-employment is in principle a gross income tax base and subject to surtax and social security contributions. The marginal tax rate on self-employment income is 50.7 per cent (2007).

In broad terms, the self-employed model implies that the computed business profit/net personal income is calculated by an exclusion of costs and income related to financial assets from the net taxable profits of the business, and that a "shielding deduction" thereafter is deducted from the business profit.[47] The part of the income attributable to the capital invested in the business is determined first, leaving the remaining part of the business income as personal income.

In more detail, the procedure is as follows:

The starting point is the net taxable profits of the business. Actual capital expenses/losses are added to this basis, but losses on trade debtors are not. Further, interest on loans from banks and other financial institutions and on debentures are neither added.

The next step is to deduct income derived from financial assets, i.e. yield on shares, deposits, debentures, etc. However, interest on trade debtors is not to be deducted. Further, gains on ordinary financial assets as mentioned are to be deducted.

After this division, we are left with a business profit that is to be reduced by a computed "shielding deduction"/"risk-free return", which consists of a shielding rate equal to the interest on 3-months government bills (the estimate for 2006 is 2.9 per cent) multiplied with a shielding basis.

The shielding basis is essentially the value of the assets that have been used in the business, i.e. plant and equipment, stock, trade debtors and intangible assets. However,

[45] For details, see e.g. Ot. prp. nr. 92 (2004-2005) chapter 2 and "Skatterett" 2007 no. 1 p. 54.
[46] For details, see e.g. sktl. sect. 5-30, ftrl. sect. 1-10 cf. Ot.prp. nr. 29 (1995-96) p. 29 et seq. and Rt. 2000 p. 1981 *Fabcon*.
[47] Cf. sktl. sect. 12-11 to 12-14.

only acquired goodwill and intangible assets are included. R&D costs are also included in the basis, but only to the extent they have not been deducted for tax purposes.

The assets in the basis are valued at the average of their taxable value at the start and end of the year; however, non-depreciable assets should be valued at the highest of their historic cost price or taxable value.

The last step before calculating the shielding deduction is that the basis shall be reduced by the loans from banks and other financial institutions.

After the divided business profit has been reduced by the shielding deduction, the self-employed may be entitled to one last deduction. This deduction is equal to 15 per cent of the salaries (including social security contributions) paid by the self-employed that year. This deduction may not, however, reduce the personal income below 6 x the basic amount (approximately NOK 372 000).

The remaining amount after all these operations is classified as personal income.

If the personal income calculated is negative, it may not be deducted from personal income from other sources, but may be carried forward and set off against a positive personal income calculated from the same business activity.

A summary of the stipulation of the deemed personal income of self-employed:

<u>General income (net trade income)</u>
+ capital costs and loss, but not more exactly defined debt interest
- actual capital income and financial gains
- shielding deduction (risk-free return of real capital invested in the enterprise)
- earned income allowance
= <u>Personal income</u>

While the self-employed model is by and large based on the same principles as the individual shareholder/partner models, there are two main differences. Firstly, the self-employed are currently taxed based on a source model, while the individuals under the shareholder/partner models are not taxed until receiving dividends/capital gain based upon as distribution model.[48] Consequently, the last mentioned taxpayers may choose to postpone the "additional" taxation as long as they see fit. Secondly, while the income under the individual shareholder/partner models is taxed as general income, the non-exempt part of the income from self-employment is treated as personal income (and thus liable to social security contribution and surtax). However, debt in the sole proprietorship is shielded with actual interests and an earned income allowance is admitted.

[48] For more details why this solution is chosen, see Ot.prp. nr. 92 (2004-2005) p. 100.

Establishing a model for taxation of self-employed that is more or less neutral and still not to complex, has proved difficult and the self-employed model may possibly be regarded as the Achilles heel of the new personal tax system.[49]

4.4 Briefly about the wealth tax

Individuals are also subject to wealth tax on capital, payable to the state and to the municipality. The tax base is net wealth less a basic deduction, cf. sktl. sect. 4-1. The current basic deduction is NOK 200 000. The municipal tax rate is currently 0.7 per cent, while the national tax rate is progressive to a maximum of 0.4 per cent.

In the context of the increased tax on (investment) capital income due to the implementation of the individual shareholder/partner models, the Bondevik II government signalled an intention to halve the net wealth tax in connection with the tax reform, and thereafter continue to scale it back with the intention of a subsequent abolition.[50]

This policy did not however gain support from the Labour Party, and was not a part of the multiparty parliamentary tax reform agreement. The present Stoltenberg government (a coalition between the Labour Party, The Centre Party and the Socialist Left Party) has consequently not implemented such a reduction of the net wealth tax in the 2006 fiscal budget. On the contrary, as measures to diminish the inequalities arising from different valuation of various components of the taxable net wealth, the fiscal budget of 2006 included an increase in the valuation of non-listed shares and of real estate including houses.

5 FUTURE TAX REFORMS - ALTERNATIVE PERSONAL TAX MODELS

Whatever personal tax system chosen, it possesses its strengths and weaknesses. The Norwegian tax reform committee thus analyzed some additional alternatives to the chosen models described above.[51] Even though these models in the end were rejected by the committee, it may be of interest to give a brief description of a couple of the most relevant proposals.

5.1 Comprehensive income tax - progressive taxation of personal capital income[52]

Under a pure comprehensive income tax system the taxpayer faces the same marginal tax rate on all types of (net) income, since the tax schedule is applied to the sum of income from all sources. The latter implies that wage and capital income are taxed at the same, usually progressive, rates. This feature of non-discrimination is often seen as the main virtue of the comprehensive income tax.

Since the need for splitting the income of active owners arises from the differential tax treatment of capital and labour, a natural solution would be to give up the dual income tax

[49] For more details, see e.g. the discussion in "Skatterett" 2007 no. 1 p. 54 and NOU 2005:2 chapter 2 and chapter 12.
[50] Cf. the above mentioned White Paper of March 2004.
[51] For details, see NOU 2003:9 chapter 9.
[52] "Ekstra skatt på netto kapitalinntekter for personer", cf. op.cit. section 9.4. The proposal is based on the minority's report in NOU 1991: 17.

and return to a comprehensive income tax system taxing personal income from capital at the same marginal rate as labour income. The main reason why the tax committee did not recommend such a solution was the desire to keep the personal tax rate on capital income in line with the corporate tax rate. Due to high international mobility of corporate investment and the difficulty of implementing residence-based taxation of corporate income, the committee found it undesirable to raise the Norwegian corporate income tax rate. If a comprehensive income tax system had been implemented, the marginal personal tax rate on capital income would have to be much higher than the corporate tax rate, even if the top marginal personal tax rates were brought down considerably. Given the impracticality of accruals-based taxation of capital gains on shares, accumulation of retained profits within the corporate sector would then be favoured by the tax system compared to saving and investment via the open capital market. This might cause capital to be locked into relatively unproductive investment projects in existing corporations, as was the case before the tax reform of 1992. In addition, even under moderate inflation, full progressive taxation of nominal capital income coupled with full interest deductibility would imply over taxation of the return on savings while amplifying the tax subsidies to homeownership. It will also give incentives to keep debts outside companies and income inside companies (e.g. financing companies by equity capital borrowed personally by individuals). Finally, reintroducing progressive capital income taxation dependent on who is the taxpayer might open the door to tax arbitrage, e.g. exploiting differences in marginal tax rates by establishing holding companies. Hence the committee (except for one member) recommended maintaining the dual income tax schedule.

5.2 A classical corporate tax system[53]

While the Norwegian income splitting system has failed to prevent tax avoidance by active shareholders, it has worked reasonably well for sole proprietorships where it is much more difficult to avoid mandatory income splitting via changes in the firm’s ownership structure. One way of coping with income shifting might then be to maintain the splitting system for proprietors, and to impose a personal tax on dividends and capital gains on shares to ensure a total corporate and personal tax burden on shareholder income roughly equal to the top marginal tax rate on labour income. In this way active shareholders would not be able to reduce their tax bill by paying themselves shareholder income rather than managerial wages. Although such a system would involve an additional tax burden on shareholder income compared to other forms of capital income, this might not increase the cost of equity capital for Norwegian companies whose shares are traded in international stock markets, since the marginal shareholders in these companies are likely to be foreigners who are not subject to Norwegian personal tax rules. However, the tax committee was concerned that full double taxation of corporate equity income would distort investment in small and medium-sized Norwegian companies without access to the international stock market. In addition, such a system would give incentives to debt financing (or with retained earnings) instead of equity financing companies.

[53] ”*Utbytteskatt uten skjerming*”, cf. op.cit. section 9.3.

5.3 The savings and consumptions model (expenditure tax)[54]

An *expenditure tax* system taxes only consumption and not savings. The tax base is equal to total consumption, which can be measured as income on a cash-flow basis less savings. The main efficiency argument in favour of expenditure (or consumption) taxation is that present and future consumption are taxed at the same rate,[55] whereas income taxation implies that present consumption is taxed at a lower rate than future consumption (due to the taxation of income from savings). The savings and consumptions model discussed by the committee had elements of such an expenditure tax. In short, under this model the taxation of ordinary income would remain the same, but the base for surtax and social security contributions would be extended to comprise all types of income (individuals` income from labour, business activity and capital). Investments in financial assets and business assets would be deductible. A prerequisite for the model was a partly or total abolition of the wealth tax. However the committee came to the conclusion it would not recommend this model. The main reasons were that this might cause capital to be put into and locked up in relatively unproductive investment projects and taxpayers may choose to consume part of their income abroad (or even decide to move abroad). In addition, as no country has yet moved from an income tax system to an expenditure tax system, there is not much practical experience to draw on.

Although Norway did not introduce such an expenditure tax system in its pure form, Norway have in practice a mixture of income and consumption taxes, for example Norway rely heavily on value added taxes.

5.4 Flat tax

Flat tax reforms mainly consist of three elements: (1) reducing the rate schedule to a single tax rate, (2) reducing the complexity of the personal income tax system by abolishing all deductions (possibly except for a basic tax allowance), and (3) implementing a low personal income tax rate. This implies that wage and capital income are taxed equally.

An expert committee was appointed by the Ministry of Finance in 1998 to evaluate the possibilities of implementing a more flat tax system in Norway. The committee submitted its evaluations in the Green Paper NOU 1999:7 "*Flatere skatt*". Several models were presented, but none of the proposals were followed up. Most likely, an alteration of the tax system was considered as to comprehensive at the time.

In the Green paper of the recent tax reform, the tax Committee did not use much space to discuss the possibilities of a flat tax. The report plainly stated that "in light of the great revenue and distribution effects…it is neither realistic nor desirable to reduce the marginal tax on labour income enough to make it possible to remove the split model". [56] The Government basically followed up on the recommendations from the committee. As even the quite modest tax reform proposals to make the tax system flatter by reducing the top

[54] "*Spare- og investeringsmodellen*", cf. op.cit. section 9.6. The proposal is based on a report of 15th of May 2003 by orders of Norsk Invstorforum, "Spare- og investeringsmodellen (SI-modellen) – en enklere og mer rettferdig uttaksmodell".
[55] This requires that the consumption tax rate is stable over time.
[56] Cf. NOU 2003:9 p. 185.

marginal rate faced serious opposition, a proposal of a pure flat tax system would most likely never stand a chance.

Even though the White Paper on the tax reform admitted that "a flat tax with a relatively big personal allowance for personal tax payers has its strength in its simplicity",[57] the "goal of redistribution makes it difficult to change to a flat tax".[58] Most of the Norwegian political parties agree that the tax system could and should be used for social redistribution while a flat tax would profit those with middle and high income.

Another argument against a flat tax in Norway is that it would most likely imply relatively vasts cuts in revenue. The White Paper on tax reform stated that, in addition to the question of redistribution, "the need for tax income" was the primary reason why a change to a flat tax was not possible.[59] As long as the country has a small public sector, it is possible to survive with low taxes, but the Norwegian welfare state has a greater need for revenue. In addition, a flat tax would be particular expensive in Norway, as it would have to leave important exemptions intact. Studies have shown that removing the exemptions, most importantly the one on interest payments, seems to be politically almost impossible.

The argued soft spot of the flat tax proposal is the rate at which it has to be set to in order to maintain the same revenue as the present system. The White Paper upholds that increasing the tax on capital "would have a negative effect on the Norwegian economy".[60] And in explaining why they would not support a flat tax, the finance fractions of the government parties argued in their comments to the White Paper that "internationally the development is in direction of lower taxes on business profits" and that Norway therefore "should keep a competitive taxation of businesses exposed to competition".[61]

6 CONCLUSIONS

The above description and analysis of the Norwegian tax reform of 2004-2006 reveals that Norway has not implemented a pure comprehensive, pure flat or pure dual personal income tax system. Norway may rather be characterised as having in practice implemented a "semi-dual" (or "semi-comprehensive") tax system. A "semi-dual" income tax system is defined as a tax system that uses different nominal tax rates on different types of income, typically by taxing some forms of capital (personal and corporate) income at low and often flat rates and remaining forms of income at higher and progressive rates. The reform must be regarded as a whole to give a correct picture of these "semi-dual" elements of the personal income taxation.

Under the tax reform of 1992, due to the large difference in tax rates between wage income and capital income together with the split model, there was a sharp division between the taxation of employees and active (working) individual

[57] Cf. The government's White Paper St.meld. nr. 29 (2003-2004), p. 119.
[58] Cf. The government's White Paper, St.mld. nr. 29 (2003-2004) p. 119.
[59] Cf. Op. cit. p. 119.
[60] Cf. Op.cit. p. 119.
[61] Cf. Innst. S. nr. 232 (2003-2004) p. 57.

shareholders/partners/self-employed on one side, and passive shareholders on the other side.

A positive effect of the new tax reform is the move towards integration of capital income and wage income taxation by way of introduction of the shielding-models and the reduction of the marginal tax rates on labour income. These changes have hampered the distortions effects due to radical differences in tax rates and poorly functioning split model, and thus minimized the discrimination in favour of or against any particular economic choices/form of organisation.

The development and result may be underlined by an example of the maximum marginal tax rates on wage income, income from self-employment and income from shares for 1992-2006:

	1992-rules	2004-rules	2005-rules	2007-rules
Marginal tax rate on wage income:				47.8
Incl. employers' national insurance contributions (14.1 pct):	56.1	64.7	61.5	54.3
Marginal tax rate on income from self-employment:	48.8	55.3	54.2	50.7
Marginal tax rate on income from shares (including company tax):	28.0	28.0	28.0	48.2

However, the corporate tax system and the integration between the corporate and personal income tax systems will influence on the choice of unincorporated versus incorporated organisation. A key issue in the reform was the introduction of a distinction between shares owned by corporate entities and shares owned by private individuals. While income from capital (share) investment is tax exempt when received by companies, individual shareholders must pay a tax of 28 per cent. Making the taxation of the same type of income dependent on who is the tax subject constitutes a breach of the neutrality principle. As a consequence, the taxation of share income and loss will to a greater extent than before depend on the business organisation, so that tax planning and restructuring within this area will become even more important than before. For example, many investors have chosen to set up holding companies for accumulation of earnings and/or for reinvestment without having to pay tax on the share income. In a press release from the Register of Business Enterprises of 3rd of January 2006, it was stated that there has been "An explosion in the incorporation of limited liability companies because of the new tax reform." In 2005, the increase in registrations was approximately 60 per cent.

In addition, even the Norwegian Tax Administration itself strongly advised the government against the shareholder model, arguing that it would be "difficult to understand and challenging to relate to for the tax payers" and that it "would make the tax payers' possibilities for controlling the tax base almost illusory".[62]

Another challenge of the new tax reform is the split tax rate structure for capital income. Under the current system some types of personal capital income is still taxed at lower rates than both share investment income and wage income. For example, interests, rents and income and capital gain on tangible and intangible assets are still taxed once as general income at a rate of 28 per cent. In addition, there are certain types of capital income that is not taxed at all, e.g. income and gains derived from the disposal of dwellings and holiday houses .[63] These differences in the rate structure may give incentives for tax planning and choice of investment etc.

In addition, it is still necessary to make a distinction between active and passive investments when it comes to income from self-employment as only active (business) income is considered personal income and taxed at progressive rates. Setting the limit between active and passive activity may complicate the tax system and render difficult the compliance, plus prompt tax-planning.

The differences in tax rates and general discrepancies in the current personal tax system is most likely due to a tendency of repair work instead of undertaking an overall overhaul when forming the new tax system. In addition, it may be politically difficult to implement major tax reforms unless there is either a broad political consensus about the need for reform or if the government proposing the reform has a clear majority in parliament. In Norway, changes of government with different policy objectives during the implementation of the tax reform have resulted in subsequent amendments in the prerequisites laid down in tax reform proposal. As an example, the pronounced tax policy of the current Government is to bring the taxes back to the 2004-level, e.g. by making the surtax and wealth tax rates and rules more stringent.

However, given the broadness of relevant issues to consider when designing a personal income tax system, tax policy will in practice involve a series of complicated trade-offs between different policies objectives. As there always will be a wide differences in views on how to make these trade-offs, tax reforms will accordingly be politically controversial.

A country's final choice of a system for the taxation of personal income will thus depend on how the trade-offs are valued in each individual country.

The current design of the Norwegian personal tax system may in broad terms be seen as an "intersection" of the need to raise revenue to the welfare state and the focus on maintaining fairness/equity together with the aim of a being as neutral as possible, as well as protecting mobile capital, and to some extent labour, upholding international obligations and counteracting tax arbitrage. In the end, whether or not a proposed reform is considered to be "fair" seems to be of prime importance in Norwegian tax politics.

[62] St.mld. nr 29 (2003-2004) p. 83. A central part of the criticism has been related to the problems finding accurate historic costs and the challenges for the tax authorities to enforce the shareholder model.
[63] Subjugated to certain conditions.

Figure 2. The personal tax system following the tax reform of 2004-2006: