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Anti-abuse tax measures

– Re-regulation of the markets or steps necessary to protect the revenue base?

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BY KRISTER ANDERSSON

Foreword

After having liberalised markets during the last decades, governments have increasingly experienced difficulties in applying their tax systems to domestic and international transactions in a consistent, non-discriminatory way. In particular, Member States of the European Union, but other states as well, have become aware of distortive and discriminatory features of their tax systems. Rectifying these distortions, however, has in the short term often resulted in a potential revenue loss. An outright re-regulation of markets by imposing restrictions on the free movement of capital and establishment of business has fortunately generally been seen as too damaging to the economies. Instead, tax changes have been contemplated and have in one way or another been imposed in almost all countries. The purpose of these tax changes has, however, in most cases been to solve the same perceived problem. The tax changes have normally been defended as justified means of "protecting the revenue base" but their effect has sometimes been more far-reaching for individuals and businesses. The anti-abuse rules have often limited the free flow of labour and capital, *reducing* the overall economic efficiency of the world economy.

Since the anti-abuse laws tend to affect the functioning of the internal market and its freedoms, the European Commission has firmly expressed its view on the design of such laws. On December 10, 2007 the Commission published *The application of anti-abuse measures in the area of direct taxation* (COM (2007) 785). In this communication the Commission states that there is an urgent need to strike a proper balance between the public interest of combating abuse and the need to avoid disproportionate restrictions on cross-border activity within the EU. The Commission further states that to be lawful national tax rules must be proportionate and serve the specific purpose of preventing *wholly artificial arrangements*. It also states that the objective of minimising one's tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits. Member States can not hinder its taxpayers' exercise of their rights of freedom of movement under the Treaty simply because of lower levels of taxation in another Member State.

It comes as no surprise that some Member States find these limitations on the scope of anti-abuse measures too restrictive. However, it should be in the interest of governments to take regard to the views expressed by the Commission, not only to improve the functioning of the internal market, but also because it is good tax policy not to let anti-abuse rules interfere with ordinary business activities. It may actually be in the Member States' own interest to implement anti-abuse rules in a very restrictive way in order not to jeopardize their tax revenues.

This publication uses as an example of anti-abuse measures the recently adopted legislative measures in Sweden, limiting the deductibility of interest payments in the corporate sector. The difference in tax treatment between debt and equity financing, with double taxation of equity financed investments and single taxation of debt financed investments, has encouraged corporate entities to increase their leverage. A number of governments have responded by introducing various measures, like thin capitalisation rules and dividend stripping rules. These measures, however, have not only affected highly leveraged companies but have also often increased the cost of investments for companies with normal financing structures. Frequently governments defend these measures as protecting the revenue base. Yet they often seem to be reducing revenues rather than protecting or increasing them.

On December 10, 2008, the Swedish parliament adopted as an anti abuse measure an amendment to the Income Tax Act, aimed at preventing tax planning through artificial intercompany interest payments. The debate preceding this legislation focused on its impact on the national tax base and the ordinary business activities of companies. There was also a discussion of whether the legislation was in conflict with theEU-law. It is no exaggeration to state that the Swedish debate well illustrates that imposing anti-abuse legislation is a complex task involving great responsibility.

This publication contains three articles illustrating the issues that were debated in connection with the introduction of the legislation. The first article, by Richard Hellenius, provides a general overview of the new Swedish anti-abuse legislation. It also highlights some unclear points that have been raised with regard to the substance and applicability of the provisions. The second article, by Krister Andersson, illustrates that tax legislation, if not carefully prepared, easily may have counterproductive effects and may actually reduce revenues. Governments should therefore watch out for potential effects on other tax bases when anti-abuse rules are contemplated. There is an obvious risk that so-called revenue protecting measures are just an attempt to re-regulate investment and financial markets, with adverse effects on overall tax revenues. To protect not only the revenue base but also the legitimacy of the tax system, governments will however have to act against wholly artificial arrangements but anti-abuse laws with this purpose must be well targeted. The last article, by Roger Persson Österman, analyses whether the newamendment is in conformity with EU law. The author concludes that it does not comply with Community law.

We hope that this publication, even though dealing with just one part of Swedish anti-abuse law, may be of interest to those involved in tax legislation procedures in Member States, and in other countries as well.

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Stockholm, June 15, 2009

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The new Swedish limitations on interest deductions*

INTRODUCTION

The main principle for interest expenses in the business income category is that they should be deducted, even if they do not constitute an expense to earn and retain income (Ch 16 sec.1 Swedish Income Tax Act, hereinafter "ITA"). However, there are a number of rules that provide exemptions to this principle, such as the rules that limit deductions for debenture interest (Ch 24 sec.5 ITA). Another exemption has been created through new legislation.

On 10 December 2008, the *Riksdag* (parliament) passed the Government proposition (bill) (2008/09:65) to introduce provisions limiting opportunities for companies to deduct interest on intercompany loans taken to acquire equity instruments issued by associated enterprises. The new provisions have been inserted into Ch 24 secs. 10 a – 10 e ITA. The rules took effect on 1 January 2009 and apply to interest expenses that accrue after 31 December 2008 (Swedish Statute 2008:1343).

The new provisions are based on the Swedish Tax Agency's memorandum *"Proposal for Limitations on the Deductibility of Interest, etc., on Certain Debts."* The proposal came about following audits by the Tax Agency, in which it had identified certain intercompany transactions which in its judgement had been carried out exclusively or virtually exclusively to obtain interest deductions in connection with Swedish taxation, and from a principle important case, the *Industrivärden case.* One for principle important case was *Industrivärden.* On 6 November 2007 The Supreme Administrative Court announced its decision in this case (RÅ 2007 ref. 85). The court granted the contested deductions for the interest cost in question. The Court concluded that the deductions could not be denied based on the Tax Avoidance Act. The outcome of this case triggered the proposal.

The Ministry of Finance circulated the Tax Agency's memorandum for comment. The Tax Agency's proposal was sharply criticised by most referral bodies, primarily because the proposed rules would also have significant impact on normal business operations. In response to the criticism, the Ministry of Finance drafted a new bill, which was explained in its memorandum *"Limitations on Interest Deductions to Prevent Certain Cases of Tax Planning among Associated Enterprises,"* which was also circulated for comment. [2]The Ministry of Finance stated that the aim of the bill was to eliminate tax planning by means of artificial intercompany interest deductions. The bill (2008/09:65) largely coincides with the proposal outlined in the Ministry of Finance memorandum. The review by the Riksdag Tax Committee did not give rise to any changes.[3]

The main provision in the new legislation can be concisely stated as that companies are not allowed to deduct interest expenses connected to a debt to an associated enterprise, to the extent the debt refers to acquisition of an equity instrument in an associated enterprise. Other provisions are aimed mainly at preventing avoidance in connection with external loans and exempting interest expense affected by the main rule, even though the underlying debts are not related to the schemes the legislation is designed to prevent.

This paper provides a general overview of the new legislation and certain unclear points

* This chapter is a translation of: Richard Hellenius "De nya ränteavdrags begränsningarna", Svensk Skattetidning, 2009 2:161-172, Norstedts Juridik.

that have been noted by referral bodies with regard to the substance and applicability of the provisions, followed by concluding remarks.

DEFINITIONS OF ASSOCIATED ENTERPRISE AND COMPANY

Except in situations involving back-to-back loans (see below), the new legislation is confined to intercompany transactions among associated enterprises and thus the definitions of associated enterprises and companies are of central importance.

Section 10 a first paragraph defines associated enterprises. The provision reads:

Upon application of secs. 10 b – 10 e, companies shall be regarded as ***associated enterprises*** *if*

1. *one of the companies, directly or indirectly, through an equity instrument or otherwise has controlling influence over the other company, or*
2. *the companies are mainly under joint management.*

During the consultative process, referral bodies argued that using such vague wording as *"are mainly under joint management"* would be highly unfortunate. The Government is of the opinion that a more precise wording could lead to avoidance and that the wording should not cause any significant problems in most cases, since it has been used in Swedish tax law for a long time. [4] The Government finds that the wording chosen must be regarded as carefully considered. With regard to the substance of the wording, the Government refers inter alia to the drafting history of ITA and notes the emphasis therein that the critical factor is the actual influence and not the formal relationships.[5]

Section 10 a second paragraph stipulates that *"'companies' in the first paragraph and in secs. 10 b – 10 e means legal entities and Swedish partnerships."* It follows that not only limited liability companies, non-profit associations, and trading partnerships constitute companies in connection with the application of the limitation rules, but also municipalities, the state and other legal entities. Under the provisions of Ch 2 sec.2 ITA and Ch 5 sec. 2 ITA, equivalent foreign companies and European economic interest groupings also constitute companies in connection with the application of the new legislation.

THE MAIN PROVISION

The rules referred to as the 'main rules' in the new legislation are found in secs. 10 b and 10 c ITA. What must be considered as the main provision is found in sec. 10 b first paragraph. The other main rule is aimed at preventing avoidance of the main provision. The main provision is explained in this section and the provision on avoidance is explained in the next section.

The main provision states the following: *"A company that is part of a group of associated enterprises may not […] deduct interest expenses connected with a debt to an associated enterprise, to the extent the debt refers to the acquisition of an equity instrument from an associated enterprise."*

The text does not clearly explain what is required for a debt to “refer” to the acquisition of an equity instrument, nor does the preparatory works of the law provide any direct guidance. In the bill, the Government only states that it should be clear in most cases whether or not a debt refers to acquisition of an equity instrument and that in questionable cases, the matter must be determined in an overall assessment. [6] The provision on temporary loans (see below) may provide some guidance.

Ch 48 sec. 2 first paragraph ITA explains what constitutes an equity instrument. The law states that ‘equity instrument’ refers to shares, rights conveyed upon subscription of shares, warrants, bonus rights, units/shares in investment funds, shares in an economic association, and other assets with comparable structure or effect. Ch 48 sec. 2 second paragraph ITA states that the provisions on equity instruments shall also be applied to participating debentures and equity certificates referring to loans in Swedish kronor (SEK), convertibles in SEK, redemption rights, and tradable put options referring to shares, forwards, and options whose underlying assets consist of shares, or forwards and options that refer to a stock index, and other assets with comparable structure or effect. Finally, the third paragraph states that shares in a private housing company are not considered equity instruments. The wording does not make it clear that debentures and the other items listed in the second paragraph must be included under the definition of equity instruments when the new limitation rules are applied, but the comments in the bill clearly express this intention.[7]

The bill states that the reason why debts connected with the acquisition of equity instruments must be included is that in all cases identified by the Tax Agency, the class of asset used to create the intercompany debt relationship consisted of shares in companies and that the sellers in these cases were not taxed on the gains. [8] The Tax Agency’s proposal did not confine itself to debts attributable to acquisitions of equity instruments, but was considerably broader. It also covered debts related to acquisitions of receivables, debts which meant that the company could issue dividends and debt by which a capital contribution could be provided to an associated enterprise to the extent that the contribution was used, directly or indirectly, to acquire an equity instrument or receivable, or for lending to an associated enterprise. The Tax Agency based the inclusion of such debts on its predictions of alternative tax planning practices. In their critical remarks, most referral bodies argued that the Tax Agency’s proposal would have serious consequences on normal business operations. In its memorandum, the Ministry of Finance deemed that it should be possible to reject the schemes on which these aspects of the Tax Agency’s proposal were based through the application of general rules and, if that were not possible, based on the Tax Avoidance Act.[9] If there were no tax planning involved, the new tax rules would not impede sound business operations. The overall assessment of the Ministry of Finance was that it was not necessary for the rules to cover debts related to the acquisition of receivables, which meant that the company could issue dividends or debt that entailed a capital contribution. The Government concurred.[10]

TEMPORARY EXTERNAL LOANS AND BACK-TO-BACK LOANS

The main provision has been supplemented with special rules aimed at preventing certain kinds of tax avoidance in which external lenders have been included. The provisions cover certain situations involving back-to-back loans, as well as certain situations in which external loans have been replaced by intercompany loans. The bill states as the reason for the rules that companies would otherwise be able to circumvent the rules on deductibility limitations either by having an external lender acting as an intermediary between the lending company and the borrowing company that are associated enterprises, or by first raising a temporary loan from an external bank in connection with the acquisition of an associated enterprise that is later replaced by an intercompany loan.[11] One reason why the Government judged that special rules against such avoidance were needed was, its belief that there is manifest risk in these external situations that prevention would be impossible through application of general rules and the Tax Avoidance Act.[12]

The rule against avoidance through use of temporary debt is found in sec. 10 b second paragraph and the wording is as follows: *"If a temporary debt to a company that is not an associated enterprise is replaced by a debt to a company that is an associated enterprise, the first paragraph [i.e., the main provision] shall be applied to the latter debt if the provision would have been applicable to the former debt if the company had been an associated enterprise."*

This provision largely coincides with the proposal presented in the Ministry of Finance memorandum. In the consultative process on that memorandum, it was argued that the term *"temporary debt"* is vague and should be defined to make it clear when an external loan may be replaced by an intercompany loan. In the bill, the Government states that it believes the term *"temporary debt"* should not normally lead to any problems on application. [13] The Government also states that it believes it would be inappropriate to specify in the actual provision how much time must have elapsed for the external debt to no longer be considered temporary, since this could open the doors to certain evasive practices. The comments in the bill make it clear that the provision is not intended only to apply to cases in which the entire external debt is replaced by an intercompany debt, but also to cases in which only part of the debt is replaced.[14]

The rule against avoidance through the use of back-to-back loans found in sec. 10 c, states that the main provision is also *"applied [...] to a debt to a company that is not an associated enterprise to the extent that a company that is an associated enterprise has a claim on the former company; or on a company that is associated with the former company, as long as the debt can be presumed connected to this claim and refers to the acquisition of an equity instrument from an associated enterprise."*

The opinion in the bill may provide some guidance concerning the substance of the part of the provision that reads *"as long as the debt can be presumed connected with this claim."* In the proposal submitted for comment to the Council on Legislation, the wording in this part was *"as long as the debt can be regarded as attributable to this claim."* With reference to the opinion of the Council on Legislation, the Government states in the bill that the phrase *"attributable to"* should be replaced with *"connected with"* since this would more clearly express the intended target of the rule. [15] The Government further states that the aim is not to require a direct connection between borrowing and lending, but that it should be apparent from the circumstances in the individual case that there is some kind of connection between the debt and the claim.

EXEMPTIONS

In light of the aim of the rules and the explicit goal that sound business operations should not, as far as possible, be impeded, two exemptions have been incorporated: the 'ten percent rule' and the 'escape clause.' The exemptions are found in sec. 10 d.

The ten percent rule

According to the 'ten percent rule' found in sec. 10 d first paragraph item 1, interest expenses should be deducted if *"the [i]ncome that corresponds to the interest expense would have been taxable at a rate of at least ten percent according to the law in the state where the beneficial owner is domiciled, if the interest were the company's only income."*

The final wording of the provision was not found until the bill stage, but it agrees in large part with the Ministry of Finance proposal. The Ministry of Finance memorandum stated that the proposed exemption would be relatively easy for both companies and the Tax Agency to apply. Several referral bodies stated that they did not agree. However, the Government found that the ten percent rule would in most cases not be unnecessarily complicated to apply in practice.[16]

The bill states that the level of taxation shall be determined by means of a hypothetical test. The comments in the bill state *inter alia* that this means that when assessing whether the criteria for minimum ten percent taxation are met, only the income corresponding to the relevant interest expense should be taken into account, and that surpluses or deficits arising from normal operations or normally deductible expenses in the beneficial owner should thus not be taken into account. [17] It is thereafter stated that the conditions for applying the rule shall not be considered as met if, for instance, the interest income can be neutralised through a basic allowance, tax-exempt amount, or similar deduction. Further more, it is stated that the deductibility of interest is generally not dependent on whether the recipient was taxed for the interest or when the recipient reports the corresponding amount for taxation, and that in cases where the interest has not been received, a hypothetical assessment must be made of whether the amount would have been taxed at a minimum rate of ten percent if it had been received. However, it is clear that it should not be possible to postpone taxation indefinitely. It is also stated that how the tax on the interest received is designed should not determine the matter, which is explained to mean, for instance, that standard assessments may be covered by the exemption, provided the income is taxed at a minimum rate of ten percent.

With regard to the substance of the term 'beneficial owner,' the comments in the bill state that the intention of the term is that the recipient must receive the income corresponding to the interest expense for its own use, and that in other words, it is not sufficient to have just a formal right to the income; the company must be the actual and rightful owner that enjoys the economic benefits.[18]

A special restriction applies if the associated enterprise that is the beneficial owner of the interest may deduct dividends. The following is stated in sec.10 d second paragraph: *"If the associated enterprise that is the beneficial owner may deduct dividends, the first paragraph item 1* [the ten percent rule] *may not be applied if the Tax Agency can show that both the acquisition and the debt underlying the interest expense were not entered into predominantly for commercial reasons."* The ten percent rule proposed in the Ministry of Finance proposal did not cover interest expenses to enterprises able to claim a deduction for dividends. The reason given for this limitation was that *"there is risk that the interest income in these specific cases will remain untaxed if it is redistributed" (see Supreme Administrative Court RÅ 2007 ref. 85)."* [19] This limitation was sharply criticised in the consultative process. Based on the opinions of the referral bodies, the Government found it reasonable to allow companies that may deduct dividends to apply the ten percent rule. However, in light of the unique tax situation of companies that may deduct dividends, the Government found that a possibility should be introduced to deny the deduction for the interest expense in certain cases. This is the underlying reason behind the provision in sec.10 d second paragraph. Regarding the level stated in the text, i.e., *"predominantly"* (for commercial reasons), the Government states that it settled on this wording in part because the Tax Agency does not have an inside view into a company's operations. [20] In this context, "predominantly" means more than fifty percent. If the Tax Agency can show that the transactions were not predominantly for commercial reasons, the consequence will be that a deduction for the interest expense cannot be claimed, neither based on the ten percent rule, nor on the exemption in the 'escape clause.'

In situations where the deduction is limited under the back-to-back rule, there is a corresponding exemption. Section 10 e stipulates that *"[i]nterest expenses referring to such debts as specified in sec. 10 c should be deducted if a company that has such a claim as specified in sec.10 c is taxed for the income connected to this claim in accordance with what is stipulated in sec.10 d, first paragraph 1."* In these cases, the hypothetical test should thus refer to the associated enterprise that has a claim on the external lender.

The escape clause

As mentioned, the ten percent rule has been supplemented with an 'escape clause,' included in sec. 10 d first paragraph item 2. Under this provision, interest expenses should be deducted if *"[b]oth the acquisition and the debt on which the interest expenses are based are motivated mainly by commercial reasons."* There is a corresponding exemption for situations such as back-to-back loans. Section 10 e stipulates that *"[i]nterest expense referring to such debts* *specified in sec. 10 c should be deducted if both the acquisition and the debt on which the interest expense is based are motivated mainly by commercial reasons."*

Interest expenses may thus be deducted, regardless of how the corresponding income is taxed, if both the acquisition and the debt on which the interest expense is based are motivated mainly by commercial reasons. In the ITA, "mainly" means at least 75 percent. [21] The comments in the bill state that the quantified wording has been inserted for two reasons: first, because it must be clear that the exemption should be applied only if the commercial reasons are clearly superior to other reasons for the transactions and, second, to emphasise that the exemption may be applied even if the reasons are not solely commercial. [22] The provision mainly coincides with the proposal in the Ministry of Finance memorandum. Many referral bodies were highly critical of the Ministry's proposal. Most expressed the opinion that the difficulties involved in proving and managing the commercial basis for the transactions as proposed would become disproportionately onerous, and that in addition to the tax level, the practical problems that would ensue from a significant burden of proof must be considered. It was also argued that the requirement that intercompany transactions must be based on commercial reasons to a minimum extent of 75 percent is disproportionately high in relation to that which applies under the Tax Avoidance Act. With regard to opportunities to apply the provisions as intended, it was argued that in many cases the events to be assessed may lie far in the past and that the "mainly" requirement could lead to significant problems. Doubts were also expressed as to whether it is de facto possible to evaluate the degree of the various reasons. The opinions from referral bodies did not give rise to any changes.

In their consultative remarks on the Ministry of Finance proposal, most referral bodies stated the opinion that the proposed rules were incompatible with EC law and that the restrictions could be accepted only if they served the purpose of preventing schemes based on creating purely artificial arrangements with no economic basis and whose sole purpose is tax avoidance. These referral bodies cited, for instance, that the ECJ has confirmed that measures to prevent over-indebtedness must be restricted to purely artificial arrangements, in a case on thin capitalisation rules (case C-524/04, 13 March 2007, *Test Claimants in the Thin Cap Group Litigation).* It was argued in the consultative remarks that this could be achieved if the word "mainly" in the proposed bill was eliminated. In the bill, the Government argues that the ECJ has established that intercompany transactions between associated enterprises must not be tested according to the rules on free movement of capital, but only according to the rules on freedom of establishment. [23] In the Government's opinion, the proposed provisions will not conflict with the EC Treaty rules on freedom of establishment. The Government states that this is not a matter of applying different rules in comparable situations or applying the same rule in different situations, and that the rules limiting interest deductions are the same, regardless of whether the lending company is domiciled in Sweden or another Member State. The opinions of the referral bodies thus did not give rise to any changes.

CONCLUDING REMARKS

A review of the wording of the law and the preparatory works shows significant lack of clarity with regard to the substance of the rules and that uncertainty must be acknowledged with respect to the compatibility of these deductibility limitations with EC law. The impact of the new legislation on opportunities to reject transactions under the Tax Avoidance Act is another question.

The lack of clarity about the substance of the new rules on limitations on deductibility can be expected to lead to a number of applications for preliminary rulings. However, current restrictions on opportunities to obtain preliminary rulings in cases where the procedure would require the court to take a position on evidentiary matters may be expected in many cases to prevent taxpayers from obtaining preliminary rulings. As a result, companies that want to carry out internal restructurings for commercial reasons other than reducing taxes may come to the erroneous conclusion that they must refrain from doing so. In that light, it would have been highly preferable if the substance of the new rules had been clearer. This applies in particular to the ten percent rule. It can be mentioned here that the preparatory works on this provision are so ambiguous that after the bill had been submitted to the Riksdag, they led to a discussion of the circumstance that if the beneficial owner of the income is able to provide a group contribution, it may make the ten percent rule inapplicable. However, in my opinion, both the wording of the provision and the preparatory works indicate that the ability to provide a group contribution should not affect the applicability of the provision.

The connections that a person trying to apply this law needs to establish in order to test whether a company's debt refers to acquisition of an equity instrument, whether an external debt was temporary, or whether a company's debt to an external company is connected to a claim that an associated enterprise has on a company associated with the external company will, in my opinion, in many cases be a very onerous task, and in some cases an impossible one. The fact that the provisions do not differentiate between interest expenses related to loan agreements made before and those made after the new provisions were enacted accentuates this. Because significant aspects of the substance of the ten percent rule thus far remain vague, there will be a great need for clarifications until guiding case law comes about, which, among else, may create serious problems for affected companies.

The consultative remarks and Government opinions make it very clear that there is disagreement about the compatibility of the limitations on deductibility with the freedom of establishment under EC law. Moreover, there has been a discussion along the legislative process as to whether the limitations on deductibility may also conflict with the 2003 Interest and Royalties Directive. With respect to the Government's analysis of the compatibility of the provisions with the freedom of establishment, it must be noted that the Government's account of applicable law does not include an analysis of *Lankhorst-Hohorst* (C324/00), in which a German rule on thin capitalisation was tried. The German rule was not directly aimed at foreign enterprises, but the ECJ nevertheless found that it presented a barrier to freedom of establishment. We can now only wait for a trial that settles if the Swedish legislation is in conformity with Community law or not.

There should be no objections to the Ministry of Finance's ambition to achieve legislation that does not impede sound business operations. However, the Ministry's opinion that it should be possible to reject schemes or practices of the type presumed by the legislature, but omitted from the legislation in question, through application of the Tax Avoidance Act, is debatable. In this matter as well, we must wait for trial.

The bill states that there is reason to follow up the legislation in various respects to evaluate whether the chosen solution prevents tax planning. [24] Whether new methods are used to circumvent the legislation now that the identified type of tax planning has been prevented, as well as how opportunities to apply the Tax Avoidance Act have been improved through the new legislation were issues specifically mentioned. The bill also states that if it should prove that tax planning in connection with e.g. external acquisitions or external loans also constituted a threat to the Swedish business tax base, the Government intends to follow up with legislative changes to counteract the problem.

On 19 December 2008, the Government issued the appropriation directions for the Tax Agency for the 2009 budget year. [25] In the appropriation directions, the Government instructs the Tax Agency to produce a broader survey of the prevalence of interest deductions and evaluate the need for further deductibility limitations, a task that must be completed already in 2009. The mandate includes surveying the prevalence of interest deductions both retrospectively and prospectively and analysing whether there is a need to amend, supplement, or expand the new rules or introduce other forms of limitations on interest deductions.

If a need to implement significant changes is deemed to exist after these evaluations, I hope that representatives of private enterprise will be included in the inquiry process. I believe the lessons learnt from the legislative process that preceded the current limitation rules show that all parties have a great deal to gain by ensuring that from the outset in the inquiry phase the issues are examined from all sides.

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ENDNOTES

[1] Swedish Tax Agency reference no. 131 348803-08/113
[2] Swedish Ministry of Finance reference no. Fi2008/4093
[3] Riksdag Tax Committee 2008/09:SkU19
[4] Swedish Government bill 2008/09:65 p. 48.
[5] Ibid.
[6] Bill cit. p. 50
[7] Bill cit. p. 83.
[8] Bill cit. p. 49.
[9] Swedish Ministry of Finance reference no. Fi2008/4093 pp. 30-31.
[10] Bill cit. p. 54.
[11] Bill cit.p. 54 f.
[12] Bill cit.p. 55.
[13] Bill cit.p. 56.
[14] Bill cit.p. 84.
[15] Bill cit. p. 55.
[16] Bill cit. p. 58.
[17] Bill cit.p. 85
[18] Bill cit.p. 86.
[19] Ministry of Finance reference no. Fi2008/4093 p. 36.
[20] Bill cit. p. 65.
[21] Swedish Government bill 1999/2000:2, part 1 p. 502 f.
[22] Swedish Government bill 2008/09:65 p.87.
[23] Bill cit. p. 71.
[24] Bill cit. p.74 f.
[25] Swedish Ministry of Finance reference no. FI2008/7329

BY KRISTER ANDERSSON

Artificial interest deductions, swings and roundabouts[*]

INTRODUCTION

What should legislators do if companies or individual taxpayers incur purely artificial expenses to reduce tax? This is not a new question, but in recent years, parliaments in various countries have taken entirely different approaches. When individual taxpayers in the Netherlands used the "interest box" combined with the full deduction allowable on debt interest (up to a ceiling) to offset the marginal tax rate on earned income, the Dutch parliament lowered the tax on earned income. Many countries have elected to reduce incentives to make artificial interest deductions by sharply cutting corporate tax rates. Other countries have chosen to try regulating the markets by implementing more or less arbitrary rules on when interest payments may or may not be deducted.

Most pundits agree that purely artificial arrangements should be impeded or even prevented through legislation. The focus has often been on transactions with companies domiciled in tax havens where the tax rate on interest received is low or non-existent. However, the tax revenue loss in the individual state is the same if debt interest is deducted and taxation occurs in a country where the tax rate is comparable or even higher. When selective measures are implemented, the baby is at great risk of being thrown out with the bath water. In this respect, the matter of limitations on interest deductibility resembles the issue of drafting and applying transfer pricing rules or CFC rules. The risk is that lofty ambitions to preserve the national tax base will result in lower rather than higher tax revenues, as intended.

As far as I know, few assessments and little analysis have been done of the magnitude of tax avoidance by means of interest deductions through purely artificial arrangements and of the effects tax avoidance legislation may have on the national tax base. The absence of limitations on the deductibility of interest may be an inherent incentive that attracts foreign direct investments and thus increases the tax base. There is evident risk that the wrong measures may lead to a country losing more on the swings than it gains on the roundabouts, even though a complete lack of legislation may seem abhorrent.

The aim of this paper is to shed light on a few of the difficult deliberations that must be made to assess the extent to which limitations and regulations can be introduced to uphold the legitimacy of the tax system without jeopardising the tax base in the process. The case of Sweden is used as an example. Sweden abandoned after many decades the unlimited deduction of interest payments in the corporate sector. The change came about in a peculiar way and it deserves to be examined. The conclusions are however not country specific but general in nature.

BACKGROUND

The principle of full deductibility for interest expenses has been guarded in Sweden consistently for the century modern income tax has applied. As far as possible, various types of debt have been treated the same way, and the principle of taxing the net income has governed the taxation of both individuals and companies. However, a strategic decision was taken, departing from earlier principles, through a vote in the Riksdag on 10 December 2008 (thus passing

[*] This chapter is based on an article by Krister Andersson "Räntesnurror, gungor och karuseller", Svensk Skattetidning, 2009 3:289-303, Norstedts Juridik.

Government Bill 2008/09:65 on the introduction of provisions to limit corporate interest deductions related to intercompany loans to acquire equity instruments from an associated enterprise). The new provisions have been inserted into Ch 24 secs.10 a – 10 e of the Swedish Income Tax Act ("ITA"). They took effect on 1 January 2009 and apply to interest expenses that accrue after 31 December 2008 (Swedish Statute 2008:1343).[1]

The stated reason for the decision to depart from earlier principles was that in the course of performing business tax audits, the Swedish Tax Agency had identified certain transactions among associated enterprises which it judged as having been carried out exclusively or virtually exclusively to obtain interest deductions for Swedish tax purposes. A court decision was understood as implying that the deductions could not be denied based on the Tax Avoidance Act. The strong reaction from the Tax Agency came about in part due to the Supreme Administrative Court's ruling of 6 November 2007 in *AB Industrivärden.* [2] In an earlier case (RÅ 2001 ref. 79) the Supreme Administrative Court had considered whether the Tax Avoidance Act as amended up to 1 January 1998 could be applied to a municipality that had transferred all shares in a number of operating subsidiaries to another subsidiary against a promissory note. The subsidiary paid interest on the promissory note to the municipality that was tax exempt on interest, and financed these interest payments with group contributions from its own subsidiaries. The Supreme Administrative Court found that the Tax Avoidance Act was not applicable to these practices. The Court now found that the circumstances in *AB Industrivärden* essentially coincided with those in RÅ 2001 ref. 79, and thus should be judged the same way as in the earlier case.

Based on this ruling, the Tax Agency's head analyst stated in an interview with the Swedish News Agency that the corporate income tax was for all practical purposes a voluntary levy and that the state coffers could lose SEK 60 billion of the approximately 100 billion generated by the corporate income tax. "In the Tax Agency's view, intragroup transactions have no commercial basis. They do not constitute purchases to expand or deepen the business; they are transacted solely to avoid tax." [3] In a televised interview on Christmas Eve 2007, the head analyst expanded on the Agency's thinking and pointed out that large companies with more than 100 employees could dribble away tax revenues of SEK 60 to 65 billion.

In this context, the Tax Agency also decided to withdraw a large number of cases from the courts and matters under review. Instead, the Agency asked the Government to change the law. Over the course of 2008, the Tax Agency successively revised the purported tax losses downwards to a few billion. The political process had begun and the legislative process continued after a record-short consultative period during the summer, which was followed by extensive revisions to the draft bill produced by the Tax Agency. If the draft circulated for comment by the Ministry of Finance had not been changed, it would have driven corporate internal financing activities out of the country and Swedish companies would have sustained a significant competitive blow. However, the proposal was still considered far too detrimental to the economy and tax revenues. A comprehensive escape clause was inserted in response, which solved the worst of the problems. The concrete legislative drafting process began after a consultative period of only one week for the revised proposal. However, the scope of the final proposal was also much broader and not confined to purely artificial arrangements. Ordinary business operations were severely affected, despite the Government's assurances that this would not occur. Among the adjustments made, restricting rules were inserted in favour of long-term shareholders in investment firms and economic associations. As said, the law was enacted on the 10th of December, Nobel Prize day.

PRESERVING THE TAX BASE

Since tax revenues are used to pay for public expenditures resolved by the Riksdag, it is imperative to make sure that there is a tax base allowing revenues to flow into state coffers. Taxes naturally affect the targeted activity – taxes are frequently used to reduce the prevalence of harmful activities, such as smoking and emission of pollutants. Taxes are also used to encourage certain behaviour or simply to bring in a needed amount to the public purse. The design of the tax system is largely determined on the base of observations of how these activities, and thus the tax base, are affected by the taxation.

There is broad consensus in Sweden and abroad that purely artificial arrangements whose sole purpose is to avoid tax should be impeded or preferably wholly prevented. EC law provides opportunities to intervene against such schemes and phenomena. A communication from the EU Commission clearly states the Commission's view on how tax avoidance rules must be designed in order to harmonise with EC law. [4] The Commission states, *inter alia*, that to be legal, national tax rules must be proportional and intended to prevent purely artificial arrangements. The Commission also points out that the objective of minimising the tax burden is in itself a valid commercial consideration as long as the arrangements entered into with a view to achieving it do not amount to artificial transfers of profits. Insofar as a taxpayer has not entered into abusive practices, Member States cannot impede his exercise of the rights of freedom of movement simply because of lower levels of taxation in another Member State's tax systems. This is the case even in respect of special favourable regimes in that other Member State.

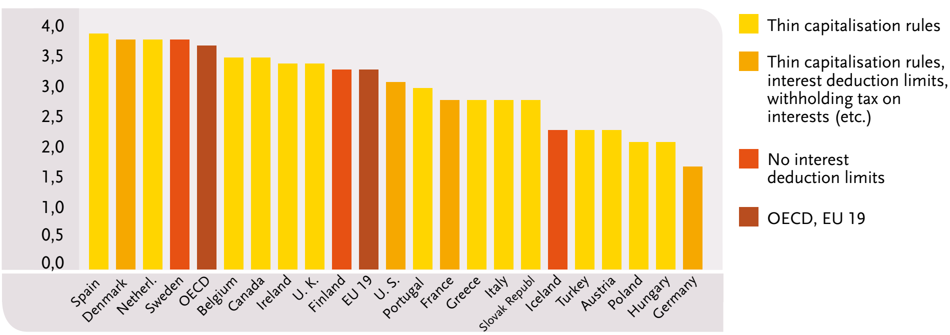
CFC rules and thin capitalisation rules are two types of legislation whose stated objective usually is that of preventing tax avoidance. Here, the Commission points out that short of abolishing CFC rules altogether or refraining from applying them within the EU/EEA, it is necessary to ensure that the CFC rules are targeted at wholly artificial arrangements only. With regard to thin cap rules, the Commission says that measures to prevent thin capitalisation are not per se impermissible, but their application must be confined to purely artificial arrangements.

From a legal standpoint, it seems clearly established that tax avoidance rules can and may be applied in the EU to protect the tax base against purely artificial arrangements and transactions. However, whether this is desirable from a national perspective, and whether such measures have resulted in maintained, increased or even decreased tax revenues is another matter.

EFFECTS OF TAX AVOIDANCE RULES ON TAX REVENUES

It is important that the tax system do not encourage transactions that are purely artificial and jeopardise the tax base and thus the tax revenues, but it is difficult to delimit the coverage of tax avoidance laws so that they affect only purely artificial arrangements. An international comparison of corporate tax revenues as a percentage of the economy provides no support for the notion that tax revenues from the corporate income tax is higher in countries that have enacted various forms of tax avoidance legislation (see Figure 1). On the contrary, tax revenues in the countries that have extensive, or even very extensive, tax avoidance laws aimed at preventing purely artificial interest deductions are lower as a percentage of the economy than in other countries that have no such laws.

FIGURE 1 CORPORATE TAX REVENUE, SHARE OF GDP (%)

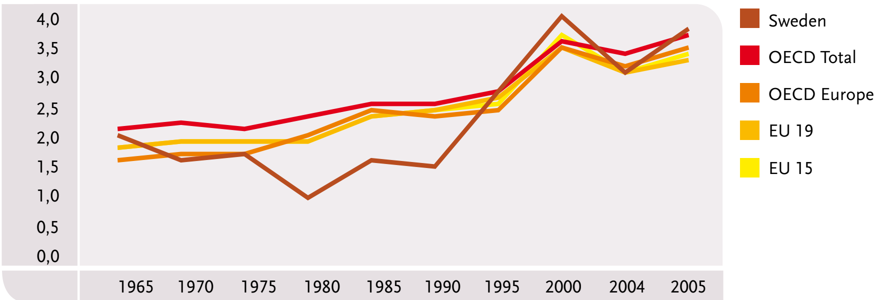


SOURCE: IBFD AND OECD (DATA FOR 2005).

Figure 1 shows that Denmark, a country with extensive rules to prevent artificial interest deductions and artificially high indebtedness, has high corporate tax revenues, but the figures refer to 2005, when the more restrictive Danish rules had yet to be implemented. A country like Germany has comprehensive tax avoidance rules, but low corporate tax revenues. It seems as if the level of the corporate tax rate and extensive tax avoidance laws should co-vary. Limitations on the deductibility of interest are implemented more often in countries with high corporate tax rates, but their tax revenues remain low.

Despite its erstwhile very high corporate tax rate, Sweden has never before imposed limitations on the deductibility of debt interest. The corporate tax rate was reduced when the tax system was reformed in 1990-91, which was followed by a steep rise in corporate tax revenues, still with no limitations on interest deductibility (see Figure 2).

FIGURE 2 CORPORATE TAX REVENUE, SHARE OF GDP

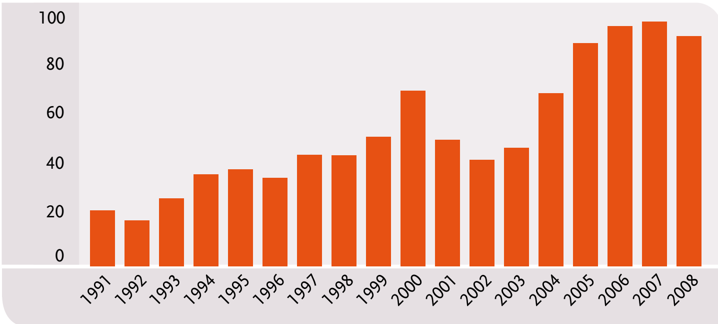


SOURCE: OECD, REVENUE STATISTICS

Corporate tax revenues are high in Sweden compared to many other countries, but they are sensitive to economic trends. No trend-related downturn due to the purported large number of cases involving artificial interest deductions can be seen in the statistics (see Figure 3). However, corporate tax revenues are expected to decline dramatically in the next few years due to the recession and the losses incurred.

Although it could not be proven that tax revenues had been undermined, the Tax Agency argued that this would occur after the Supreme Administrative Court's ruling in the above-mentioned Industrivärden case on 6 November 2007. However, for the decline in tax revenues to reach SEK 60 billion, companies would have to raise new loans to such a magnitude that the debt would exceed the value of the total capital stock of private enterprise (the value of all property, plant, and equipment). However, even less dramatic borrowing could entail a decline in tax revenues. The question is whether there were any indications of an increase in borrowing.

FIGURE 3 CORPORATE TAX REVENUE, BN SEK



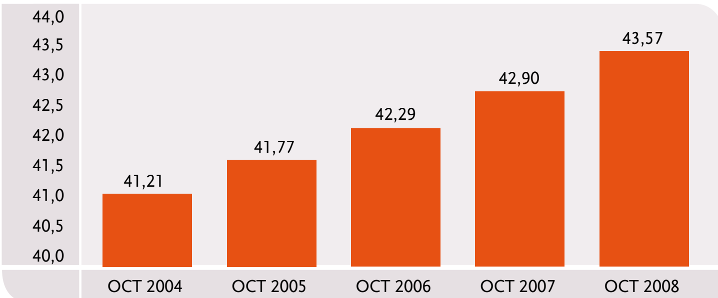
SOURCE: MINISTRY OF FINANCE

In fact, consolidation and solvency have very tangibly increased in the private sector since the tax reform of 1990-91. This can only make sense because the difference in the cost of equity capital and loan-financed capital narrows when the value of interest deductions declines due to reductions in the corporate tax rate. Compared with other countries, there is still an incentive to high indebtedness in the private sector, above all, through the double taxation of distributed profits at a high rate in international comparison. In particular, the high capital gains tax on shares in Sweden (with no phasing-out rule) sets us apart from the rest of the world. However, the lowering of the corporate tax rate has had a decisive impact on corporate debt, which has declined. In addition, the double taxation burden was lightened for a few years in the early 1990s when the capital gains tax was cut by half, but it was increased again when the Social Democratic government took office in 1994. However, restrictions on the deductibility of corporate interest expenses were never discussed in this context. On the contrary, the deductibility of interest expenses was regarded as a logical and competitive means to stimulate higher investments in Sweden.

Figure 4 shows the median solvency in Swedish limited liability companies during the period of 2003-2007. As shown on the chart, solvency has increased every year. When companies are categorised by size, there are substantial differences in solvency between large and small companies. The smallest companies in particular are distinguished by high solvency (see Figure 5).

FIGURE 4

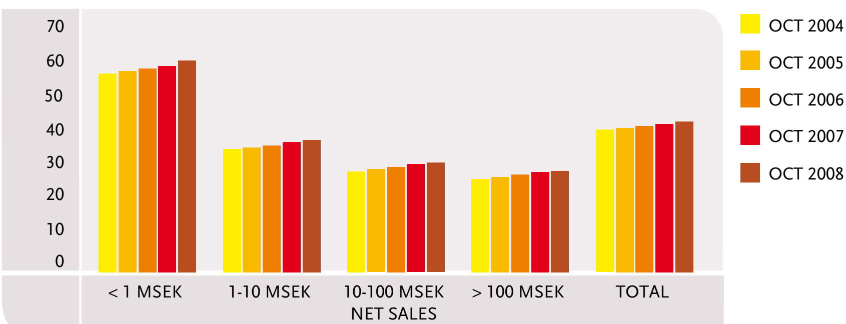
Median solvency in Swedish limited liability companies



SOURCE: UC 2008

FIGURE 5 MEDIAN SOLVENCY

Median solvency in Swedish limited liability companies 2004-2008, ranked in order of net sales (MSEK)

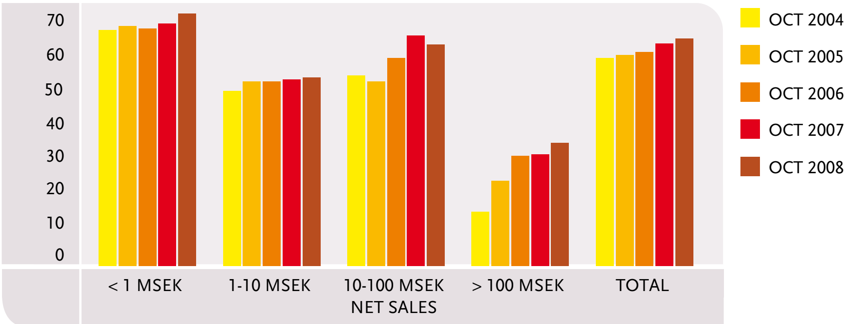


SOURCE: UC 2008

Solvency also varies by sector. In international contexts, the financial sector is the one most often associated with artificial interest deductions, but solvency has also increased in this sector over the last five years (see Figure 6).

FIGURE 6 MEDIAN SOLVENCY, FINANCIAL SECTOR

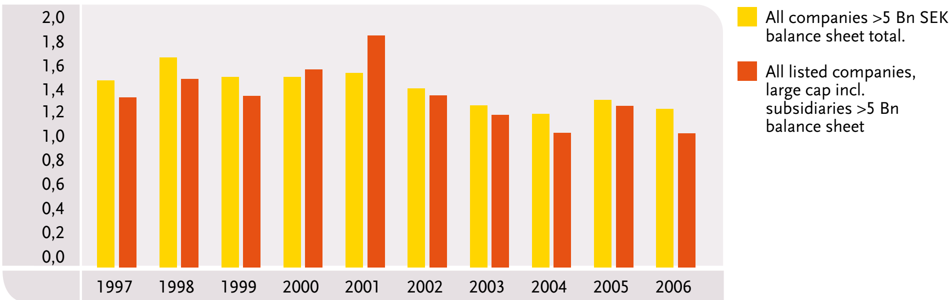
Median solvency in limited liability companies in the financial sector 2004-2008



SOURCE: UC 2008

Signs of higher indebtedness are nowhere to be found. However, studying aggregate data does not suffice to illustrate the threat posed by artificial interest deductions. Indebtedness could occur in a corporate group by using only a few companies to reduce the tax base. Accordingly, a study of a large number of companies that are part of the same corporate group is required. However, it would take artificial interest deductions amounting to tens of millions of Swedish kronor to erode the tax base. The capacity to undertake such transactions is confined to relatively large companies. For small companies, the transaction costs would be so high that the tax reduction would not even cover the consultant fees. A study of debt/equity ratios in the 500 largest companies should cover the group of companies that have sufficient capacity to carry out transactions of a magnitude that could affect the corporate tax outcome in central government finances. But solvency has increased and the debt/equity ratio has decreased among this group of companies as well (see Figure 7).

FIGURE 7 DEBT/EQUITY RATIO - 500 LARGEST COMPANIES



SOURCE: STATISTICS SWEDEN.

Thus, by all of these measures, the Swedish tax base has not been exposed to any undermining. Although it seems unlikely, this naturally does not mean that companies will not act differently in future years. But considering the difficulties of borrowing at all during the prevailing financial crisis, it does not seem probable in the least. The problem the Tax Agency is determined to fight at any cost seems to have been extremely limited, which should have led to a cautious response from lawmakers.

THE ART OF MAXIMISING TAX REVENUES — THE SWINGS AND THE ROUNDABOUTS

In order to judge how lawmakers intent on promoting the Swedish tax base and preserving high tax revenues should behave, it is useful to evaluate the consequences on central government finances of taking action against artificial interest deductions versus doing nothing. Earlier Social Democratic governments have not acted, even though the corporate tax rate was much higher then, and thus the risks of tax avoidance greater. Can there be rational reasons why no measures were taken?

As I suggested at the outset, it is a delicate matter to design taxation in such a way that the tax base is not adversely affected to the extent that tax revenues end up lower than they otherwise could have been.

To assess the risk to the tax base and the tax revenues posed by artificial interest deductions (whether or not they can be attributed to purely artificial arrangements, against which EC law accepts preventive legal measures, if proportionate), the total economic picture must be analysed. To benefit from an interest deduction, a profit must first be created against which the interest expense can later be deducted. In an artificial interest deduction, the first level of double taxation cannot be maintained, but this requires a profit situation to exist. For a profit to arise, an economic activity must take place, which means that the production factors, labour and capital, must be used. Beyond this, the company also uses raw materials and energy to a varying extent. Economists usually describe this in terms of a production function, where labour and capital generate a return on equity. To put it simply, people, equipment, and machinery must be used to produce. At least three different production situations must be considered to assess the consequences of artificial interest deductions and any measures against them.

The first situation is when a Swedish company that has been using labour and capital to produce in Sweden for a long time decides to reduce its taxable profits through an artificial interest deduction. The profit generated, of which a percentage is paid in tax, will now decline or even be completely erased. Tax revenues decline and the national economy is the loser. Production in the company is not affected, however, and the same number of people are employed and continue paying taxes. [5]

In the second situation, things are starting to go so badly for a company that has provided both jobs and tax revenues through operations in Sweden that the owners are no longer earning the return on their capital they require. Assume that a reduction in tax dues can make the return to the owners high enough to meet those requirements and thus the company stays in business, but pays no corporate income tax. While the national economy loses the corporate tax revenues, jobs are provided and capital is employed by keeping the company going. This generates substantial tax revenues in the form of taxes on wages, social security contributions, value added tax, and capital income taxes (to the extent the owners reside in Sweden). The state would lose a great deal more in tax revenues if the company went out of business or moved abroad.

The third situation involves a foreign investor, who is looking for a country in which to localise production but is unwilling to pay corporate income tax. Countries that have no thin cap rules or limitations on interest deductibility will then appear to be attractive options. When the investor produces in such a country, he pays for labour, which generates tax revenues, but he pays no corporate income tax because a purely artificial arrangement is used to transfer taxable profits to a country where the tax is low or non-existent. The national economy actually does not lose even the corporate tax revenues because the country that did not permit artificial arrangements would never be considered for the localisation of production. However, a tax base is created because the labour can be taxed and the tax on labour is much greater than the tax on a potential profit.

There is actually a fourth situation that should be considered, which refers to the state of affairs when a company is sold. The situation becomes exceedingly clear if it involves a state-owned company sold to a foreign investor who intends to move the taxable profits out of the country and thus bids higher than all other prospective investors. The state then takes in a higher amount through the sale, an amount that also reflects the acquiring company's intention not to pay corporate tax in the future. [6] The corporate income tax is thus prepaid, so to speak, and there is actually no rational reason to complain when the company later pays no corporate income tax, which the other prospective buyers would have done – but in return, they would have paid a lower price. However, this will not stop such a debate from ensuing when the acquired company no longer pays corporate income tax. Not least in the United States, comparisons of what companies paid in tax before and after a buyout have triggered widespread political reactions, with demands that companies taken over should pay at least as much tax as they did before.

The situations outlined above need to be assessed and quantified to judge the effects on central government finances of limiting interest deductibility. Comparative examination of the tax bases provides answers to these questions. In 2007, the corporate income tax yielded about SEK 100 billion. According to the figures reported by the Tax Agency and eventually by the Ministry of Finance, purely artificial interest deductions add up to SEK 7 billion and thus reduced corporate tax revenues from SEK 107 to 100 billion. Total tax revenues are estimated at SEK 1,513 billion (2008). Of these revenues, SEK 910 billion come from tax on labour while SEK 174 billion come from tax on capital income. Consumption taxes generate another SEK 431 billion.

As said, to benefit from an artificial interest deduction a company has to have a profit so that a deduction can be granted. If we assume that production is achieved by using labour and capital in fixed proportions (a common assumption in the economic literature, i.e., a Cobb-Douglas production function), we can estimate how much labour must be used to generate the profit that is subsequently diminished through artificial interest deductions. [7] It is important to note that labour is taxed more heavily than capital. If 6.5% (7/107) of the corporate income tax is lost through interest deductions, a profit of SEK 7 billion must be created, which requires a great deal of labour. Through the use of this labour to generate profit, the state takes in SEK 59 billion (6.5% of the tax revenues on labour). In addition, the state takes in SEK 28 billion in VAT, which can also be regarded as a tax on labour.

Certainly, the state loses SEK 7 billion in corporate income tax, but on the other hand, the production that creates a profit of SEK 7 billion generates a full SEK 59 billion in revenues from tax on labour, as well as another SEK 28 billion in consumption taxes. The tax on labour alone thus gives the state SEK 52 billion more in tax revenues than it would have had if the production did not occur and thus no profit would ever have been made that could subsequently be "conjured" away.

A loss of 7 should thus be weighed against a profit of 52. The very best outcome for the state would occur if the state could prevent companies in the first category from venturing into artificial interest deductions. However, it is impossible to design tax law in such a precise fashion. The other company categories will inevitably be affected, and the outcome of the measures would impact central government finances in the wrong direction. If only one out of eight companies were in either the second or third category, it would be enough for laws limiting interest deductions to result in lower tax revenues. If consumption taxes are included, the ratio becomes one out of eleven. A rule of thumb could be that if one company out of ten that use artificial interest deductions chooses to move production abroad, shut down operations, or not locate the business in Sweden because limitations on interest deductibility are introduced, the state will lose tax revenues by restricting the deductibility of debt interest. In other words, the state loses more on the swings than it gains on the roundabouts.

Earlier governments, both Social Democratic and non-socialist, have concluded that limitations on corporate interest deductions should not be implemented. They have judged that the tax base is best preserved if production is located in Sweden. As a result of the relatively high taxes on labour and consumption, even a marginally adverse impact on production and employment is so detrimental that it risks a negative outcome for tax revenues. Unfortunately, after the initial alarming reports from the Tax Agency, the current government has judged otherwise and has even gone so far as to impose special restrictions on such truly long-term Swedish owners as cooperative associations and investment firms. The preceding Social Democratic government also acted on similar matters, and also upon the Tax Agency's initiative, by implementing tighter CFC rules and taking a more aggressive stance with regard to transfer pricing. It is not unlikely that these rules are also reducing production and thus employment in Sweden, to the detriment of tax revenues. On the other hand, it can be difficult to refrain from acting against purely artificial arrangements and transactions, but there is apparent danger that the economy will suffer, especially in a small, open economy like that in Sweden. To ameliorate the risk that tax revenues will be reduced, legislation must hit the target with great accuracy.

CONCLUSIONS

Analysing the possible effects on central government finances of changes in the tax system is no easy task. Individual and corporate actions are affected by the changes, and a purely statistical analysis is an extreme assumption that rarely gives an accurate picture of the actual tax outcome. It is important to uphold and strengthen the legitimacy of the tax system. Accordingly, measures to preserve the tax base must be designed to fit their purpose to prevent the risk that they will lead to the diametrically opposite effect, that is, a decline in total tax revenues. The legal drafting of tax avoidance rules must be very restrictive and proportionate to achieve the purpose of preserving the tax base. Legislation per se also risks legitimising similar practices and instilling greater tax awareness among individuals and companies. It is thus extremely important that tax avoidance legislation be carefully considered and analysed before bills are presented and enacted. Unfortunately, this was not the case in the decision to deny deductions in certain cases for corporate interest expenses.

After the Tax Agency frightened the politicians with the claim that more than half of the corporate tax revenues would vanish, Sweden abandoned its traditional strategy of allowing full deductions for interest expenses. Even though the Tax Agency revised the tax revenue loss due to purely artificial arrangements from SEK 60 billion to 7 billion (or even just a few billion), the Government still chose to legislate against long-term Swedish owners by implementing provisions that limit corporate opportunities to deduct interest in connection with intercompany loans to acquire equity instruments from an associated enterprise. This was the biggest strategic decision within corporate taxation in many decades and it was carried out with no analysis of the consequences for central government finances and the impact on Swedish competitiveness in a globalised world.

Very few companies use artificial arrangements to obtain interest deductions in the form of artificial interest deductions, and there is no statistical support whatsoever for claims that artificial interest deductions have undermined the tax base or have increased in scope. On the contrary, the statistics show sharply increased solvency in the private sector. With respect to analysing the consequences for tax revenues, there is no clear-cut answer, but the preceding simple analysis shows that a rule of thumb could be that the state loses tax revenues by restricting the right to deduct debt interest if only one out of ten companies that use artificial interest deductions chooses to move production abroad, shut down the business, or refrain from establishing operations in Sweden in response to limitations on interest deductibility. In other words, the state loses more on the swings than it gains on the roundabouts. That does not mean that legislation against purely artificial arrangements cannot be justified, but it does stress the need for precise legal drafting.

It is of course regrettable that no strategic analysis and discussion was initiated in a matter of such great national importance. It is to be hoped that future bills will be more thoroughly supported and analysed before they are presented.

In general, governments should be cautious about the effect on other tax bases when anti-abuse rules are contemplated. There is an obvious risk that so called revenue protecting measures are nothing else but an attempt to re-regulate investment and financial markets, with adverse effects on overall tax revenues. However, governments will have to react to wholly artificial arrangements in order to protect not only the revenue base but also the legitimacy of the tax system.

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ENDNOTES

1 For a description of the new limitations on interest deductibility, see Richard Hellenius, SvSkT 2/2009, pp. 8-17.

2 Supreme Administrative Court ruling in case RÅ 2007 ref. 85.

3 From the article "Statskassan kan förlora 60 miljarder" ["State coffers could lose 60 billion"] DN.se, 24 December, 9:06 p.m. It may seem remarkable that a ruling in a case involving an investment firm garnered so much attention, since tax avoidance in investment firms presupposes a net interest loss, while investment firms tend to show a net interest income virtually every year. The analyses of the investment firms' tax situation, by the Tax Agency and later the Ministry of Finance, seem to have been substandard.

4 COM (2007) 785

5 Production could possibly increase in the company through the increase in competitiveness for the individual company that uses an artificial interest deduction. In that case, the effect on tax revenues becomes even more difficult to penetrate because labour and capital are reallocated by extension. Since wages, capital remuneration, and profitability may differ between companies that use artificial interest deductions and those which do not, the tax base is affected. A poorly functioning product market and lack of competition can by extension erode the tax base, especially if the economy is relatively closed.

6 The eliminated corporate tax payments are capitalised in the purchase price, which represents the value of the company. This effect also arises when privately owned companies are sold. The higher purchase price leads to an increased capital gain for the seller of the privately owned company. To determine the effects on state tax revenues, the capital gains tax that the seller pays must be compared to the eliminated corporate tax. When the capital gains tax is high (as in Sweden) a tax revenue loss need not arise. In addition, the tax is paid earlier than the tax that would be paid on any future profits.

7 Customary assumptions that the production function is linearly homogeneous and that artificial interest deductions do not affect the relative factor prices are assumed to have been met.

BY ROGER PERSSON-ÖSTERMAN

The new Swedish Anti-Avoidance Rules – Are They in Conformity with Community law?

INTRODUCTION

To prevent arrangements aimed at avoiding application of tax law, the Swedish Government has introduced an amendment to the Income Tax Act (ITA), restricting the right to deduct interest from taxable profits. In brief, the proposed rules are as follows:

A company that is part of a group of affiliated companies may not deduct debt interest paid to another company in the group, in so far as the debt derives from an acquisition of shares in a company in the group. However, the prohibition is not to be applied a) where the income corresponding to the interest would be taxable at a rate of at least 10 percent in the state where the beneficial owner of the income is a resident or b) where the acquisition of shares as well as the loan on which the interest is paid are motivated mainly by commercial interests.

For the purpose of the rules referred to above, companies shall be considered as affiliated, where one of these companies directly or indirectly, through possession of shares or otherwise, has the principal influence on the administration of the other companies.

The Swedish Government takes the view that these rules would not constitute a violation of the freedom of establishment established by Article 43 of the EC Treaty. According to the Government, the rules do not amount to discrimination since it is neither a question of applying different rules in comparable situations nor of applying equal rules in different situations. The Government holds that the rules concerning non-deductible payments of interest apply equally to domestic and foreign companies and irrespectively of whether the company concerned is taxed as resident or non-resident.

OBSTACLES TO THE FREEDOM OF ESTABLISHMENT

Article 43 EC and the prohibition of discrimination

Article 43 of the EC treaty provides that obstacles to the freedom of establishment are prohibited. Freedom of establishment within the EC implies, as a general rule, that the laws of the Member States may not discriminate on grounds of nationality. Consequently, a Member State cannot discriminate a company on the basis of its domicile by applying tax law. For tax purposes, a company is usually considered as resident in the country of its seat or registration. For further reference, a company that is unrestrictedly liable to tax in the Member state concerned will be called `resident company´.

Case-law on Article 43 EC

It follows from the European Court of Justice (ECJ) case-law that the rules regarding freedom of establishment forbid not only overt discrimination of a company by reason of its seat, but all covert forms of discrimination that will in fact, by the application of other criteria, lead to the same result (see, for instance, 152/73, Sotgiu vs Deutsche Bundespost paragraph 11, C-331/91, The Queen v. IRC ex parte Commerzbank, paragraph 14, C-294/97, Eurowings, paragraph 40).

In C-324/00, Lankhorst-Hohorst, the conformity of the German law on thin capitalization with the EC Treaty was in question. According to the Körperschaftsteuergesetz (Law on corporation tax), repayments regarding loan capital which a company had obtained from a shareholder not entitled to corporation tax credit could, with respect to taxation, be regarded as a covert distribution of profits, where repayment calculated as a fraction of the capital was agreed and the loan capital was more than three times the shareholder's proportional equity capital. Such recharacterisation could only be avoided where the company could have obtained the loan capital from a third party under otherwise similar circumstances or where the loan capital constituted borrowing to finance normal banking transactions.

Under German law, there was no entitlement to corporation tax credit, first, for non-resident shareholders and, second, for corporations governed by German law which were exempt from corporation tax. The second group involved mainly legal persons governed by public law or carrying out tasks in specific fields. As the ECJ held, in the large majority of cases resident parent companies would receive a tax credit, whereas non-resident parent companies would not. Consequently, as a general rule, interest paid by a resident company to a non-resident parent company would be regarded as a dividend, whereas in the case of a resident subsidiary whose parent company was also resident, interest would be treated as expenditure. According to the ECJ, p. 32, such legislation led to a differentiation in treatment between companies according to their seat, constituting an obstacle to the freedom of establishment provided by Article 43 EC. Moreover, according to the ECJ, the fact that in some cases a resident company could fall under the rules in question did not affect the existence of such differentiation.

Does the Swedish legislation contain covert discrimination?

The Swedish legislation shows obvious similarities with the legislation at issue in Lankhorst-Hohorst. Where the German law prescribed that interest paid by the resident company was to be regarded as dividend, the Swedish legislation stipulates that such interest shall be non-deductible in assessing the taxable profit of the borrowing company. Both rules have the aim to prevent tax avoidance and the effect that interest paid to a non-resident company does not reduce the taxable profit of the resident company. Under these circumstances, it follows from Lankhorst-Hohorst that to amount to discrimination the tax measure in question need not make an explicit difference between resident and non-resident companies. It is sufficient in this respect that the legislation will result in a situation which is more favourable for resident companies than for foreign corporations. Accordingly, the fact that some resident companies, namely investment companies, may be treated in the same, less favourable, way as non-resident companies does not affect the existence of differentiation.

Under Ch. 15 sec. 1 of the Swedish ITA companies shall consider loan yield as revenue in their calculations of taxable profits. Under article Ch. 65 sec. 14, the profits of a corporation shall be taxed at a rate of 26,3 percent. Ch. 39 sec. 15 ITA provides that investment companies, for purposes of taxation, are entitled to deduct dividends distributed to their shareholders. Hence, those companies are able to eliminate revenue deriving from loan capital. It follows by Ch. 39 sec. 15 ITA that an investment company is a Swedish limited liability company or a Swedish economic association that in principle has as its sole function to manage securities that offers its shareholders diversification of risks, and is held by a large number of individuals. In practice, the latter means that only a listed company can qualify as an investment company. Following a judgment by the Supreme Administrative Court 2008 (RÅ 2008 ref. 14), it is also clear that receivables from group companies are not securities in the meaning of the legislation at issue – This would imply that an investment company has a limited possibility for the type of tax planning which the legislation is aimed at preventing.

It is thus apparent that interest payments between Swedish companies only to a very limited extent can be affected by the new legislation. In contrast, non-resident companies, resident in various countries and thus being subjected to different tax rates, more often are likely to be taxable at a rate below ten percent. Hence, the amendment will lead to a more favourable tax position for companies affiliated to companies resident in Sweden than for groups involving companies that are domiciled abroad. Accordingly, the amendment contains an obstacle to the freedom of establishment provided in Article 43 EC.

JUSTIFICATION OF OBSTACLES TO THE FREEDOM OF ESTABLISHMENT

Case-law on justifying circumstances in tax matters

It is established case-law that restrictions on the freedoms granted by the EC treaty can be justified by overriding reasons of public interest, if such a measure is appropriate to ensure the attainment of the objective in question and does not go beyond what is necessary to attain it (see, for instance, C-446/03, Marks & Spencer p. 35, and C-196/04, Cadbury Schweppes plc p. 47).

In the preliminary rulings C-105/07 Lammers & Van Cleeff, C-524/04 Thin Cap and C-196/04 Cadbury Schweppes plc, the ECJ assessed the compatibility with article 43 EC of national tax measures aimed at combating tax avoidance.

The judgment in Cadbury Schweppes plc concerned the United Kingdom legislation on controlled foreign companies (CFCs). According to the Income and Corporation Taxes Act, as a general rule, resident companies were not taxed on the profits of their subsidiaries. Furthermore, the same act stipulated that profits of a foreign company in which a resident company owned a holding of more than 50 percent were to be attributed to the resident company, where the CFC was subject to a lower level of taxation in comparison with the resident company. Taxation of the resident company on the profits of its subsidiary could be avoided, inter alia, in certain situations in which an intention by the resident company to escape United Kingdom tax seemed to be excluded. Where no exemption was applicable, the group of companies could be subjected to the so called motive test, in order to be relieved from the heavy taxation provided by the CFC legislation. To satisfy this test, the resident company had to show that the reduction in United Kingdom tax resulting from the transactions routed between itself and its foreign subsidiary was not the main purpose or one of the main purposes behind those transactions and that the achievement of tax reduction was not the main reason, or one of the main reasons, for incorporating the CFC (p. 62).

The ECJ held that the application of the exemptions contained in the Income and Corporation Taxes Act along with the motive test did not suffice to conclude that there was a wholly artificial arrangement intended solely to escape tax. According to the ECJ, to find that there was such an arrangement, there must be objective circumstances showing that the objective pursued by freedom of establishment has not been achieved. Consequently, for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

Thus, where the subsidiary, in terms of premises, staff, and equipment, corresponded with an actual establishment, it was to be regarded as an incorporation carrying out genuine economic activity in the host Member State.

In Thin Cap, the legislation at issue provided that interest paid by a United Kingdom resident to a non-resident company belonging to the same group of companies was treated as a distribution of profits. That rule applied to loans made by a non-resident company to a resident subsidiary of which the former owned 75 percent of the capital or where both the companies were 75 percent subsidiaries of a non-resident third company. The ECJ referred to the judgments in Cadbury Schweppes plc and Lankhorst-Hohorst, and stated that legislation of a Member State which does not have the specific purpose of preventing wholly artificial arrangements goes beyond what is necessary to combat tax evasion. According to the ECJ, the interest in question could be treated as distribution of profit only if, and in so far as, the interest exceeded what would have been agreed upon at arm's length. Hence, the requirement that the challenged arrangement do not contain any element of commercial motives was upheld by the ECJ with respect to legislative measures concerning interest.

In Lammers & Van Cleeff, the ECJ scrutinized Belgian thin cap rules. The court upheld the reasoning in Thin Cap and stated clearly:

"a national measure restricting freedom of establishment may be justified on the ground of prevention of abusive practices where it specifically targets wholly artificial arrangements which do not reflect economic reality and are designed to circumvent the legislation of the Member State concerned and, in particular, to escape the tax normally due on the profits generated by activities carried out on national territory." (summary).

The court continued: "legislation of a Member State may be justified by the need to combat abusive practices where it provides that interest paid by a resident subsidiary to a non-resident parent company is to be treated as a distribution only if, and in so far as, it exceeds what those companies would have agreed upon on an arm's-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies." (p 29).

The conclusion is very clear, anti-avoiding measures must be limited in scope and cover wholly artificial arrangements only.

The exemption for transactions motivated mainly by commercial interests

The objective of the rules introduced by the Swedish Government is to prevent deductions of payments of interest to companies not subject to income tax in Sweden. It has been found that in some groups of companies, transactions involving borrowing of capital in conjunction with acquisition of shares in a company that forms part of the group have been carried out in order to avoid tax on profits that would otherwise be taxable in Sweden (Submission to Lagrådet [the Law Council] on 25 September, 2008, p 19). As has been held by the ECJ in Lammers & Van Cleeff, Thin Cap and Cadbury Schweppes plc, the combat of tax avoidance and evasion is an overriding reason of public interest which can be invoked as a justification for restrictions on the freedom of establishment. However, justification is possible only if the legislation in question targets wholly artificial arrangements which do not reflect economic reality.

The legislation contains two exemptions from the general rule that interest paid to affiliated companies shall be non-deductible. The interest shall be treated as a deductible expense, first, where the income corresponding to the interest paid would be subject to taxation at a rate of at least 10 percent in the state where the beneficial owner of the income is a resident, and, second, where the acquisition of shares as well as the loan capital on which the interest is due are motivated mainly by commercial interests. The word mainly is to be understood as 75 percent or more (Prop. 1999/2000:2, part 1, p. 502).

It is clear that a company can acquire a corporation in a country where tax rates are below 10 percent and do so for commercial reasons. As held by the Swedish Government, a multinational group of companies that conducts business throughout the world may need to establish a head-office in every region where production or sale is performed. In some regions, only a few countries are financially and politically stable enough to be suited as a basis for headquarters (Prop 2008/09:65 p 68). In such cases, if transactions within the group are carried out partly for tax reasons, the denial of deduction might be applicable. However, according to the ECJ in Cadbury Schweppes plc, such legislation may not be applied, despite the existence of tax motives, when the establishment is made partly for commercial reasons.

Thus, for the Swedish legislation to comply with Community law, the word mainly in the statute must be removed. It must be clarified that the legislation targets wholly artificial arrangements only.

IMPLICATIONS OF THE INTEREST AND ROYALTY DIRECTIVE

Introduction

The European Community has established a Directive intended to ensure that interest and royalty payments between associated companies of different Member States are subject to tax in a Member State once only.

The directive is Council Directive 2003/49/EC of 3 June, 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

Interest and royalty payments arising in a Member State will be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment of a company of a Member State situated in another Member State.

The Swedish legislation restricting the right to deduct interest could be in breach of the directive

Rules in the Directive

According to EC law, the Swedish proposed restriction on the right to deduct interest between affiliated companies would most likely be regarded as a source tax on paid interest. It would otherwise be possible to circumvent the application of the rules of the Directive. Therefore, the conclusion is that the Swedish proposed amendment, as such, is covered by the rules of the Directive.

However, there are a number of articles in the Directive which may leave scope for the national legislator to introduce limits on the application of the Directive.

First, in article 4 (a) it is stated that the source State shall not be obliged to ensure the benefits of this Directive on payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State.

Second, in article 5 it is stated that the Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. It is also stated that Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of the Directive or refuse to apply it.

Analysis

As the amendment does not classify the interest paid as a distribution of profits, article 4 would not be applicable. What remains to be examined is whether article 5 could justify the restriction on the interest deduction.

Obviously, the Swedish legislation covers a broader range of transactions than fraud or abuse. The question is thus whether the amendment covers those transactions only, for which the principal motive or one of the principal motives is tax avoidance.

As shown above, the Swedish restriction applies if the transactions are not motivated by mainly commercial reasons. The word mainly is to be understood as 75 percent or more (Prop. 1999/2000:2, part 1, p 502). This is for the tax payer to show.

Clearly, this demonstrates that the Swedish legislation covers a wider range of transactions than those transactions for which the principal motive or one of the principal motives is tax avoidance.

Therefore, the conclusion must be drawn that the Swedish legislation is in breach of the Directive as well as the treaty.

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