

# Interest Expenses as a Technique of Profit Shifting Used by Slovak Companies

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**Abstract.** The use of tax havens is both controversial and attractive for the academic community. Most research and output is associated with providing empirical evidence of shifting taxable profits from jurisdictions with higher tax to lower or zero tax jurisdictions. Various methods and techniques are used to shift profits, and we intend to analyze in greater detail one of the often-used profit shifting techniques. This paper aims to analyze the impact of the transfer of registered offices of Slovak companies to tax havens on the level of the reported ratio of interest expenses per assets before and after the transfer of the registered office to selected jurisdictions. In addition to statistical testing of the selected indicator before and after seat migration, we also provide a comparison of a selected indicator between Slovak companies' ownership links with tax havens and Slovak companies with no ownership links with tax havens. We divide tax havens into three categories, onshore, midshore and offshore jurisdictions. In our analysis, we use two databases. The first is the Bisnode database, which lists the Slovak companies with the owner in selected jurisdictions between 2005-2015. The second database is the datasets of the financial statements of Slovak companies for individual years prepared and provided by Finstat.

**Keywords:** Interest Expenses, International Holdings, Tax Havens, Profit-Shifting, Tax Planning.

## 1 Introduction

The use of interest expenses in the area of international tax planning and tax optimization belongs to frequently used methods and techniques of shifting taxable profits to low or zero tax jurisdictions. In addition to tax optimization itself, when mentioning internal debt financing within equity-linked companies (holding companies), we also mention the benefits of control by debt, so the majority creditor can take legal action to control the company. With tax optimization, it is essential to recognize interest as a tax expense under conditions that consider the so-called thin-capitalization rules and the EU Directive on interest and royalty payments (the EU Interest and Royalties Directive). While the European Directive can be used between associated companies of different EU Member States, thin-capitalization rules are unilateral measures at the national level. Thin-capitalization rules are included within

the Slovak Income Tax Act 2015 (§ 21a on Income Tax Act) and allow for the possibility of including interest and associated costs for loans and borrowing up to a maximum of 25% of EBITDA into tax expenses. The theoretical economic literature on profit shifting suggests that a foreign subsidiary will use more internal debt if the multinational holds another subsidiary in a low-tax jurisdiction and if the spread between the host-jurisdiction tax rate and the lowest tax rate within the multinational group is large.

This paper focuses on analyzing the use of the selected channel of profit shifting from the Slovak Republic into selected jurisdictions and the proposal of methodology in this particular field, which is also applicable in the field of research in other countries.

## **2 Literature Overview**

Thin-capitalization rules are part of the BEPS project (Basic Erosion and Profit Shifting), and in October 2015 the OECD made a best practice recommendation in Article 4 suggesting a Fixed Ratio Rule to replace thin-capitalization rules. Low-capitalization rules have been taken into account since the 1960's, and the OECD report on thin-capitalization rules was published in 1986. The new Fixed Ratio Rule solution can be considered more effective than the current low-capitalization regime [14]. Guenther first analyzed the dependence between the level of interest expenses and foreign tax rates and levels of long-term debt for U.S. multinational firms [9]. Results from his model demonstrate that the effect of interest expense deductions on U.S. tax liability depends on the ratio of foreign tax rate to the U.S. rate. Firms with low relative foreign rates receive a tax benefit for interest expenses equal to their U.S. tax rate, while firms with high relative foreign tax rates receive a tax benefit for interest expenses that is less than their U.S. tax rate. Richardson and Davos consider the deductibility of interest expenses as one of the most controversial issues in taxation law, which raises the issue of modification on a regular basis [21]. According to these authors, the existing and potential approaches to the deductibility of interest expenses have their inherent problems and weaknesses (mainly approaches to either limit or restrict the deduction for interest, e.g., economic equivalence, a pro rata allocation of interest or matching interest payments to interest receipts).

The results of Hong and Smart suggest that while income shifting to tax havens may reduce the revenues of high-tax jurisdictions and increase tax base elasticities, it tends to make the location of real investment less responsive to tax rate differentials [10]. Auerbach, Devereux, Keen and Vella describe the technique of profit shifting through the use of debt [2]. This planning technique relies on the deductibility of interest payments under most existing corporate tax systems.

A multinational company is supposed to have two affiliates, one in a high tax country and one in a low tax country. The affiliate in a low tax country requires financing for its business, but instead of using the funds directly from the third-party bank, it is equity funded by the affiliate in the high tax country using funds borrowed from a bank in the high tax country. The interest paid to the bank is deducted from the profit in the high tax country. Vallaste describes the use of internal debt (loan) through international

holding [24]. The financing structure is supposed to have two companies again. The first one (parent company) in the onshore or midshore jurisdiction (e.g., the Netherlands, Cyprus, Malta) and the second in the selected offshore jurisdiction (e.g. Belize) – (grandmother company). The financing structure is appropriately set up after the provision of loans with different interest rates (e.g. loan at 12% interest rate to the subsidiary/borrower in one direction and loan at 10% interest rate from the offshore company to onshore or midshore company).

Buettner, Overesch, and Wamser analyzed the data on German multinational firms, and their findings indicate that introducing thin-capitalization rules or making it tighter exerts significant adverse effects on FDI (Foreign Direct Investment) in high-tax jurisdictions [5]. A multinational firm operating an internal capital market can minimize its overall tax payments by lending from the affiliate facing the lowest tax within the firm to all other subsidiaries [19]. Buettner, Overesch, Schreiber and Wamser state that their findings indicate that thin-capitalization rules effectively reduce the incentive to use internal loans for tax planning but result in higher external debt [4]. Johannesen stresses that unilateral tax provision may not be sufficient as the profit shifting is structured in the international environment and the multinational firms finance foreign investment with a hybrid instrument treated as debt in the host country and equity in the home country [13]. Cross-border hybrid instruments help with generating significant tax savings relative to financing and with standard debt and equity instruments. Maßbaum and Sureth-Sloane in a general capital structure model analyzed if thin capitalization rules affect dividend and financing decisions and whether they can partially explain why corporations receive both debt and equity capital (Belgian, German and Italian rules as examples) [18]. They find that the so-called Miller equilibrium and definite financing effects depend significantly on the underlying tax system and its tax parameters.

Mardan shows that the optimal level of internal interest deductions decreases with the financial development of the host country [17]. Kollruss states that the introduction of a new thin-capitalization-rule under the German Tax Reform Act in 2008 marked one of the deepest cuts in modern German tax history [15]. As a consequence of the new act, tax planning opportunities for German Corporations reducing their high tax burden by using cross-border intragroup debt financing structures have been limited massively. Under the new German Corporate Income Tax Act, net interest expenses of a German corporation are tax deductible only up to 30% of the taxable profit (EBITDA) per current fiscal year. Buettner and Wamser, based on their analysis of German firms, consider the empirical magnitude of interest deductions as overestimated as a technique of profit shifting [6]. According to their results, the upper limit for the implied tax-elasticity of reported profits due to profit shifting is around 0.11%. However, the existing literature estimates point at figures of 1.3% or 2%. They further argue that the low tax sensitivity of internal debt can be explained by indirect effects related to the taxation of the parent company. They consider the Controlled Foreign Corporation (CFC) rules to be an effective tool against profit shifting to low tax jurisdictions. When they took into consideration the German CFC rules when measuring the profit shifting tax incentives, the predictive power of the tax incentive and its effects on an internal debt increase. This finding has interesting implication for the U.S. case, where

according to Altshuler and Grubert, the so-called "check-the-box" rule allows U.S. multinationals' tax haven subsidiaries to circumvent the CFC rule [1]. This suggests that the U.S. multinationals engage more in profit shifting using internal debt than their German counterparts, and also that the empirical tax sensitivity of internal debt should be higher in the U.S. case. Grubert finds that the most critical channel for profit shifting within multinational firms is associated with the allocation of research and development (R&D) expenditures [8].

### 3 Methods, Objective and Data

This article aims to assess the use of interest deductible expenses (loans) by Slovak companies as the channel for profit shifting to low tax jurisdictions. The use of interest expenses belongs among the techniques of profit shifting and it is the subset of using debt channel (debt financing). The indicator of interest expenses per assets will be analyzed as a critical lever. The examined indicator was selected, respectively derived based on Reuter, who appoints the using of debt among the several other variables that capture profit shifting behavior [20]. We have been monitoring the change of this indicator within Slovak companies before and after relocating the official seat to selected jurisdictions. At the same time, we compared the indicator (and its differences) between Slovak companies with and with no ownership links to tax havens (parent company as the owner come from the preferential tax jurisdictions).

The list of Slovak companies that have moved to tax havens (2005-2015) was obtained from the Bisnode database. The financial statements of all Slovak companies were drawn from the financial statements of the dataset provided by Finstat.

We have divided into three categories, jurisdictions marked by Bisnode as tax havens:

- OFFSHORE JURISDICTIONS (OFF): Bahamas, Belize, Bermuda, British Virgin Islands, Gibraltar, Guernsey (United Kingdom), Jersey (United Kingdom), Cayman Islands, Marshall Islands, the Netherlands Antilles, Panama, Man Island, and Seychelles;
- MIDSHORE JURISDICTIONS (MID): Hong Kong, Cyprus, Malta, United Arab Emirates, United States of America;
- ONSHORE JURISDICTIONS (ON): Liechtenstein, Latvia, Luxembourg, Monaco and the Netherlands.

From the nature of the business conditions, taxation and disclosure of information on ultimate beneficial owners (UBO), tax havens are most commonly divided into onshore and offshore categories. Offshore financial centers (pure tax havens) are generally defined as jurisdictions in which the financial sector is disproportionately more significant than the domestic economy. In the onshore category we can find mainly jurisdictions with a diversified economy and a classic tax system but often designed to provide opportunities for substantial tax cuts for companies [7, 25]. Some sources still use the so-called midshore category, most frequently as Cyprus, Malta or Hong Kong [23]. While the division of the individual jurisdictions to the offshore category is almost

automatic, as the other jurisdictions, we have decided on the division between onshore and midshore categories mainly because of their use and the costs needed to set up and manage companies. This categorization will help us to better interpret the trends in behavior in the field of use of the investigated technique of profit shifting. Some authors analyse profit shifting by testing multinational companies' ownership links to individual tax havens rather than to groups of them [e.g. 12].

We have researched the Slovak companies whose owners come from the preferential tax jurisdictions (direct capital connection - the owner registered in the Slovak Business Register). This has led to the creation of an international holding structure. According to Líška and Sabolová, holding structures are indispensable, particularly in the field of investment protection under international treaties, in the case of requirements to maintain a high degree of anonymity of the ultimate beneficial owner, in the use of special preferential tax regimes and some servicing activities (such as marketing, financing and purchasing) [16].

## 4 Results

In the first part of the analysis, we monitored the change of the indicator of interest expenses per assets before and after the transfer of the registered office to selected jurisdictions (tax havens). For this analysis, data was available for a total of 669 Slovak companies. The relatively low number of available companies' financial statements (both before and after the transfer to tax haven) was caused for example by the fact, that almost 60% of Slovak companies moved their registered office to tax havens within three years of being established. We used a non-parametric Wilcoxon test (before the statistical analysis we identified 2% of the outliers that we excluded from the analysis) (Table 1).

**Table 1.** Descriptive characteristics of interest expenses per assets.

		BEFORE	AFTER
N	Valid	655	655
	Missing	0	0
Mean		.0326	.1085
Median		.0059	.0103
Std. Deviation		.10600	.91033

In the analyzed sample of enterprises, the median value of the indicator of interest expenses per assets before the transfer of the registered office was 0.0059 (interest expenses constituted 0.59% of the assets), while after the change of the registered office, the median value of this indicator increased to 0.0103, that creates an increase of 75%. This difference was shown to be statistically significant (p-value 0.007) at a significance level of 0.01.

The drop in the indicator was recorded in 295 Slovak companies, and the increase was recorded for the remaining 360 companies. Although based on the Wilcoxon test results, we reject the hypothesis of a statistically insignificant difference before and

after the change of residence. The indicator dropped in 45% cases (remaining 55% increase), which can be considered as insufficient evidence to claim that after the change of the place of residence, the indicator of interest expenses per assets increases. In the analyzed sample of enterprises, 39% of the companies showed the current increase in assets as well as an increase in interest expenses, of which 5.6% of the companies had a percentage increase in the assets higher as a percentage increase in the interest expenses, which led to a decrease in the indicator. Also, interesting is the fact that 27% of the companies showed zero interest expenses before the transfer of the headquarters and were non-zero after the transfer (it can be assumed that the investigated profit shifting technique was automatically used after formation of ownership link with tax haven).

We also analyzed whether the change of indicator after the relocation of the ownership is statistically significant from the view of jurisdiction category (Table 2a and 2b).

**Table 2a.** Wilcoxon Signed Ranks Test – individual categories.

Jurisdiction			N	Mean Rank	Sum of Ranks
MID	After-before	Negative ranks	110 <sup>a</sup>	128.28	14111.00
		Positive ranks	163 <sup>b</sup>	142.88	23290.00
		Ties	0 <sup>c</sup>		
		Total	273		
OFF	After-before	Negative ranks	18 <sup>a</sup>	23.00	414.00
		Positive ranks	23 <sup>b</sup>	19.43	447.00
		Ties	0 <sup>c</sup>		
		Total	41		
ON	After-before	Negative ranks	167 <sup>a</sup>	169.10	28240.00
		Positive ranks	174 <sup>b</sup>	172.82	30071.00
		Ties	0 <sup>c</sup>		
		Total	341		

Note: a. AFTER < BEFORE

b. AFTER > BEFORE

c. AFTER = BEFORE

**Table 2b.** Wilcoxon Signed Ranks Test – individual categories.

Jurisdiction		After-before
MID	Z	-3.515 <sup>a</sup>
	Asymp. Syg. (2-tailed)	.000
OFF	Z	-.214 <sup>a</sup>
	Asymp. Syg. (2-tailed)	.831
ON	Z	-.503 <sup>a</sup>
	Asymp. Syg. (2-tailed)	.615

Note: a. Based on negative ranks.

b. Wilcoxon Signed Ranks Test.

The nonparametric Wilcoxon test showed a statistically significant difference in the value of the observed indicator only for companies in the midshore jurisdictions. The increase in the indicator was reported by 60% of Slovak companies, which moved to jurisdiction in the midshore category. In the case of the offshore category, 56% of the companies reported an increase, and in the case of the onshore category, it was only 51% of the companies. What is interesting, however, is the view of the median values of the surveyed indicator. The highest median value of the pointer is in onshore jurisdictions, and its value is almost the same before and after the change of residence (before 0.0123, after 0.0121). The highest difference in median value after the change of residence is in midshore jurisdictions, where the indicator rises from 0.0028 to 0.0088, which represents a threefold increase.

In offshore jurisdictions, the median value rose almost 15-times from 0.0003 to 0.0045. Offshore companies are primarily used on the first level of ownership to achieve a higher degree of anonymity of the ultimate beneficial owner. The profit shifting from the Slovak company directly through the offshore company is inefficient due to the 35% withholding tax (the Slovak Republic does not have double taxation treaties with the offshore jurisdictions). However, other channels of tax base minimization can be used through debt, and the offshore company can only be a means to cover the owner. The expectation that the highest median value after relocation will be mainly for the midshore category has been confirmed, mainly due to the popularity of Cyprus and Malta with Slovak companies.

In particular, Cyprus is being used because of the wide possibilities of using tax and accounting laws in the field of tax optimization. The founding and management of companies in Cyprus is also significantly lower compared to the Netherlands and Luxembourg of the onshore category, although at a result of a worsening company image (Dutch companies are also the most commonly used as the seat of Slovak companies - 27%, from the perspective of invested share capital up to 52 %). In the Netherlands, the standard corporate income tax rate is 20%, resp. 25% and cannot be further optimized (often further owned by the offshore company on the second level). Companies that have moved to the Netherlands or Luxembourg have high values of the indicator before the transfer. Most often moves of headquarters to the Netherlands were with companies operating within the NACE sector of wholesale and retail; professional, scientific and technical activities and real estate activities.

Specifically, we tested the change in the investigated indicator for the Netherlands and Luxembourg (A), where there was no statistically significant difference (p-value 0.881). For Cyprus and Malta (B), a statistically significant difference (p-value of 0.000) was already recorded (Table 3 and 4).

**Table 3.** Descriptive characteristics (A).

		BEFORE	AFTER
N	Valid	333	333
	Missing	0	0
Mean		.0531	.0583
Median		.0129	.0127
Std. Deviation		.21893	.27795

**Table 4.** Descriptive characteristics (B).

		BEFORE	AFTER
N	Valid	183	183
	Missing	0	0
Mean		.0256	.1626
Median		.0033	.0141
Std. Deviation		.07212	1.04778

If we compare only the selected jurisdictions of the Netherlands and Luxembourg vs. Cyprus and Malta, the median value of the indicator before the change of residence is higher in the Netherlands and Luxembourg. However, after the change of residence, the median value is higher in the Cyprus and Malta group. The assumption is that Cypriot and Maltese companies are most often used in aggressive tax planning (cost of corporate structure vs. potential range of tax savings). The Netherlands and Luxembourg are used more frequently by large and profitable (richer) companies. It is also expected that large and richer companies could invest more in tax optimization channels respecting the local tax settings. We also analyzed the change of indicator in the NACE sector. We only focused on selected NACE sectors where the total number of companies on the total amount was more than 10%. The highest median value is shown by NACE sector *real estate activities* - an increase of 18%. The most significant percentage change in the median value of the indicator was reported by companies in the *wholesale, retail and repair of motor vehicles sector* - a 6.3-times increase. Companies in the NACE sector of *professional, scientific and technical activities* showed a 10% decrease in the median value of the indicator and the *manufacturing industry* decreased by 8% (Table 5).



**Table 5.** Median value changes by NACE sectors.

SK NACE sector	BEFORE	AFTER	Change	P-value
Real estate activities	0.0234	0.0277	18% increase	0.09
Professional, scientific and technical activities	0.0107	0.0096	10% decrease	0.954
Wholesale, retail trade and repair of motor vehicles	0.0010	0.0063	530% increase	0.001
Manufacturing industry	0.0062	0.0057	8% decrease	0.058

Before the analysis, we assumed that the highest median values would be for the sectors *real estate activities* and *wholesale, retail and repair of motor vehicles*. The assumption in the median values was reached in the *real estate activities* sector, on the other hand, the increase in the indicator after the transfer of the seat to the tax haven occurred in only 54% of cases. Similarly, 54% of companies showed an increase in the observed indicator in the *professional, scientific and technical activities* sector. For the *wholesale, retail and repairs of motor vehicles* sector, the most significant increase in the median value of the indicator was observed, with an increase of up to 65%. In the *manufacturing industry*, only 39% of companies reported an increase in median value.

Statistical significance at the significance level of 0.01 was recorded only for the *wholesale, retail and repair of motor vehicles*. There was no significant statistical difference in the observed indicator due to the transfer of ownership to the tax haven of other sectors.

In the sphere of monitoring trends of behavior of Slovak companies, the use of the technique of deductible expenses for the purpose of profit shifting is important in addition to monitoring changes following the transfer of a tax domicile to a comparison of median values between Slovak companies located in the tax haven with those Slovak companies that do not have their registered office in the tax haven. Therefore, we have chosen a different view of the investigated indicator, which would be more logical to prove whether the Slovak companies use the investigated technique of profit-shifting.

Again, we used the same data sources as in the previous analysis, working with the company database as of 2015. We had 56,407 companies based in the Slovak Republic and 1,227 Slovak companies based in the tax havens - ownership link to tax havens. In the analysis, we did not work with the entire dataset of companies without linking to the tax havens, but we randomly generated about 10% of the companies and compared the value of the indicator of these two groups of companies. Due to the high variability of data in both groups of companies, we compared the median values of the monitored indicator (Table 6).

**Table 6.** Descriptive characteristics – with and with no links to tax havens

With no links	N	Valid	5649
		Missing	0
	Mean		0.214
	Median		0.0083
St. Deviation			.12862
With links	N	Valid	1227
		Missing	0
	Mean		0.539
	Median		0.0117
	Std. Deviation		

The median value of the indicator of interest expenses per assets is 41% higher in companies with ownership link to tax haven than Slovak companies with no links to tax havens. The Mann-Whitney nonparametric test showed a statistically significant difference in the indicator on a significance level of 0.01 (p-value 0.000).

## 5 Discussion

The thin-capitalization rules were introduced in the Slovak Republic only with effect from 2015. Our analysis, therefore, examined data, trends in the behavior and the use of the technique of profit shifting under conditions without thin-capitalization rules. The impact of the introduction of the thin-capitalization rules on the use of debt channel as technique of profit shifting should be investigated in Slovakia in the near future. Research methodology in this area could be similar to that proposed by, for example, Maßbaum and Sureth-Sloane or Buettner, Overesch and Wamser, that the effect of the thin-capitalization rules on the use of interest expenses as profit shifting technique depends on the underlying tax system and its tax parameters [4, 18]. The analysis in the broader context of setting up the Slovak tax system will also allow looking at other channels of tax optimization as for example dividends or R&D. Our empirical results suggest that the Slovak companies use the method of interest deductible expenses in a way as described by more authors [e.g. 2, 19, 24]. The basic prerequisite for the implementation of the investigated technique is ownership link on tax havens. The list of tax havens should, in our opinion, be longer than that produced by Bisnode. There is a lack of onshore jurisdictions there, for example, Great Britain with which ownership links were up to 1,303 Slovak companies as of 2nd quarter of 2018 [3]. If we look specifically at the Netherlands and Luxembourg in the analysis, it turned out that the companies that moved their headquarters into these jurisdictions had a median of 0.0129 to 0.0127. Our results are comparable with Mardan, who shows that the optimal level of internal interest deductions decreases with the financial development of the host country [17]. The Netherlands and Luxembourg are considered one of the most developed jurisdictions in the area of tax planning, property protection, and investment. Regarding the type of jurisdictions, it would be interesting in the future to focus on what types of profit shifting channels are used in individual home countries regarding

their NACE business sectors. Our empirical results show that the NACE sector also influences the use of individual profit shifting techniques and methods in addition to the choice of the parent company (e.g., the use of interest expenses as debt channel in the NACE sector of real estate activities is more used than in the manufacturing industry).

## 6 Conclusion

Our analysis of the indicator of interest expenses per assets showed that Slovak companies with ownership links to tax havens demonstrated an increased value of this indicator compared to other Slovak companies with no ownership links to tax havens by 41%. A statistically significant difference was also demonstrated in the median values of the indicator followed after the transfer of the seat of the Slovak companies to the tax haven (75% increase). So, it is visible, based on our empirical results (based on the analysis of data between 2005 and 2015) that Slovak companies use the debt financing technique, respective of interest deductible expenses for profit shifting to low tax jurisdictions. When testing a statistically significant difference in the value of the indicator before and after the change of residence by jurisdiction category and by NACE sector, we have achieved different results. The statistically significant difference in indicator of interest expenses per assets from the type of jurisdiction was reflected in ownership links to midshore jurisdictions. Up to 61% of Slovak companies that moved their seat to the midshore jurisdiction showed an increased median value of the indicator after the relocation. We believe that the main reason for using these jurisdictions is their preferential tax regimes and accounting system and the relatively low costs of setting up and managing companies in those jurisdictions versus the potential range of tax savings. A statistically significant difference was not demonstrated in onshore jurisdictions (51% increase in the indicator). The median values in this category before and after the transfer of tax residence remained almost the same, but these values are the highest or at the level of the midshore category after relocation. Regarding NACE sector, the highest median values are recorded in the real estate business sector and the highest increases in the NACE sector is with wholesale, retail, and repair of motor vehicles (up to 530%). Although, given the above-mentioned limitations (incomplete list of tax havens and low number of companies tested), our analysis does not have to provide sufficient evidence to claim that after the transfer of residence there is an increase in the indicator of interest expenses per assets. Our results create minimally the base to deduce the tendency in the behavior of selected Slovak companies with regard to the use of the investigated technique of profit shifting out of the Slovak Republic.

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