

Tatjana Jovanovic<sup>1</sup>

## THE FINANCIAL STRUCTURE OF THE FDI IN SLOVENIA

*The research focuses on testing the financial structure of FDI in Slovenia in the years 2003/04 and 2013/14 that is before and after tax reform. It turned out that contrary to the author's expectations, the indebtedness increased in the observed period.*

*Keywords: FDI; financial structure; debt financing; Slovenia.*

Тетяна Йованович

## ФІНАНСОВА СТРУКТУРА ПІІ У СЛОВЕНІЇ

*У статті досліджено фінансову структуру ПІІ у Словенії, порівняння проведене для періодів 2003–2004 та 2013–2014 рр., тобто до та після податкової реформи. На протилежну початковій гіпотезі дослідження та очікуванням, протягом досліджуваного періоду заборгованість збільшилась.*

*Ключові слова: пряме іноземне інвестування; фінансова структура; фінансування боргу; Словенія.*

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Татьяна Йованович

## ФИНАНСОВАЯ СТРУКТУРА ПИИ В СЛОВЕНИИ

*В статье исследована финансовая структура ПИИ в Словении, сравнение проведено для периодов 2003–2004 и 2013–2014 гг., т.е. до и после налоговой реформы. Вопреки изначальной гипотезе и ожиданиям, в исследуемом периоде задолженность возросла.*

*Ключевые слова: прямое иностранное инвестирование; финансовая структура; финансирование долга; Словения.*

**Introduction.** International companies transfer profits through permanent establishments and branches, in economic language this is often called foreign direct investment (FDI). The International Monetary Fund (IMF) defines this term as investment in order to obtain long-term controlling interest in a company. The main motivation of a direct investor is to implement a certain degree of influence over the management of direct investment, irrespective of the fact that this raises upward controlling interest. The objectives of direct investment is completely different from portfolio investments, when investors do not expect any impact or active participation in company's management. Recommendation of the OECD is that countries adopt as a criterion the control of at least 10% of ordinary shares or voting rights (OECD, 2008). FDI occur in the form of new business creation or taking over existing business with the possibility of extension. It presents the establishment or acquisition of a foreign entity in which investor (usually a company) in addition to financial resources invests a whole range of resources (equipment and different skills) and in which a majority holding in capital has established control over management. They consist of two main categories: i) direct net transfers to the parent company of a subsidiary, either through debt, or equity; ii) reinvested earnings of subsidiaries (Rojec, 1994).

The international taxation fundamental premise is the knowledge that when companies invest outside the borders and engage in international trade, they become the subject of tax laws of at least two countries (Scholes et al., 2002). Generally, it is expected that all companies (even only operating nation-wide) respond to taxation, capital markets, financial and investment decisions, but the impact and opportunities

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<sup>1</sup> University of Ljubljana, Slovenia.

are much greater when considering internationally (FDI) operating ones. These opportunities appear as a well-known tax deferral, transfer pricing or the use of internal debt financing to carry out the investment, spreading on much more complex strategies. Taxes undoubtedly affect the financial structure of FDI's. As a result, these companies choose the financial structure taking into account the differences in international taxation. Unlike companies that operate only within national environment, FDI have the possibility of lending or borrowing cash from its subsidiaries to optimize the capital structure in all subsidiaries and at the same time minimize the tax burden of the group (Cordes et al., 2005). While capital is becoming increasingly mobile between countries, multinational companies face a choice of where to locate production facilities. In response to this mobility, there is increasing pressure on governments to maintain and attract capital into their jurisdictions. Governments may attempt to do this in many different ways – from creating a flexible labor market or investing in infrastructure development to focusing on the taxation of mobile capital (Devereux and Griffith, 2002).

There are two instruments to avoid the now observed profit shifting of multinational enterprises (MNEs) used in national governments. On the one hand, tax competition has led to a significant decrease in corporate tax rates (Ramb and Weichenrieder, 2005). On the other hand, countries, typically large and high-tax ones, have implemented anti-avoidance rules to prevent profit shifting (Weichenrieder, 2009). Anti-avoidance measures can be divided into:

- measures based on general legal principles which are not codified in legislation but are included in philosophies and approaches in law ("substance over form", "abuse of law" etc.);
- general anti-avoidance rules which have the same meaning as the mentioned above except they are codified and included in legislation;
- specific anti-avoidance rules applicable to specific situations (controlled foreign corporations, foreign portfolio investments, thin capitalisation rules (TCR), anti-tax-haven rules, transfer pricing etc.).

One of the most commonly used international tax planning strategies (for profit shifting) nowadays is thin capitalization. It is a financing strategy MNEs use to make FDI. When an MNE initiates business activities in another country, it frequently forms a local subsidiary to conduct business. These investments need to be funded to support business expansion. FDI can be financed as equity and/or debt. Debt is preferred since it creates an opportunity to lower income taxes, as interest expenses are tax deductible, while dividends are not. When investment in a high-tax country is funded with intercompany debt extended from a low-tax country, profit is shifted to the country imposing lower taxes. Thus, MNE reduces its worldwide tax rate without incurring additional trade expenses. This can motivate MNEs to fund overseas investments in high-tax jurisdictions with a high ratio of debt-to-equity (Webber, 2010).

The instrument of national governments to fight this strategy is called the thin capitalization rule. Between 1996 and 2005 the number of the EU countries to introduce some sort of debt-to-equity restriction increased from 8 to 17 (Buettner et al., 2009). The instrument was introduced in Slovenian tax legislation in 2005 in connection with the harmonisation of corporate taxation legislation with the EU law and the freeing up of international capital and financial flows.

While there are no empirical evidence of worldwide spread tax strategies for Slovenia, the paper focuses on the observation of the trend of internal indebtedness of multinational companies operating in Slovenia in the period after this tax reform. The main objective of the paper is to analyse the trend of internal indebtedness of FDI operating in Slovenia in the period of 2003/04 and 2012/13. Following the introduction, the paper offers the review of literature on FDI and TCR, while the third section presents the problem statement and the methodology of the paper. The fourth section covers the research results, finishing it in the fifth section with conclusions. In the last section, the directions for further investigation are offered.

**Literature review.** Research to date has shown that tightening TCRs reduces the leverage and share capital (capital shares) of controlled companies. Empirical research into leverage and the value of assets, plants and equipment of controlled corporations of German multinationals in 24 countries between 1996 and 2004 has shown that leverage fell significantly in the countries with a TCR in place. While it has been shown that TCRs are effective at limiting debt financing, investment is more tax-sensitive if debt financing is restricted (Buettner et al., 2008). An equally important element in tax planning of multinational enterprises is their ability to structure finances in terms of capital and debt, not only for the enterprise as a whole but also within the group. Aside from the direct loss of revenue, increasing the opportunities for tax savings gives multinational enterprises advantages with respect to enterprises that only do business at the national level. The introduction of the so-called TCRs that deny (i.e. do not recognise for tax purposes) interest expenses for internal loans if the debt-to-capital ratio or the amount of interest exceeds a specific limited threshold, is actually spreading (Haufler and Runkel, 2012).

The literature indicates that TCRs are effective at limiting internal borrowing (Wamser, 2008; Buettner et al., 2009; Overesch and Wamser, 2010; Buettner et al., 2012; Buslei and Simmler, 2012) with particular effectiveness in the countries with high corporate income tax. G. Wamser (2008) has empirically demonstrated that up to a certain phase enterprises are capable of substituting internal borrowing with external one.

The reduction of the permitted debt-to-capital ratio in the course of the tax reform in Germany between 2001 and 2004 led to a significantly smaller share of intra-company borrowing (Overesch and Wamser, 2006). In the early 1990s more than 75% of German internal direct investment consisted of loans, while outbound direct investment primarily consisted of capital (Weichenrieder, 1996). One of the studies for the USA, prepared on the data set for thin capitalization rules in 54 countries in the period 1982–2004 found out that restrictions on affiliate's debt-to-assets ratio reduce this ratio on average by 1.9%, while restrictions on affiliate's borrowing from the parent-to-equity ratio reduce this ratio by 6.3%. Also, restrictions on borrowing from the parent reduce the affiliate's debt-to-assets ratio by 0.8%, which shows that rules targeting internal leverage have indirect effect on the overall indebtedness of affiliate firms (Blouin et al., 2013). Studies concerning the tax rates found out that an increase by 1% of corporate income tax in a host country of a controlled corporation held by a US multinational increases the leverage by 0.4% (Altshuler and Grubert, 2003).

The impact on capital structure from the introduction or tightening of TCRs has been demonstrated by numerous German authors including (Weichenrieder, 1996;

Overesch and Wamser, 2006; Buettner et al., 2008; Weichenrieder and Windischbauer, 2008; Wamser, 2008). At the aggregate level, firm leverage is fairly similar across the G7 countries, and factors identified by previous studies as being important in determining the cross section of capital structure in the US affect firm leverage in other countries as well. However, deeper examination of evidence for the US and other countries suggests that theoretical underpinnings of the observed correlations are still largely unresolved (Rajan and Zingales, 1995). The majority of studies come from Germany and the USA, while there are only a few, very basic papers on the rest of the world (Massbaum and Sureth, 2009; Kocer, 2009; Grantley, 2012; Martins, 2012).

**Problem statement and methodology.** While literature indicates that tax rules (TCRs) are effective at limiting internal borrowing, we are interested if this was the case for Slovenia as well. We decided to analyse the data for all 666 companies operating in Slovenia and having foreign ownership of no less than 25% in the capital of the taxable person (associated enterprises) focusing on the research question: "Is there a statistically significant difference in internal corporate debt in the measurement periods 2003–2004 and 2012–2013?"

The sample of enterprises was developed on the basis of the data obtained from AJPES (Eng. – Agency for Public Legal Records and Services), it has the following features from the statistical point of view:

- for each enterprise (unit), traceable data are available enabling reliable statistical tests for pairs of comparisons of changes over time;
- since the data are predominantly abnormally distributed (many enterprises have real zeros in variables), the use of non-parametric tests is a more suitable method for analysing the data;
- since after investigating the data we found, in addition to asymmetric distributions of numerical variables, a considerable share of extreme values, we decided to substitute some extreme values with missing values. In order to be able to extrapolate the findings from the sample to the population as a whole, it is important that the sample reflects the real situation as well as possible. When testing 666 enterprises in the original sample, we find that the extreme values in the case of internal and external debt correspond to leasing firms. These are specific enterprises that, although registered as companies, have more of banks' features;
- for the purposes of statistical processing of the data, we placed medium and large enterprises into a single group and dealt with them together, since they are similar from the point of view of their operations and financing. Division into the medium and large categories is done on the basis of the law (ZGD-1), which sets an artificial threshold (or criteria) for classification, although these two groups do not differ in terms of natural characteristics. Article 55 of the ZGD-1 classifies medium and large enterprises by means of specific criteria on the annual balance sheet date. The criteria for medium enterprise are met by an enterprise that satisfies two of the above criteria: the average number of workers in the financial year does not exceed 250, net sales revenues do not exceed 35 mln EUR, and the value of assets does not exceed 17.5 mln EUR. Large enterprises are those that exceed all three criteria.

To achieve our research objective, the data on long-term and short-term debt to foreign owner were analysed, comparing the category of indebtedness for the longer

period of time and using the average of two years for each period. The reason for two-year period of the observation derived from the realisation that this will ensure greater reliability and stability of measurement of individual variables, in that the figures will be more stable than if we took them merely for one year. The short-term response of thin capitalization rules generally tends to be smaller than the average or long-term response.

We measured internal debt using the category of long-term loans taken out with foreign entities that have direct investments in the reporting entity ( $X$ ) and short-term loans taken out with foreign entities that have direct investments in the reporting entity ( $Y$ ), obtained from the balance sheet. For the purpose of this analysis the obtained data were transformed into the newly created variables NZ0304 and NZ1213 of the average values:

$$NZ0304 = ((X + Y)_{2003} + (X + Y)_{2004}) / 2; \quad (1)$$

$$NZ1213 = ((X + Y)_{2012} + (X + Y)_{2013}) / 2. \quad (2)$$

We tested the statistical significance using the non-parametric test on two dependent samples – the Wilcoxon matched-pair signed rank test, due to the fact that the variables are not normally distributed. In SPSS 22.0 statistical package, this non-parametric test is frequently used in a similar manner to the paired-sample t-test. The Wilcoxon test is used to determine differences between the groups of data that appear in pairs and are non-normally distributed. In our case, this means that for enterprise Z we have data both for 2003/2004 and for 2012/2013, and that this connection or identification of the enterprise is clear (based on the enterprise registration number). The above test is used to determine the magnitude of differences between matched groups and to determine more than only the direction of difference.

**Key results.** The statistical significance of differences between these two variables was tested in order to analyse the differences over time. Important here is not only the difference in the overall average (for enterprises), but also the consistency of differences from enterprise to enterprise. In order to satisfy as far as possible the conditions of the analysis, it is important that the variables under analysis are normally distributed. Because these are typically economic variables, we cannot expect normal distribution, in that we have found that a large share (around 80%) of enterprises were not indebted to associated enterprises at all. In these cases, the value of internal debt was zero in real terms, while the other variables are distributed in such way that the frequency of each individual value is 1. Table 1 presents the descriptive statistics for the two variables. We took the preliminary step of removing the highest extreme values that could have had an excessive influence on the analysis. To each extreme value exceeding 10000000 we assigned the missing value -999999, which is automatically removed in SPSS.

Distribution of the variables is not normal. This is indicated by asymmetry (skewness) and peakedness values (kurtosis) that exceed -2, 2. Abnormal distribution is also indicated by two measures of central tendency – median and mode – both of which are 0. If distributions were perfectly normal, all the measurements (mean, median and mode) would be approximately equal. The most frequent value is 0, for which reason median and mode are less useful than mean as the measure of central tendency.

Table 1. Descriptive statistics for the internal debt variables, author's

		NZ0304	NZ01213
#o of companies:	Valid	638	646
	Missing	28	20
Mean		197119.5887	306025.53
Median		.0000	.0000
Mode		.00	.00
Standard deviation		894253.45024	1116820.679
Variance		799689233268.052	1247288429880.440
Skewness		6.077	5.162
Std. error of skewness		.097	.096
Kurtosis		40.678	30.807
Std. error of kurtosis		.193	.192
Minimum		.00	.00
Maximum		8275179.44	9872000
Quantity		125762297.61	197692489.50

Our null hypothesis assumed there are no differences in internal debt between the two periods (2003/04 and 2012/13). In so far as statistical significance is lower than 0.05, we can reject the null hypothesis. Figure 1 shows that the difference between 2003/2004 and 20012/13 is statistically significant and that the hypothesis of the differences existence in internal debt of enterprises can be confirmed. We can state that changes in tax legislation in 2005 effected the level of internal debt of Slovenian enterprises in which the share of more than 25% is held by the companies established in the EU.

### Hypothesis Test Summary

	Null Hypothesis	Test	Sig.	Decision
1	The median of differences between NZ0304 and NZ1213 equals 0.	Related-Samples Wilcoxon Signed Rank Test	.000	Reject the null hypothesis.

Asymptotic significances are displayed. The significance level is .05.

Figure 1. Test of statistical significance, author's

But we have not got the answer on the question whether the actual change was in the form of a reduction or an increase of internal debt, while the research question assumed a reduction of internal debt. As seen from Figure 2, the internal debt of Slovenian companies has increased in the period 2012/13 as compared to 2003/04.

We were interested to specify Slovenian FDI (observed units) in two groups: small vs. medium and large ones. After carrying out the test of statistical significance, we found that both in the case of small enterprises and in that of medium and large enterprises, there was an increase in internal debt, where the gap in the case of medium and large enterprises is greater than in the case of small enterprises.

The analysis of the change in the average level of debt of FDIs in Slovenia in which foreign entities have 25% or more, leads us to finding that the average internal

debt has grown in the period since the tax reform, although it is evident from Figure 2 that the growth in average internal debt is greater in the group of enterprises corresponding to the criteria for medium and large enterprises. The test of statistical significance showed that the difference in internal debt between 2003/2004 and 2012/2013 is statistically significant for small enterprises (Figure 4).

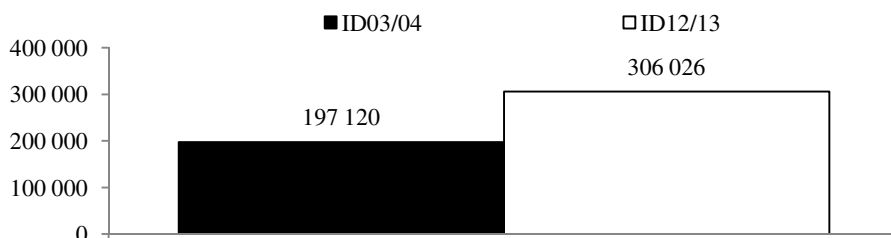


Figure 2. Average internal debt 2003/04 vs. 2012/13, author's

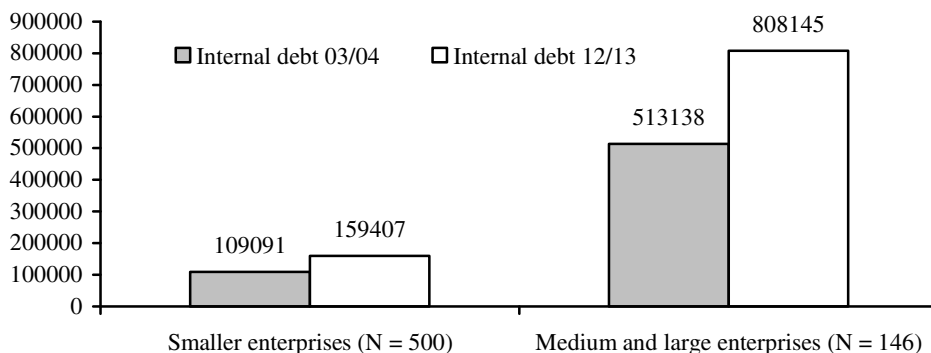


Figure 3. Average internal debt of enterprises in the sample by years (2003/2004 and 2012/2013) and by the criterion of enterprise size, author's

### Hypothesis Test Summary

	Null Hypothesis	Test	Sig.	Decision
1	The median of differences between NZ0304 and NZ1213 equals 0.	Related-Samples Wilcoxon Signed Rank Test	.006	Reject the null hypothesis.

Asymptotic significances are displayed. The significance level is .05.

Figure 4. Test of statistical significance, author's

The test of statistical significance in the sample of medium and large enterprises also showed that the difference in internal debt between 2003/2004 and 2012/2013 is statistically significant (Figure 5), which means that in the case of the majority of enterprises in this group (medium and large) there was significant increase or reduction with regard to the average.

## Hypothesis Test Summary

	Null Hypothesis	Test	Sig.	Decision
1	The median of differences between NZ0304 and NZ1213 equals 0.	Related-Samples Wilcoxon Signed Rank Test	.017	Reject the null hypothesis.

Asymptotic significances are displayed. The significance level is .05.

Figure 5. Test of statistical significance, author's

As can be seen from Figure 5, there is an increase in internal debt both among small enterprises and among medium and large enterprises. The research question is only partially confirmed, because although a change occurred there was no reduction of internal debt, which however could be the result of several factors not considered in the analysis. In Figure 6, the x axis shows internal debt for the period before the introduction of the Act, that is words 2003/2004, while the y axis shows the internal debt values for 2012/13. For small enterprises there is a positive increase – the higher the debt level is in 2013/04, the higher is also the debt in 2012/13. This positive impact is shown by the diagonal line, which represents a regression line and explains up to 12% of the variance of internal debt in 2012/2013. We can say, in other words, that 12% of the internal debt value in 2012/2013 is explained merely by the level of internal debt in 2003/2004, and that this has increased because the slope of the line is positive, on the assumption that no other influence is considered. For medium and large enterprises the regression line is less steep and explains just 0.9% of the variance in internal debt.

To put our research in a wider context, we have studied the comparable from the Bank of Slovenia reports which use the internationally accepted criterion of direct investment (10% of equity). This 10% limit of equity separates investments with long-term interest from those with short-term one. Net liabilities (liabilities minus claims) represent foreign investors' other capital in Slovenian affiliates, and mostly comprise loans, trade credits and deposits. The time series of the ratio of net liabilities to the total FDI has shown an increase in net liabilities since 2007. In 2007 net liabilities to foreign investors accounted for 30.6% of the total FDI and has increased by 2.4 bln EUR. This increase was partly the result of a change in the collection of data on capital links in debt instruments, and partly the result of significantly higher borrowings in 2007 as compared with the previous years. In 2008 the net liabilities to foreign owners accounted for 33.2% of the total FDI, while in 2009 net liabilities fell to the level similar to that recorded at the end of 2007. In 2011 there was an increase of 786.7 mln EUR in foreign owners' debt financing, while the increase in 2012 was just 16.4 mln EUR (Bank of Slovenia, 2012).

**Conclusions.** The main objective of our study was to test the internal indebtedness of Slovenian FDI in 2003/04 and in 2012/13. Unlike generally accepted limit of 10% of equity, our analysis included EUR data for companies which are 25% or more owned by foreign entities. This limit was adjusted to the tax rule implemented in 2005, which is obligatory for the entities with no less than 25% of the shares or hold-



ings in the capital or voting rights of the taxable person. Nevertheless, contrary to the expectations, internal indebtedness of Slovenian FDI has not decreased. On the contrary, internal indebtedness has increased, with small differences according to EUR criterion of enterprise size.

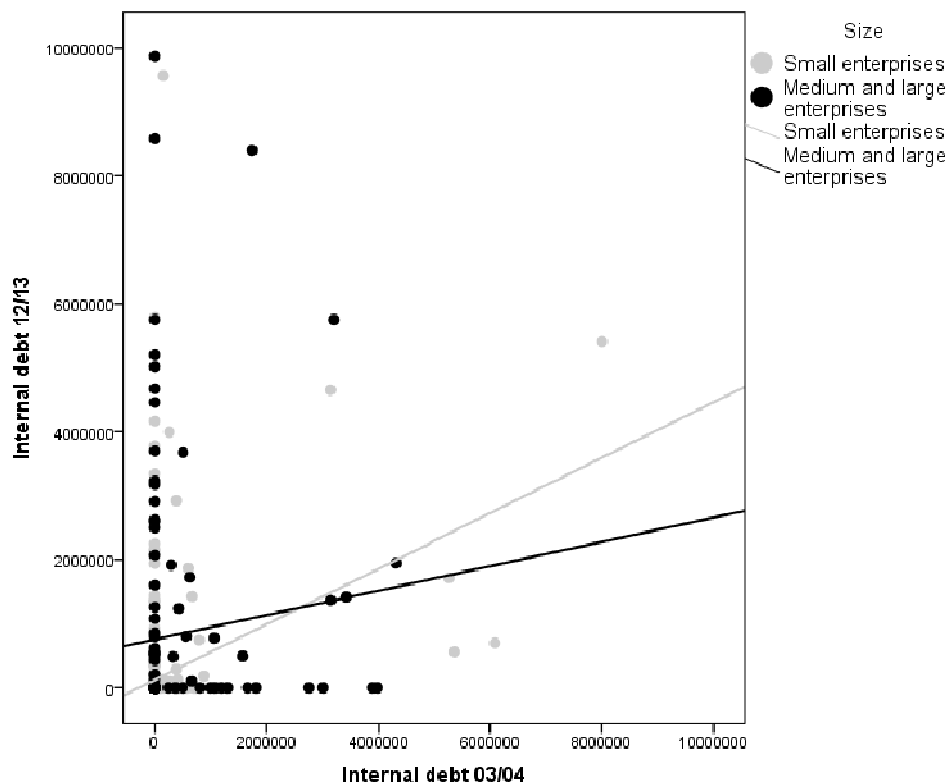


Figure 6. Internal debt of enterprises before and after the tax reform, author's

A considerable amount of research focusing on the influence of TCRs on corporate financial decisions has been carried out, particularly in Germany, although the question of whether tax revenues simultaneously grow remains unanswered. For Slovenia it appears, both on the basis of our research and on the basis of Bank of Slovenia data, that the structure of FDI is the exact opposite of that in other EU member states (particularly old member states). Between 1994 and 2006 the structure of FDI in Slovenia was only approximately 20% debt, while in the same period debt financing of FDI in Germany was more than 60%.

**Directions for further investigations.** It is assumed that the legislator opted to fix the equity-to-debt ratio on the basis of empirical data, for which reason we have also analysed the latter. As the proposer of this form of regulation, the Ministry of Finance of the Republic of Slovenia considered that the tax basis and the rights of taxpayers are sufficiently protected by the proposed regulation and at the same time predicted that the proposed system would also be suitable from the point of view of tax administration. In this manner, it would be very interesting to analyse the procedural

model for changes of tax rules and assessment of their impact on a wide range of socioeconomic aspects.

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