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# Limitations of the Deductibility of Intra-Group Interest Payments

The Swedish Legislation and its Compatibility  
with the Freedom of Establishment

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# Summary

On January 1, 2009, new rules regarding *limitations of the deductibility of intra-group interest payments* came into force in the Swedish legislation. The rules aim to prevent the use of certain tax planning practices, where a company appropriates itself tax advantages by taking advantage of the unlimited right to deduct interest expenses. The tax advantage is ensued when the paying company makes an interest deduction in Sweden whereas the corresponding interest income is taxed at a low tax-rate or not at all by the receiving company.

The rules are, in the main, limiting the deductibility of interest payments attributable to intra-group loans obtained to finance an acquisition of shares from another company member of the same group. In order to not obstruct business-motivated transactions, two complementary rules has been introduced that exempts certain transactions from the purview of the principal rule. According to those rules, interest can still be deducted on condition that *either* the corresponding interest income is subject to tax at a minimum rate of ten percent at the level of the receiving company *or* the intra-group acquisition as well as the internal loan is *principally business-motivated*. The expression *principally business-motivated* implies that the businesslike reasons have to amount to 75 percent.

The rules apply to all companies that are resident in Sweden and members of a group of companies. The majority of interest paid by a subsidiary to an parent company, which are both resident in Sweden, will be deductible, since the corresponding interest income is normally subject to tax at a rate exceeding that of ten percent. As regards interest paid to a parent company resident in a state other than Sweden, it is not the matter of course that the corresponding interest income will be subjected to such taxation. Accordingly, the effect is that subsidiaries to foreign parent companies to a larger extent are affected by the rules than in case of resident parent companies.

In the thesis, it argued that the difference in tax treatment caused by an application of the Swedish rules is contrary to EU law and the freedom of establishment in particular. Still, the rules can be justified by the need to prevent abuse on condition that they are only targeting wholly artificial arrangements entered into for tax purposes only. However, a requirement prescribing that the businesslike reasons have to amount to 75 percent goes beyond what is necessary, as business-motivated transactions will also be affected. This deficiency could be rectified by removing the word *principally* from the wording of the rule. The argumentation is based on the reasoning of the Court of Justice in the cases *Lankhorst-Hohorst*, *Cadbury Schweppes* and *Thin Cap Group Litigation*.

# Sammanfattning

Den 1 januari 2009 trädde nya regler i kraft som begränsar rätten till avdrag för ränteutgifter för företag i intressegemenskap. Syftet med reglerna är att motverka ett särskilt skatteplaneringsförfarande, där ett företag utnyttjar den obegränsade rätten till avdrag för ränteutgifter för att tillskapa sig skatteförmåner. Skatteförmånen uppstår genom att den motsvarande ränteinkomsten beskattas lågt eller inte alls hos mottagaren.

De nya reglerna avser i huvudsak att begränsa avdragsrätten för ränteutgifter hänförliga till koncerninterna lån upptagna i syfte att finansiera ett förvärv av en delägarrätt från ett annat företag inom samma koncern. För att inte affärsmässigt motiverade förfaranden ska träffas av reglerna har två kompletteringsregler införts, som undantar vissa förfaranden från huvudreglernas tillämpningsområde. Ränteavdrag får därför ändå göras *dels* då den inkomst som motsvarar ränteutgiften är föremål för beskattning om minst tio procent i den stat där det mottagande företag har sin hemvist och *dels* i de fall då såväl förvärvet som den skuld som ligger till grund för ränteutgifterna är huvudsakligen affärsmässigt motiverade. Uttrycket *huvudsakligen affärsmässigt motiverad* innebär att transaktionen ska präglas av affärsmässighet till 75 procent

Reglerna är tillämpliga i förhållande till samtliga bolag med hemvist i Sverige som ingår i en intressegemenskap. Majoriteten av räntebetalningar som betalas erläggs av ett dotterbolag till ett moderbolag, som båda har hemvist i Sverige, kommer inte att omfattas av avdragsförbudet, eftersom den korresponderade ränteinkomsten normalt är föremål för beskattning överstigande tio procent hos moderbolaget. Vad gäller räntebetalningar till moderbolag med hemvist i en annan stat än Sverige är det inte på samma sätt självklart att dessa kommer att beskattas med en skattesats som överstiger tio procent. Reglerna får därför den effekten att avdragsförbudet drabbar dotterbolag med utländskt moderbolag i högre utsträckning än då moderbolaget svenskt.

I uppsatsen argumenteras det för att regler som medför en sådan skillnad i den skattemässiga behandlingen som beskrivits ovan inte är förenlig med EU-rätten och den fria etableringsrätten i synnerhet. Emellertid torde reglerna kunna rättfärdigas med hänsyn till behovet att förhindra skatteflykt. En förutsättning för rättfärdigande är emellertid att reglerna endast träffar *rent konstlade upplägg*, vilka endast företagits i syfte att erhålla skattefördelar. Ett krav på att affärsmässigheten ska uppgå till 75 procent går dock utöver vad som är nödvändigt, då även transaktioner som är affärsmässiga till viss del kommer att träffas av reglerna. Denna brist kan emellertid åtgärdas genom att huvudsaklighetsrekvisitet avlägsnas ur lagtexten. Argumentationen är till stora delar baserad på det resonemang som förts av EU-domstolen i fallen *Lankhorst-Hohorst*, *Cadbury Schweppes* och *Thin Cap Group Litigation*.

# Abbreviations

AG	Advocate General
CFC	Controlled Foreign Corporation
CJ	Court of Justice
DTC	Double Tax Convention
EC	European Community
EEA	European Economic Area
e.g.	exempli gratia; for example
et al.	et alii; and others
et seq.	et sequens; and the following one or ones
EU	European Union
i.a.	inter alia; among other things
i.e.	id est; that is
p.	page
para.	paragraph
SEK	Swedish Krona
TEC	the Treaty establishing the European Community; the EC Treaty
TEU	the Treaty on European Union; the EU Treaty
TFEU	the Treaty on the Functioning of the European Union
viz.	videlicet; namely

# 1 Introduction

## 1.1 Problem background

On January 1, 2009, new rules regarding *limitations of the deductibility of intra-group interest payments* came into force in the Swedish legislation. The rules aim to prevent the use of certain tax planning practices, where a company appropriates itself tax advantages by taking advantage of the unlimited right to deduct interest expenses. The tax advantage is ensued when the paying company makes an interest deduction in Sweden whereas the corresponding interest income is taxed at a low tax-rate or not at all by the receiving company.

*The Swedish Tax Agency*<sup>1</sup> initiated the adoption of the new rules by submitting a proposal<sup>2</sup> to the Swedish government with suggestions for limiting interest deductions on intercompany loans. In the proposal, the Swedish Tax Agency stated that the tax planning practice at issue eroded the Swedish tax base and estimated the yearly tax revenue loss to several billion Swedish kronor (SEK). The Swedish Tax Agency had previously attempted to challenge these transactions by applying *the Tax Avoidance Act*.<sup>3</sup> However, *the Swedish Supreme Administrative Court*<sup>4</sup> ruled that the Tax Avoidance Act did not apply in these situations.<sup>5</sup>

The proposal of the Swedish Tax Agency was heavily criticised by the consultive bodies, mainly because the scope of the proposed rules was considered too wide. The consultive bodies feared that the rules would extend to a large number of intra-group loans, irrespectively of the purpose of obtaining those loans and irrespectively of whether a tax advantage had been appropriated to the taxpayer in question or not. Because of the heavy critic of the consultive bodies, the *Swedish Ministry of Finance* reviewed the Swedish Tax Agency's proposal and in their presented memorandum,<sup>6</sup> the scope of the rules was considerably narrowed. Most notably, two exception rules had been drawn up, precluding the application of the rules limiting the deductibility of interest payments in respect of intra-group loans fulfilling certain requirements. The exception rules were introduced in order to render possible ordinary intra-group financing, e.g. intra-group financing motivated by business reasons. After passing the consideration of the *Council of Legislation*<sup>7</sup>, the Swedish Government submitted a legislative proposal<sup>8</sup>,

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<sup>1</sup> *In Swedish*: "Skatteverket".

<sup>2</sup> See Proposal of the Swedish Tax Agency regarding Limitations of the deductibility of interest payments on certain loans, issued 2008-06-23 (No 131-348803-08/113).

<sup>3</sup> *In Swedish*: "Lag (1995:575) mot skatteflykt".

<sup>4</sup> *In Swedish*: "Regeringsrätten".

<sup>5</sup> See RÅ 2001 ref. 79 and RÅ 2007 ref. 84-85.

<sup>6</sup> See Memorandum (Fi2008/4093) of the Swedish Ministry of Finance.

<sup>7</sup> *In Swedish*: "Lagrådet."

<sup>8</sup> See Government Bill 2008/09:65.



largely based on the Ministry of Finance's memorandum, which, consequently, was accepted.

Although revised, the rules regarding limitations of the deductibility of intra-group interest payments were – and still are – subjected to critic by the consultive bodies as well as in the legal debate.<sup>9</sup> The rules are feared to have restrictive effects on normal business activities and, as those restrictive effects affect interest paid by Swedish companies to foreign group members to a larger extent than interest paid to resident group members, it is argued that the rules do not comply with *EU law* and the *freedom of establishment* in particular.

The freedom of establishment, set out in *Article 49 TFEU*, confers a right to all EU nationals to set up companies and therethrough carry on their business under the same conditions as nationals of the host state. According to *Article 54 TFEU*, the freedom of establishment also applies in relation to companies seated within the Union. Hence, the freedom of establishment implies an obligation on the Member States to grant *national treatment* of foreign persons and companies when in the position of *host states*. Furthermore, if in the position of *home states*, the Member State must refrain from applying legislation hindering its nationals from establishing themselves in another Member State. However, under certain circumstances recognised by EU law and on condition that the rules are proportionate, national legislation subjecting foreigners to *special treatment* may be justified.

## 1.2 Purpose and question formulation

The purpose of this thesis is to examine whether the regulations on limitations of the deductibility of intra-group interest payments in the Swedish legislation, set out in Chapter 24, Paragraphs 10a – 10d of the Swedish Income Tax Act, is compatible with EU law or, more specifically, the freedom of establishment as laid out in Articles 49 and 54 TFEU.

In order to achieve this purpose, the following have to be answered:

- Are the Swedish rules on limitations of the deductibility of intra-group interest payments in breach of Articles 49 and 54 TFEU on the freedom of establishment?
- If in breach, is there a valid ground of justification curing the breach?
- If validly justified, are the rules proportionate?

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<sup>9</sup> See e.g. Government Bill 2008/09:65, p. 69-72, Consideration of Svenskt Näringsliv regarding Fi2008/4093, issued 2008-09-29 and Hellenius. Richard, “*De nya ränteavdragsbegränsningarna*” in *Svensk Skattetidning* 2009/2, p. 161.

## 1.3 Method and material

The method used will be a traditional legal dogmatic method. I will review and analyze relevant documents such as statutory acts together with their preparatory work as well as case law and legal writing. The paper will be based on both Swedish and EU sources of law.

In approaching the subject, I will follow the examination pattern used by the Court of Justice when assessing whether a national measure is in breach of the free movement provisions.<sup>10</sup> Accordingly, the first question examined is whether the Swedish rules are contrary to the freedom of establishment, i.e. whether the rules are discriminatory in their application or otherwise have restrictive effects on cross-border movements within the EU. If the rules are found to constitute a breach, I will move on to examine whether there are any possible grounds of justification applicable in the present situation. Finally, if the conclusion is that the rules can be justified, it has to be examined whether the rules are proportionate within the meaning of EU law.

During the course of writing this thesis, the *Treaty of Lisbon*<sup>11</sup> entered into force.<sup>12</sup> The Treaty of Lisbon amends the two core treaties of the European Union, namely *the Treaty on European Union*<sup>13</sup> and *the Treaty establishing the European Community*.<sup>14</sup> The latter is renamed *the Treaty on the Functioning of the European Union*.<sup>15</sup> However, there has been little change to the substantive law contained in the former Treaty. The free movement provisions,<sup>16</sup> which are of particular interest to this thesis, have been renumbered but not subjected to any textual changes. Accordingly, cases and materials concerning these provisions, in context of the previous Treaty, are still relevant sources of law.

## 1.4 Delimitations

The purpose of this thesis is to examine the compatibility of the Swedish rules on limitations of the deductibility of intra-group interest payments

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<sup>10</sup> For more on the Court's examination pattern; see e.g. Hilling, Maria, "Free movement and Tax Treaties in the Internal Market", Uppsala: Iustus Förlag, 2005, p. 90 and Dahlberg, Mattias, "Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital", The Hague: Kluwer Law International, 2005, p. 26.

<sup>11</sup> "Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community", Official Journal of the European Union C 306/50, 17 December 2007.

<sup>12</sup> *Treaty of Lisbon* entered into force on 1 December 2009.

<sup>13</sup> "Treaty on the European Union", Official Journal of the European Union, C 191, 29 July 1992.

<sup>14</sup> "The Treaty establishing the European Community", Official Journal of the European Union, C 325/40, 24 December 2002.

<sup>15</sup> See "Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union", Official Journal of the European Union C 115 of 9.05.2008.

<sup>16</sup> Articles 28-66 TFEU – The Free Movement of Goods, Persons, Services and Capital.

with Articles 49 and 54 TFEU on the freedom of establishment. Consequently, the thesis will only examine the compatibility of the rules in relation to *primary law*. Possible incompatibilities between the Swedish rules in question and *secondary law* therefore falls outside the scope of this study. Furthermore, the thesis will be limited to tax planning schemes involving only establishments within the EU/EEA area.<sup>17</sup>

As mentioned in *Paragraph 1.3*, the subject will be approached in line with the examination pattern of the Court of Justice. However, as regards this thesis, one of the steps of the Court's reasoning has been left out, namely the assessment of *which* of the free movement provisions that is applicable. The interest deduction limitations at issue in this thesis apply to intra-group interest payments, e.g. interest payments made to affiliated companies. According to the Swedish rules, two companies are affiliated if, firstly, either of them has, directly or indirectly, the *deciding influence* over the other company or, secondly, if the two companies are under *principally the same management*. In the *Baars*<sup>18</sup> case, the Court of Justice declared that a national of a Member State, who has a holding in the capital of a company established in another Member State, which gives him *definite influence* over the company's decisions and allows him to determine its activities, is exercising his right of establishment.<sup>19</sup>

Since the national rules at issue concern cross-border payments, one might argue that the *free movement of capital* provision in *Article 63 TFEU* might also be applicable. However, only one of the fundamental freedoms can apply in each case. According to case law of the Court of Justice,<sup>20</sup> legislation such as the legislation at issue in this thesis, which targets only at relations within a group of companies, *primarily* affects the freedom of establishment. Since restrictive effects on the free movement of capital are only an unavoidable consequence of the restriction of establishment, an independent examination of the rules in relation to the free movement of capital is not necessary. However, the scope of the free movement of capital provisions are wider than the scope of the freedom of establishment provisions, which, in principle, does not confer any rights to companies established outside the EU/EEA area. As the thesis is limited to establishments within EU/EEA area, the Swedish rules at issue will be examined in relation to the freedom of establishment only.

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<sup>17</sup> However, in Paragraph 2.2 "*Practical examples*" a tax planning scheme involving the United States is described. The example is included in the thesis for the purpose of illustrate the basic principles of intra-group tax planning with interest deduction only.

<sup>18</sup> C-251/98 *Baars v Inspecteur der. Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787.

<sup>19</sup> C-251/98 *Baars v Inspecteur der. Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787, para. 22. See also C-492/04 *Lasertec* [2007] ECR I-3775, para. 20.

<sup>20</sup> See e.g. C-36/02 *Omega* [2004] ECR I-9609, para. 27, C-452/04 *Fidium Finanz* [2006] ECR I-9521, para. 48 and C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2107, para. 34.

## 1.5 Terminology

As regards this thesis, the expression *host state* refers to the Member State in which business is established. *Discrimination or restrictions in the host state* refers to the situation where the host state applies special treatment to foreign persons to the detriment of such persons. The expression *discrimination or restrictions in the home state* aims to describe the situation where the home state applies rules that will hinder or deter nationals or residents to establish themselves abroad. Furthermore, the expression *outbound dividends* refers to dividends paid by domestic companies to shareholders in other States, seen from a perspective of the state of residence of the paying company. Consequently, the expression *inbound dividends* refers to dividends paid by foreign companies to domestic shareholders. *Domestic dividends* are dividends paid by domestic companies to domestic shareholders.

The entering into force of the Lisbon Treaty also has consequences for terminology. In particular, since the Treaty of Lisbon, the European Union now has legal personality in its own right and absorbs what used to be known as the European Community. Therefore, *the European Union*, *the Union* or *the EU* replaces all references to *the Community* and the term *EU law* is now used instead of *EC law*. However, the term *Community* will still be used in respect of historical references. The former *European Court of Justice* and *Court of First Instance* are renamed *the Court of Justice* and *the General Court* respectively. *The Court of Justice of the European Union* refers collectively to the Court of Justice, the General Court and any specialist Judicial Panels created.<sup>21</sup>

As for the purposes of this thesis, the Court of Justice will, at times, solely be referred to as *the Court*. The term *Treaty* is used as a reference to *the Treaty on the Functioning of the European Union*.

## 1.6 Outline

The following chapter, *Chapter 2*, contains a description of the basic principles of tax planning practices with interest deductions. The purpose is to give the reader a basic understanding of how this type of tax planning is carried out and elucidates the legal framework conditions necessary to achieve the desired tax effects. In *Chapter 3*, the Swedish legislation regarding limitations of the deductibility of intra-group interest payments is described. Naturally, as they are the subject of examination, a description of the content and implications of these rules are essential in order to answer the propounded questions of this thesis.

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<sup>21</sup> Guidelines provided by the *Directorate-General for Translation of the European Commission*, [http://ec.europa.eu/translation/writing/style\\_guides/english/what's\\_new\\_style\\_guide\\_en.pdf](http://ec.europa.eu/translation/writing/style_guides/english/what's_new_style_guide_en.pdf) visited 2009-12-10.

*Chapter 4* deals with the impact of EU law in the field of direct taxation. The chapter aims to provide the reader with a general comprehension on the subject, which is helpful in understanding the further discussion. In *Chapter 5*, the purport of the freedom of establishment is described. Since the Swedish legislation on interest deduction limitations targets interest payments made by companies only, the chapter is focusing on the rights conferred to legal persons. *Chapter 6* concentrates on limitations of the freedom of establishment and how the Court approaches the question of whether a national measure constitutes such a limitation.

In *Chapter 7*, the first question of this thesis will be addressed, namely whether the Swedish rules at issue are in breach of the freedom of establishment. The chapter contains, in addition to the content of the previous chapters, cases and materials of relevance in order to provide an answer to this question. The chapter also provides an analysis based on the presented facts, leading to a conclusion of whether the Swedish rules are limiting the freedom of establishment.

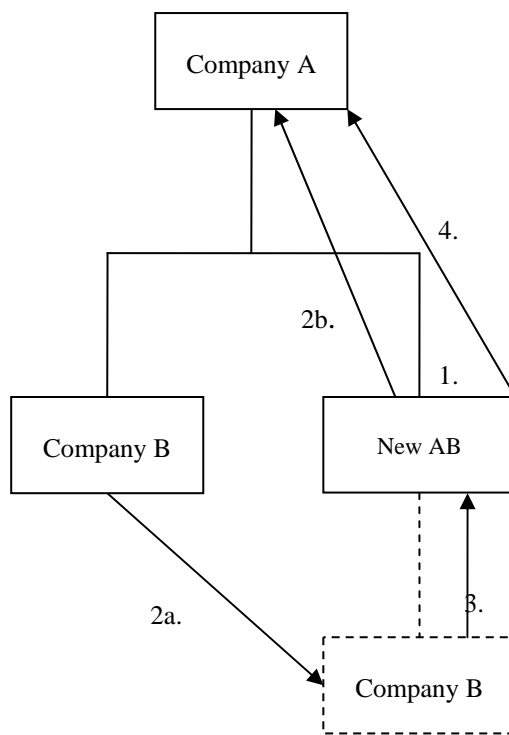
*Chapter 8* contains a description of the different grounds of justification found in the Treaty and in the case law of the Court of Justice. In *Chapter 9*, the second and third question of this thesis will be examined, viz. whether the Swedish rules on interest deduction limitations can be justified and, if so, whether they meet the requirement of proportionality. The chapter contains cases and materials that, beside the information presented in the previous chapter, are pertinent to answer the propounded questions.

Finally, *Chapter 10* provides some conclusive remarks regarding the findings of this thesis.

## 2 Tax Planning Practices with Interest Deductions

### 2.1 The basic principles

The term *tax planning practices with interest deductions* aims to describe a variety of transactions, resulting in tax advantages due to interest deductions made within a group of companies. The transactions in question can be designed in a number of ways, although they display the common feature that while the paying company in Sweden is allowed to fully deduct interest expenses, the corresponding interest income is taxed at a low tax rate or not at all by the receiving company.<sup>22</sup> In this chapter, the *legislation regarding limitations of the deductibility of intra-group interest payments*<sup>23</sup> will be disregarded from, wherefore several of the tax planning practices described below no longer will give rise to the same tax effects. *Figure 1.1* below aims to depict the basic principles of intra-group tax planning with interest deductions:<sup>24</sup>



1.) *Company A* establishes a new Swedish share company, *New AB*.

2a.) *Company A* transfers *Company B*, a wholly owned profit-making Swedish subsidiary, to *New AB* to market price.

2b.) As remuneration, *Company A* receives an interest-bearing bond from *New AB*. The interest of the bond and other terms are market orientated.

3.) *Company B*, now owned by *New AB*, is able to make a group contribution to *New AB*.

4.) *New AB* pays interest to *Company A*. The interest payments are financed by the group contributions made by *Company B* to *New AB*.

*Figure 1.*

<sup>22</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 5.

<sup>23</sup> See Chapter 24, Paragraphs 10a – 10e of the Swedish Income Tax Act.

<sup>24</sup> The design of the figure is based on the description of an example of a so-called “*interest spinner*” outlined by the Swedish Tax Agency in their Proposal regarding Limitations of the deductibility of interest payments on certain loans, issued 2008-06-23 (No 131-348803-08/113), p. 17.

Company A is typically a foreign company, resident in a low-tax jurisdiction. Consequently, the tax imposed on the interest payment received by Company A is low or non-existent.<sup>25</sup> Company B is, according to Chapter 35 of the Swedish Income Tax Act, able to distribute its profit to its Swedish parent company, New AB, by making a group contribution. The received group contribution is included in the taxable income of New AB, but by making use of the unlimited right to deduct interest expenses, the received group contribution can be set off against the interest payments.<sup>26</sup>

New AB is not, according to the Swedish Income Tax Act, able to make a group contribution to Company A, as it is required that the receiving company is liable to pay tax on the corresponding income in Sweden in order for New AB to be able to deduct the group contribution as a cost. Nor can New AB reduce its result by using *transfer pricing*, i.e. transferring underpriced assets or providing underpriced services to Company A, as those prices runs the risk of being adjusted by application of the *correction rule* in Chapter 14, Paragraph 19 of the Swedish Income Tax Act.<sup>27</sup>

## 2.2 Practical examples

Hence, an intra-group tax planning practice with interest deductions involves a distribution of the worked up profit of Company B, via New AB, to another intra-group company, the parent Company A, which for different reasons is subject to more favourable tax treatment than Company B. In the textbook example, the more favourable tax treatment is due to the fact that the company receiving the interest payments is located in a low-tax jurisdiction, many of them being so-called *tax havens*.<sup>28</sup>

Another way, to achieve a more advantageous tax treatment using the interest deduction scheme, is to take advantage of *diverse legislation* of different countries. For instance, USA applies a set of classification rules, often referred to as *Check-the-Box*. These rules implies a possibility for a parent company resident in the US to make the choice of being liable to tax on the revenue of its subsidiaries by checking a certain box in its income tax return form. The parent and its subsidiary are then fiscally regarded as the same tax subject. This condition creates opportunities to obtain tax benefits, since a subsidiary resident in Sweden, which renders interest payments to its American parent company, are able to deduct these payments entirely in Sweden whereas the corresponding interest incomes received by the parent is regarded as a nullity and, hence, those incomes are not subject to tax in the US.<sup>29</sup>

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<sup>25</sup> Tivéus, Ulf. "Räntebetalningar till utlandet på koncerninterna lån finansierade med koncernbidrag – skatteflykt?" in Skattenytt, 2007, p. 687.

<sup>26</sup> Government Bill 2008/09:65, p. 34.

<sup>27</sup> [www.skatteverket.se/skatter/skatteupplagg/rantesnurror.4.3dfca4f410f4fc63c8680009710.html](http://www.skatteverket.se/skatter/skatteupplagg/rantesnurror.4.3dfca4f410f4fc63c8680009710.html) visited 2009-11-11.

<sup>28</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 11.

<sup>29</sup> Government Bill 2008/09:65, p. 35.

Similar rules, where companies within a group, in respect of fiscal matters, are considered as a unified entity, exist in a number of different countries. As regards tax planning practices carried out by Swedish companies, the Dutch so-called *fiscal unity*-rules are one of the most frequently used set of rules.<sup>30</sup>

Tax advantages, by means of interest deductions, could also be achieved in the case when the parent company is a Swedish *tax subject covered by a particular tax regime*. States and municipalities are exempted from tax and, consequently, interest income received by such juridical persons will not be subject to tax.<sup>31</sup> Another tax subject suitable for tax planning of this kind is *investment companies*, i.e. companies whose main business is to hold securities of other companies purely for investment purposes. According to Chapter 39, Paragraph 14 of the Swedish Income Tax Act, investment companies shall deduct dividends paid to its shareholders as a cost.<sup>32</sup> Accordingly, the profit of such companies can be neutralized by setting off acquired interest payments against deductions for dividends paid.<sup>33</sup>

The final practical example described in this paper involves a foreign company within a group, establishing a *permanent establishment*<sup>34</sup> in Sweden. The foreign company obtains a loan from an affiliated company in order to finance the acquisition of shares in Swedish profit-making companies. The foreign company then allocates the loan and the shares to the permanent establishment. Consequently, the permanent establishment in Sweden is under the obligation to make interest payments to the (low-taxed) foreign lender.<sup>35</sup> The interest payments are financed by group contributions from the acquired Swedish companies to the permanent establishment,<sup>36</sup> which enables the profit of the Swedish companies to be distributed and subjected to a more favourable taxation.<sup>37</sup>

The parent company does not have to be the final receiver of the interest payments. In principle, it is possible for the parent to transfer the bond, e.g.

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<sup>30</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 12.

<sup>31</sup> See Chapter 7, Paragraph 2 of the Swedish Income Tax Act.

<sup>32</sup> Lodin, Sven-Olof et al. *"Inkomstskatt: en läro- och handbok i skatterätt"*, Lund: Studentlitteratur, 2009, p. 542.

<sup>33</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 15.

<sup>34</sup> *In Swedish*: "Fast driftställe". A permanent establishment may be defined as a fixed place of business through which activities of an organization are wholly or partially carried on; see Chapter 2, Paragraph 20 of the Swedish Income Tax Act.

<sup>35</sup> A permanent establishment is, according to *Swedish national tax law*, liable to tax on income attributable to the permanent establishment and is, under most international *Double Tax Agreements*, liable to tax in the State in which it is situated. Accordingly, the permanent establishment forms, from a fiscal perspective, a "*separate entity*" from the rest of the enterprise of which it is a part, enabling the foreign enterprise to allocate the liability to make interest payments to its permanent establishment in Sweden.

<sup>36</sup> According to Chapter 35, Paragraphs 2 a and 3 of the Swedish Income Tax Act, group contributions are allowed between a Swedish company and a permanent establishment of a foreign company on condition that the permanent establishment is liable to tax in Sweden.

<sup>37</sup> Tivéus, Ulf. *"Räntebetalningar till utlandet på koncerninterna lån finansierade med koncernbidrag – skatteflykt?"* in *Skattenytt*, 2007, p. 690.



through a *capital contribution*, to a subsidiary of choice. Consequently, this form of tax planning entails a group of companies to transfer its respective profits to the company and tax jurisdiction of preference.<sup>38</sup> However, it should be noted that in order to attain the desired tax advantage, it is required that capital transferred to subsidiaries will not be subjected to *CFC taxation* at the level of the parent company.<sup>39</sup>

## 2.3 Legal framework conditions

The most basic condition in the Swedish tax system, in order to achieve the intended tax effects when tax planning with interest deductions, is the *unlimited deductibility of interest expenses*. The principle that interest is deductible, unless there are explicit rules stating otherwise, is fundamental in the Swedish tax system.<sup>40</sup> Chapter 16, Paragraph 1 of the Swedish Income Tax Act states that interest expenses are deductible irrespectively of if those interest expenses constitute costs for the acquiring or maintaining of an income. Furthermore, interest expenses are, in principle, deductible regardless of if the corresponding interest income is effectively subject to tax by the receiver.<sup>41</sup> Moreover, it is important to note that, interest paid to a non-resident lender is not, according to the Swedish tax rules, subject to source taxation.<sup>42</sup>

Another contributing factor, to the feasibility of the tax planning scheme at issue, is the rules in Chapter 25 a of the Swedish Income Tax Act, which states that capital gains on *shares held for business purposes*<sup>43</sup> are exempted from tax. Hence, the capital gain made by the parent company when transferring the shares of its subsidiary will not trigger any taxation.<sup>44</sup> Finally, the possibility to make *group contributions* is also a factor of relevance, as it enables profit to be distributed from the profit-making company to the recently established company. However, the possibility to make group contributions is not essential for the undertaking of this type of tax planning, since the two companies in question could also be subject to a merger, resulting in that the profitable business activities are carried out in the same company holding the debt.<sup>45</sup>

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<sup>38</sup> [www.skatteverket.se/skatter/skatteupplagg/rantesnurror.4.3dfca4f410f4fc63c8680009710.html](http://www.skatteverket.se/skatter/skatteupplagg/rantesnurror.4.3dfca4f410f4fc63c8680009710.html), visited 2009-11-16.

<sup>39</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 11.

<sup>40</sup> Lodin, Sven-Olof et al. "*Inkomstskatt: en läro- och handbok i skatterätt*", Lund: Studentlitteratur, 2009, p. 94.

<sup>41</sup> Government Bill 2008/09:65, p. 37.

<sup>42</sup> Tivéus, Ulf. "*Räntebetalningar till utlandet på koncerninterna lån finansierade med koncernbidrag – skatteflykt?*" in *Skattenytt*, 2007, p. 691.

<sup>43</sup> In Swedish: "näringsbetingade andelar"; see Chapter 24, Paragraphs 13-16 of the Swedish Income Tax Act.

<sup>44</sup> Dahlberg, Mattias. "*Internationell beskattning*", Lund: Studentlitteratur, 2007, p. 86.

<sup>45</sup> Government Bill 2008/09:65, p. 34.

## 3 Limitations of the Deductibility of Intra-Group Interest Payments

### 3.1 Overview

On January 1, 2009, new rules regarding limitations of the deductibility of interest payments came into force in the Swedish legislation. The rules are found in Chapter 24, Paragraphs 10a – 10e of the Swedish Income Tax Act under the heading: *Limitations of the deductibility of interest payments on certain loans*.<sup>46</sup>

### 3.2 Affiliated companies

Principally, limitations of the right to deduct interest will only affect intra-group transactions, i.e. transactions between *affiliated companies*.<sup>47</sup> Chapter 24, Paragraph 10a of the Swedish Income Tax Act states that two companies are affiliated if, firstly, either of them has, directly or indirectly, the *deciding influence* over the other company or, secondly, if the two companies are under *principally the same management*.<sup>48</sup> It is *the actual influence* over the company that constitutes the deciding factor of whether two companies are considered to be under the same management – not the formal ownership conditions.<sup>49</sup> The term *company* extends to all juridical persons, including states, municipalities and Swedish partnerships. Groups of companies owned by one or several natural persons also fall within the scope of the rules, although, it is only the companies that are considered as being affiliated, not the natural persons.<sup>50</sup>

Naturally, a tax planning practice with interest deductions involving *external parties* brings about the same propitious tax effect as if the transactions in question are carried out within in a group of companies. However, as noted by the Swedish Tax Agency in their survey, there are in many respects considerable differences between internal and external transactions.<sup>51</sup> As regards tax planning practices with interest deductions, at group-level, an internal acquisition of shares that is also internally financed, contrary to a transaction with external elements, only involves an organisational change. Furthermore, there is also the possibility to reiterate internal acquisitions when needed. Accordingly, the Swedish Tax Agency regarded external acquisitions to be motivated by business reasons to a

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<sup>46</sup> *In Swedish*: ”Begränsningar i avdragsrätten för ränta på vissa skulder”.

<sup>47</sup> *In Swedish*: ”Företag i intressegemenskap”.

<sup>48</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 26.

<sup>49</sup> Government Bill 2008/09:65, s. 48.

<sup>50</sup> Government Bill 2008/09:65, s. 46.

<sup>51</sup> See Proposal of the Swedish Tax Agency regarding Limitations of the deductibility of interest payments on certain loans, issued 2008-06-23 (No 131-348803-08/113), p. 20.

greater extent than internal ones, for what reason the need to legislate regarding external acquisitions was not investigated further.<sup>52</sup>

### 3.3 Principal rules

The principal rules, regarding limitations of the deductibility of interest payments on certain loans, are found in Chapter 24, Paragraphs 10b and 10c of the Swedish Income Tax Act. As is plain from the wording of the rules, the expression *certain loans* in the heading of rules extends to any of the three loan situations described below. Common to all loan situations, the company raising the loan has to be a member of a group of companies and the loan has to be obtained in order to finance the acquisition of *shares*<sup>53</sup> in another affiliated company.<sup>54</sup>

*The first loan situation* concerns the typical example, where the lender is an affiliated company. Of the tax planning practices identified by the Swedish Tax Agency, this solution was the most frequently used.<sup>55</sup> *The second loan situation* covered by the rules is when an *interim loan* from an external party is replaced with an intra-group loan. The rules are applicable on the last-mentioned loan provided that they would have been applicable on the first-mentioned loan had the external company been an affiliated company.<sup>56</sup> Finally, *the third situation* extends to loans from an external party to the extent where a company, affiliated with the borrowing company, has a claim on the external party or its affiliates, on condition that the loan can be linked to the claim. This type of loans is called *back-to-back loans*.<sup>57</sup> The rules regarding interim loans and back-to-back loans was introduced into the legislation as to prevent circumventions of the rule governing the typical example, i.e. where the lending company is affiliated with the borrowing company.<sup>58</sup>

### 3.4 Complementary rules

The rules aim to prevent a certain tax planning practice with interest deductions. Such tax planning practices are, as a rule, completely or, at least, mainly motivated by *tax reasons*. The intention is not for the rules to be applicable on *business-motivated* transactions.<sup>59</sup> Therefore, two complementary rules are found in Chapter 24, Paragraph 10d and 10e of the

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<sup>52</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 26.

<sup>53</sup> *In Swedish*: "Delägarrätt". The meaning of the term "*share*" is defined in Chapter 48, Paragraph 2 of the Swedish Income Tax Act.

<sup>54</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 13.

<sup>55</sup> Proposal of the Swedish Tax Agency regarding Limitations of the deductibility of interest payments on certain loans, issued 2008-06-23 (No 131-348803-08/113), p. 20.

<sup>56</sup> Government Bill 2008/09:65, p. 54.

<sup>57</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 33.

<sup>58</sup> Government Bill 2008/09:65, p. 55.

<sup>59</sup> Government Bill 2008/09:65, p. 56.

Swedish Income Tax Act, which exempts certain transactions from the purview of the principal rules described in *Paragraph 3.3*.

### 3.4.1 The “ten percent”-rule

The first complementary rule states that intra-group interest deductions are allowed if the corresponding interest income is taxed at a minimum tax rate of ten percent.<sup>60</sup> The threshold was set at ten percent, as it was, according to statements in the preparatory work, believed to substantially reduce the incentives to carry through the tax planning practices at issue.<sup>61</sup> When determining at what tax rate a particular interest income has been taxed, a *hypothetical test* is used, involving the hypothetical assumption that the interest income is the only income of the receiving company. Accordingly, regard should not be paid to the profit or loss made by the receiving company or to normally deductible expenses. The so-called “ten percent”-rule is, therefore, not applicable in cases where the interest income is not taxed because it is e.g. neutralised by basic allowances or falls below the tax-free threshold.<sup>62</sup>

The determination of the applied tax rate is, in principle, made according to the legislation in the home state of the receiving company. The situation where an outbound interest payment, according to the laws in the state of the receiver, is classified in a deviating way and, for that reason, is exempted from tax falls outside the scope of the “ten percent”-rule.<sup>63</sup> The same applies in the case where the interest payment is treated as a nullity. Furthermore, the rule is not applicable, if the level of taxation accorded to the interest income is less than ten percent, due to the allocation of the interest income to a foreign permanent establishment – irrespectively of what level of taxation prescribed by the laws in the state of residence of the receiving company. Furthermore, the interest income has to be subject to actual taxation in the sense that there should not be a possibility of tax deferral for an indefinite time.<sup>64</sup>

It is the intra-group company that has *the actual right* to the interest income, which is considered the lawful receiver of the interest payments. The meaning of the expression “the actual right” is, as stressed in the preparatory work, correspondent with the English legal term *beneficial owner*.<sup>65</sup> By formulating the rule in such a way, the legislator intends to hinder taxpayers to circumvent it, by directing the interest payment to a temporary receiver,

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<sup>60</sup> Chapter 24, Paragraph 10d, Subsection 1 (1) and Chapter 24, Paragraph 10e, Subsection 1 (1) of the Swedish Income Tax Act.

<sup>61</sup> Government Bill 2008/09:65, p. 59.

<sup>62</sup> Government Bill 2008/09:65, p. 85.

<sup>63</sup> Government Bill 2008/09:65, p. 59-60.

<sup>64</sup> Government Bill 2008/09:65, p. 63.

<sup>65</sup> The term refers, in short, to an individual who enjoys the benefits of owning a security or property, regardless of whose name the title is in.

resident in a state where the tax rate exceeds ten percent, who then passes the income on to the final receiver, situated in a low tax jurisdiction.<sup>66</sup>

As regards companies, which are allowed to deduct dividends paid, i.e. investment companies, special legislation has been introduced. If the Swedish Tax Agency is able to show that the acquisition as well as the loan is not *predominately*<sup>67</sup> *business motivated*, the “ten percent”-rule cannot be applied. A transaction is predominantly business motivated if motivated by business reasons to fifty percent.<sup>68</sup>

### 3.4.2 Principally business motivated transactions

The purpose of the second complementary rule is to exempt transactions, which are subjected to a low tax but are principally business motivated, from the scope of the principal rules regarding interest deduction limitations.<sup>69</sup> The legislator calls, as stated in the preparatory work, attention to the need to exempt these transactions in order to prevent companies being hindered from carrying out its business activities.<sup>70</sup>

The term *principally*<sup>71</sup> *business motivated* extends to transactions, where the businesslike reasons are clearly superior to any other reasons to perform the transaction, such as appropriating oneself tax benefits. In order for a transaction to be classified as a principally business motivated one, the businesslike reasons have to amount to 75 percent. The legislator introduced this prerequisite to emphasize that the rule applies only to transactions where the businesslike reasons are the clearly superior ones but also to draw attention to the fact that the rule does not precludes transactions, which to a minor part are motivated by tax reasons.<sup>72</sup>

The term *business motivated* aims to describe transactions, which are sound from the viewpoint of business economics and/or organisational change. The *Council of Legislation* noted that the expression *business motivated* was used as a diametrical opposite to the expression *motivated by tax reasons*. Since, in principle, the objective to minimize the total expenditure, including tax expenses, is business motivated, the Council proposed that the wording of the rules ought to be altered in order to clarify that the transaction needed to be business motivated *disregarding* all possible tax advantages.<sup>73</sup> However, no such alteration of the rules' wording was made. The Swedish Government regarded that it is in the nature of things that the

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<sup>66</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 35.

<sup>67</sup> *In Swedish*: ”Till övervägande del.”

<sup>68</sup> Government Bill 2008/09:65, p. 65.

<sup>69</sup> Chapter 24, Paragraph 10 d, Subsection 1 (2) and Chapter 24, Paragraph 10e, Subsection 1 (2) of the Swedish Income Tax Act.

<sup>70</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 34.

<sup>71</sup> *In Swedish*: ”Huvudsakligen.”

<sup>72</sup> Government Bill 2008/09:65, p. 68.

<sup>73</sup> Consideration of the Council of Legislation regarding Fi2008/4093, issued 2008-10-06.

expression *business motivated* did not include tax reasons, considering that the rules are anti-avoidance rules.<sup>74</sup> In order for the rule to apply, it is required that both the intra-group acquisition and the internal loan obtained for financing the acquisition, are business motivated.<sup>75</sup> In an *official standpoint*,<sup>76</sup> the Swedish Tax Agency states that it interpret the rule as calling for businesslike reasons on behalf of the lending as well as the borrowing company.

The memorandum of the Swedish Ministry of Finance provides some examples of restructures motivated by organisational reasons that are to be regarded as business motivated. Situations mentioned are e.g. transactions where an external acquisition of a whole group is followed by internal acquisitions of those companies or restructures due to a future external sale of a certain branch of the group.<sup>77</sup> However, in the same official standpoint as mentioned above, the Swedish Tax Agency declares that, in the Agency's opinion, statements in the Government Bill take priority over statements and examples in the previous preparatory works such as the Swedish Ministry of Finance's memorandum.<sup>78</sup> As a consequence, as regards the situation where an external acquisition of a company is followed by an internal acquisition of that company, the Swedish Tax Agency has expressed the opinion that, the external acquisition shall not be given an independent importance, but all relevant circumstances in the present case shall be taken under consideration.<sup>79</sup> Nevertheless, the purpose of the rules is *not* to limit the deductibility of interest payments linked to external acquisitions, wherefore such acquisitions, according to the Swedish Tax Agency, will be one of those circumstances taken under consideration while assessing the tax. However, an external acquisition, financed through exchange of shares, will not be given heed to, as it arises no need to obtain a loan.<sup>80</sup>

Moreover, in order to be able to determine whether a transaction is motivated by business reasons, the Swedish Tax Agency considers it necessary that the taxpayer, who invokes the second complementary rule, provides the Tax Agency with information regarding all stages in the transaction at issue as well as the causes that lies behind it and all other relevant circumstances. As regards the underlying causes, the provided information should contain, in particular, the business reasons motivating both the internal acquisition and the intra-group loan, including the business reasons for choosing the particular lender. Furthermore, information regarding what type of business the lender normally carries out and the lenders position in the group's financing structure is of interest. Examples of other relevant circumstances are in what way the group structure as well as

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<sup>74</sup> Government Bill 2008/09:65, p. 88.

<sup>75</sup> Government Bill 2008/09:65, p. 68.

<sup>76</sup> *In Swedish*: "Skatteverkets ställningstagande".

<sup>77</sup> Memorandum (Fi2008/4093) of the Swedish Ministry of Finance, p. 44.

<sup>78</sup> Official Standpoint of the Swedish Tax Agency, issued 2009-01-29 (No 131 157328-09/111).

<sup>79</sup> Zester, Anita. "Affärsmässiga skäl vad är innebörden" in *Skattenytt* 2009/5, p. 263.

<sup>80</sup> Official Standpoint of the Swedish Tax Agency, issued 2009-01-29 (No 131 157328-09/111).

the finance structure has changed owing to the transaction and how the financing structure is made up within the group, i.e. whether general principles are applied or if there are differences depending on e.g. countries involved.<sup>81</sup>

### 3.5 Burden of proof

As regards the burden of proof, the *general principle* in Swedish tax law is that the burden of proof in respect of taxable income lies on the Swedish Tax Agency, whereas the taxpayer has the burden of proof in respect of deductible expenses. To mark, for any reason, a deviation from this general principle the word *show* is introduced into the wording of the rules, indicating which party bearing the burden of proof.<sup>82</sup>

The Tax Agency is, according to the wording of the rules regarding investment companies, liable to *show* that a transaction subject to inquiry is not predominantly business motivated. In all other cases, the burden of proof is allocated in accordance with the general principle. Consequently, in order to be able to deduct interest on loans, falling within the scope of the general rules, all taxpayers, except investment companies, have to provide information to the Swedish Tax Agency supporting an application of any of the complementary rules.<sup>83</sup>

As a last remark, the expressions *predominantly* and *principally business motivated* do not refer to the *level of proof*, but are only used to bring out clearly that the transactions have to be motivated by business reasons to a certain degree.<sup>84</sup>

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<sup>81</sup> Official Standpoint of the Swedish Tax Agency, issued 2009-01-29 (No 131 157328-09/111).

<sup>82</sup> Government Bill 2008/09:65, p. 72.

<sup>83</sup> Ibid.

<sup>84</sup> Ibid.

# 4 EU Law in the Field of Direct Taxation

## 4.1 Overview

This chapter contains a survey of the legal framework within the Union law in respect of direct taxation. The purpose is to provide a general comprehension on the subject, which is helpful in understanding the further discussion as well as the choice of materials of which it is based upon.

## 4.2 The Treaty and national tax law

The Swedish tax legislation has in many aspects undergone large changes following the EU membership. The field of *indirect taxation* has been subject to an advanced harmonization within the Union. *The Treaty on the Functioning of the European Union* explicitly provides the European Union with the powers necessary for the implementation of such harmonization measures.<sup>85</sup> However, as regards matters of *direct taxation*, there is little explicit reference in the Treaty and it does not contain any provisions, which directly grounds legislative competence to the Union in this field of law.<sup>86</sup> Therefore, *direct taxation*, such as *income taxation*, was, for quite some time, considered as a matter exclusively within the competence of the individual Member States.<sup>87</sup>

The hesitation of the Member States, to delegate competence regarding fiscal matters to the Union, is a reflection of the special significance of the *power of taxation*, as the public funds raised by taxation enables the exercise of its governmental authority. Hence, the power to tax *ensures* the *sovereignty of the state*, signified domestically by supreme authority and internationally as independence under international law.<sup>88</sup> However, despite the scarcity of provisions regarding direct taxation in the Treaty, EU law has exercised a considerable influence on the tax laws in the Member States, a fact that will be examined further in the following paragraphs.

### 4.2.1 Article 115 TFEU

As the Treaty does not provide the European Union with any direct legislative competence regarding direct taxes, EU measures concerning this

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<sup>85</sup> See Articles 110 – 113 TFEU (ex Articles 90 – 93 TEC).

<sup>86</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 44.

<sup>87</sup> Lehner, Moris. “*Limitations of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty*” in EC Tax Review 2000/1, p. 5.

<sup>88</sup> Koefler, Georg W. “*Towards a Homogeneous EC Direct Tax Law; an assessment of the member states*”, edited by Cécile Brokelind, Amsterdam: IBFD, 2007, p. 59.



field of law depends on the *general harmonisation provision* set out in *Article 115 TFEU (ex Article 94 TEC)*.<sup>89</sup> Article 115 TFEU states that the Council shall issue directives for the *approximation of national laws* as directly affect the establishment or functioning of the internal market. In order for the Council to reach such a decision, unanimity is required, which unquestionable limits the prospects of an intra-Union approximation of legislation in the field of direct taxation.<sup>90</sup>

To date, only four directives in respect of direct taxation have been adopted on the basis of Article 115 TFEU, namely *the Parent-Subsidiary Directive*, *the Merger Directive*, *the Interest and Royalty Directive* and *the Savings Directive*.<sup>91</sup> As the question concerning compatibility of the Swedish rules on limitations of the deductibility of intra-group interest payments with secondary law falls out of the scope of this study, the directives will not be examined further.<sup>92</sup>

## 4.2.2 The impact of Court decisions

The Court of Justice is the final interpreter of EU law. *Article 19 (1) TFEU (ex Article 220 TEC)* states that the Court shall ensure that in the interpretation and application of the Treaty the law is observed. In lack of comprehensive legislation, the case law of the Court of Justice has in a substantial way contributed to the development and shaping of the direct tax law within the Union.<sup>93</sup> However, the question of whether the Court was competent in matters of direct taxation was, for some time, disputed.<sup>94</sup> In the *Schumacker*<sup>95</sup> case, the Court stated:

“Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law.”<sup>96</sup>

The *Schumacker* case was the first case in which the Court declared itself competent to decide on national direct tax law’s consistency with EU law and *the fundamental freedoms* in particular. An ever-growing number of cases concerning this issue have since followed, clearing any doubts

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<sup>89</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 18.

<sup>90</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 44.

<sup>91</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 20.

<sup>92</sup> See also Paragraph 1.4 on *Delimitations*.

<sup>93</sup> Hilling, Maria. “*Free movement and Tax Treaties in the Internal Market*”, Uppsala: Iustus Förlag, 2005, p. 35.

<sup>94</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 45.

<sup>95</sup> C-279/93 *Schumacker* [1995] ECR I-225.

<sup>96</sup> C-279/93 *Schumacker* [1995] ECR I-225, para. 21.

regarding the Court of Justice's competence in the field of direct taxation.<sup>97</sup> The resulting case law has, unquestionably, largely affected several components of national taxation systems and provided the Member States with crucial indications on how to develop their tax policies.<sup>98</sup>

A vast number of direct taxation cases has concerned the *fundamental freedoms* provided for in the Treaty. The fundamental freedoms consist of the *free movement of goods, persons, services and capital* between Member States.<sup>99</sup> The free movement provisions are essential for the creation of the *internal market*, which in itself is one of the means for the realisation of the European Union. An internal market is believed to ensure optimal allocation of resources, enhancing the economic welfare of the Member States.<sup>100</sup> The free movement of persons can be divided into two different freedoms, viz. the *free movement of workers* and the *freedom of establishment*.<sup>101</sup> The latter freedom, being the subject of this thesis, is examined further in the following chapter.

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<sup>97</sup> The *Schumacker* case was the first case where the Court expressly dealt with the question of competence in the field of direct taxation, however, it was not the first case concerning matters of direct taxation per se; see cases C-6/60 *Humblet v Belgian State* [1960] ECR 559 and C-270/83 *Commission v France* (“*Avoir Fiscal*”) [1986] ECR 0273.

<sup>98</sup> Cerioni, Luca. “*EU corporate law and EU company tax law*”, Cheltenham: Edward Elgar, 2007, p. 36.

<sup>99</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 70.

<sup>100</sup> Hilling, Maria. “*Free movement and Tax Treaties in the Internal Market*”, Uppsala: Iustus Förlag, 2005, p. 69.

<sup>101</sup> Barnad, Catherine. “*The substantive law of the EU: The Four Freedoms*”, Oxford: Oxford University Press, 2007, p. 249.

# 5 The Freedom of Establishment

## 5.1 Overview

In this chapter, the purport of the freedom of establishment within the meaning of EU law is described. In order to be able to determine whether the Swedish legislation regarding limitations of the deductibility of intra-group interest payments are contrary to the free movement-provision in question, it is, of course, important to elucidate the scope of the rights it confers to the taxpayers. Since the Swedish legislation on interest deduction limitations targets interest payments made by companies only, the chapter is focusing on the rights conferred to legal persons.

## 5.2 Articles 49 and 54 TFEU

The *freedom of establishment* is one of the fundamental freedoms within the EU, which are central to the effective functioning of the internal market.<sup>102</sup> The principal rule regarding the freedom of establishment is set out in *Article 49 TFEU (ex Article 43 TEC)* and reads as follows:

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

Article 49 (1) TFEU provides an obligation of *restrictions* on the freedom of establishment of *nationals* of a Member State in the territory of another Member State shall be prohibited, that is a right to *national treatment*.<sup>103</sup> The first sentence of Article 49 (1) refers to *primary establishments*, i.e. nationals exercising their right of establishment by participating in the incorporation of a company under the laws of another Member State.<sup>104</sup> Article 49 (1), the second sentence, deals with *secondary establishments*,

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<sup>102</sup> Anthony, Arnall. *The European Union and its Court of Justice*, Oxford: Oxford University Press, 2006, p. 462.

<sup>103</sup> Hilling, Maria. “*Free movement and Tax Treaties in the Internal Market*”, Uppsala: Iustus Förlag, 2005, p. 124.

<sup>104</sup> Barnad, Catherine. “*The substantive law of the EU: The Four Freedoms*”, Oxford: Oxford University Press, 2007, p. 332.

involving the situations where a national is setting up branches, agencies or subsidiaries.<sup>105</sup>

## 5.2.1 The rights conferred on legal persons

The term *nationals* primarily refers to individuals or, to use the terminology of the European Union, *natural persons*. However, the rights conferred by Article 49 TFEU extends to *legal persons* as well, a fact that becomes evident as Article 49 TFEU is read in conjunction with *Article 54 TFEU (ex Article 48 TEC)*.<sup>106</sup> Article 54 (1) TFEU provides that:

Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union shall, for the purposes of this Chapter, be treated in the same way as natural persons.

According to case law of the Court, the factor that connects a company with the legal system of a particular state is the *corporate seat* of the company in question, as nationality in respect of individuals.<sup>107</sup> It should be noted that, the reference made by the Court of Justice to the corporate seat includes all three of the criteria mentioned in Article 54 (1) TFEU, namely registered office, central administration or principal place of business.<sup>108</sup> The meaning of the expression *companies or firms* is defined in Article 54 (2) TFEU as companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those that are non-profit making.<sup>109</sup>

All EU-nationals have the right to establish themselves through a primary establishment whereas a secondary establishment requires an already existing establishment within the Union.<sup>110</sup> Companies can exercise their right of primary establishment by participating in the incorporation of a company in another Member State. In that case, *Article 55 TFEU (Article 294 TEC)* ensures national treatment to the out-of-state company as regards participation in the capital of the newly established company.<sup>111</sup> What level of holding needed in order to invoke the freedom of establishment was dealt with in the *Baars*<sup>112</sup> case. The Court stressed that *control or management* of

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<sup>105</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 138.

<sup>106</sup> Barnad, Catherine. “*The substantive law of the EU: The Four Freedoms*”, Oxford: Oxford University Press, 2007, p. 330.

<sup>107</sup> See e.g. C-270/83 *Commission v France* (“*Avoir Fiscal*”) [1986] ECR 0273, para. 18 and C-330/91 *Commerzbank* [1993] ECR I-4017, para. 13.

<sup>108</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 142.

<sup>109</sup> Article 54 (2) TFEU.

<sup>110</sup> Ståhl, Kristina and Roger Persson Österman. “EG-skatterätt”, Uppsala: Iustus Förlag, 2006, p. 92.

<sup>111</sup> Barnad, Catherine. “*The substantive law of the EU: The Four Freedoms*”, Oxford: Oxford University Press, 2007, p. 332.

<sup>112</sup> C-251/98 *Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787.

the company were factors connected with the exercise of the freedom of establishment or in the Court's own words: "... when the holding gives [the shareholders] definite influence over the company's decisions and allows them to determine its activities."<sup>113</sup> However, in the judgment, the Court provided no general guidelines of to determine when those conditions were met, why an analysis on a case-by-case basis is necessary.<sup>114</sup> Although rare, a primary establishment can also occur where a company transfers its seat to another Member State.<sup>115</sup> In order to make the provisions on the right of secondary establishments effective, national rules prescribing that business can be conducted only through primary establishments are prohibited.<sup>116</sup>

Once a company has *accessed the market in the host state*, it must be ensured the enjoyment of national treatment by the host state as long as it continues to exercise the right of establishment. For example, the Court expressed this point of view in the case *Commission v Italy*.<sup>117</sup> The case concerned an Italian law, stating that only companies, in which the majority of the shares were state-held, could conclude agreements in respect of providing public authorities with data-processing systems. As the Court found the law to essentially favour Italian companies, it did not comply with Article 49 TFEU.<sup>118</sup>

The wording of Article 49 TFEU implies that it only prohibits restrictions of the freedom of establishment in the legislation of host state. However, the freedom of establishment also, to some extent, compromises *a right of departure*. As regards the situation where a company is transferring its seat, the home state are, at the present stage of EU law, allowed to impose restrictions on emigrating companies.<sup>119</sup> The case *Daily Mail*<sup>120</sup> concerned an English company that wanted to transfer its seat to the Netherlands in order to avoid paying taxes in the UK. In its judgment, the Court of Justice declared that the freedom of establishment did not confer a right to companies, incorporated under the law of a Member State, to transfer their head office to another Member State while retaining the status under the legislation of the first Member State.<sup>121</sup>

However, by reference to case law of the Court, it appears as if restrictive measures of the right to departure could only be imposed in respect of primary establishments, that is to say when a company transfers its company

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<sup>113</sup> C-251/98 *Baars v Inspecteur der. Belastingen Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787, paras. 22 and 28-31 and C-436/00 *X and Y v Riksskatteverket*, ECR I-10829, para. 37.

<sup>114</sup> Dahlberg, Mattias. "Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital", The Hague: Kluwer Law International, 2005, p. 142.

<sup>115</sup> Barnad, Catherine. "The substantive law of the EU: The Four Freedoms", Oxford: Oxford University Press, 2007, p. 332.

<sup>116</sup> See e.g. C-270/83 *Commission v France* ("Avoir Fiscal") [1986] ECR 0273, para. 22.

<sup>117</sup> C-101/94 *Commission v Italy* [1996] ECR I-2691.

<sup>118</sup> C-101/94 *Commission v Italy* [1996] ECR I-2691, para. 9.

<sup>119</sup> Cerioni, Luca. "EU corporate law and EU company tax law", Cheltenham: Edward Elgar, 2007, p. 71.

<sup>120</sup> C-81/87 *Ex p. Daily Mail* [1988] ECR 5483.

<sup>121</sup> C-81/87 *Ex p. Daily Mail* [1988] ECR 5483, para. 24.

seat. As regards primary establishments, the Court decided in the case *X and Y AB*<sup>122</sup> that Article 49 TFEU precluded the application of provisions hindering a company incorporated under its laws from establishing itself in another Member State.<sup>123</sup>

## 5.2.2 Definition of establishment

Article 49 (2) TFEU deals with the purview of the expression freedom of establishment. As regards companies, the Article in question stipulates that the freedom of establishment include the right to *set up and manage undertakings* under the conditions laid down for its own nationals by the law of the country where such establishment is effected.<sup>124</sup> In the case *Factortame*,<sup>125</sup> the Court of Justice defined the expression further by stating that the concept of establishment within the meaning of Article 49 TFEU et seq. involves "the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period."<sup>126</sup> From this statement, the following three criteria regarding the meaning of the term establishment can be deduced: (1) the person in question has to be engaged in some sort of *economic activity*; (2) the activity has to be of a *permanent nature*; (3) the activity has to have a *cross-border character*.<sup>127</sup>

As regards *the first criterion*, the fact that a company, in order to benefit from the freedom of establishment, has to be engaged in an economic activity is underlined by the wording of Article 54 (2) TFEU, which excludes non-profit-making enterprises from its field of application. Moreover, the economic activity has to be *genuine*, meaning that a company cannot rely on the rights conferred to it by the Treaty if establishing an *artificial arrangement* for the purpose of e.g. enjoying more favourable tax treatment in the host state.<sup>128</sup> Regarding *the second criterion*, an activity of permanent nature has been defined by the Court as the involvement in the economic life of a Member State on a *stable and continuous basis*.<sup>129</sup> *The third criterion* excludes *purely internal situations*, i.e. situations where all the facts are confined within one Member State and therefore no connection with EU law, from the scope of Article 49 TFEU.<sup>130</sup> However, according to

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<sup>122</sup> C-200/98 *X and Y AB v Riksskatteverket* [1999] ECR I-8261

<sup>123</sup> C-200/98 *X and Y AB v Riksskatteverket* [1999] ECR I-8261, para. 26.

<sup>124</sup> Dahlberg, Mattias. "Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital", The Hague: Kluwer Law International, 2005, p. 149.

<sup>125</sup> Case C-221/89 *The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others*, [1991] ECR I- 03905.

<sup>126</sup> Case C-221/89 *The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others*, [1991] ECR I- 03905, para. 20.

<sup>127</sup> European Commission's *Guide to the Case Law of the European Court of Justice on Articles 43 et seq. EC Treaty: Freedom of Establishment*, issued 2001-01-01, p. 17.

<sup>128</sup> See e.g. case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commission of Inland Revenue* [2006] ECR I-7995, para. 35.

<sup>129</sup> See cases C-55/94 *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 28 and C-70/95 *Sodemare* [1997] ECR I-3395, para. 24.

<sup>130</sup> See e.g. C-204/87 *Bekaert* [1988] ECR 2029.

Court's case law,<sup>131</sup> the scope of Article 49 TFEU extends, in principle, to the situation where a national is subjected to *reverse discrimination*, even though the situation appears to lack cross-border elements. Reverse discrimination refers to the situation where a Member State subjects its own nationals to a more burdensome taxation than foreigners or non-residents.<sup>132</sup>

The criteria outlined above are at help as to understand the concept of establishment within the meaning of EU law, although, the list is non-exhaustive. In the *Gebhard*<sup>133</sup> case, the Court stated that the concept of establishment should be interpreted broadly. Considering the various nature and sizes of different establishments, an unambiguous and complete definition of the concept in question is difficult, if not impossible, to create. Therefore, an examination of all relevant facts and circumstances is necessary for a determination of whether an establishment exists.<sup>134</sup>

### 5.2.3 Direct effect

A Treaty provision can be ascribed *direct effect*, enabling companies to take advantage of EU law provisions regardless of national texts, which are there to put them into practice.<sup>135</sup> The basic conditions, in order for a Treaty provision to be ascribed direct effect, are that the provision in question is *clear, unconditional and capable of producing rights for individuals*.<sup>136</sup> The provision has to be clear and unconditional in the sense that the applicability of the provision cannot be dependent upon an eligibility assessment or that further measures are taken by the EU or a Member State.<sup>137</sup> In the *Reyners*<sup>138</sup> case, the Court of Justice declared that the provisions concerning the freedom of establishment had direct effect.<sup>139</sup>

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<sup>131</sup> See e.g. C-107/94 *Asscher v Staatssecretaris van Financiën* [1996] ECR I-3089, para. 32: "...Article [49] nevertheless cannot be interpreted in such a way as to exclude a given Member State's own nationals from the benefit of Community law where by reason of their conduct they are, with regard to their Member State of origin, in a situation which may be regarded as equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty."

<sup>132</sup> Ritter, Cyril. "Purely internal situations, reverse discrimination, Guimont, Dzodzi and Article 234" in *European Law Review* 2006/5, p. 690.

<sup>133</sup> C-55/94 *Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 24.

<sup>134</sup> S:t Clair Renard, Susanne, "Etableringsrätt, fri rörlighet för tjänster" in *Publica EU – en kommentar till EG-rätten* (2/14), edited by Dan Eliasson and Nils Wahl, Stockholm: Norstedts Juridik, 1996, p. 4.

<sup>135</sup> [http://europa.eu/legislation\\_summaries/institutional\\_affairs/decisionmaking\\_process/1145\\_47\\_en.htm](http://europa.eu/legislation_summaries/institutional_affairs/decisionmaking_process/1145_47_en.htm), visited 2009-12-01.

<sup>136</sup> C-26/62 *van Gend en Loos v Nederlandse Administratie der Belastingen* [1963] ECR I.

<sup>137</sup> Bernitz, Ulf and Anders Kjellgren. "Europarättens grunder", Stockholm: Norstedts Juridik AB, 2002, p. 88.

<sup>138</sup> C-2/74 *Reyners v Belgian State* [1974] ECR 631.

<sup>139</sup> C-2/74 *Reyners v Belgian State* [1974] ECR 631, para. 25.

# 6 Limitations of the Freedom of Establishment

## 6.1 Overview

The chapter contains a description of the two different approaches applied by the Court of Justice when determining whether a national tax measure constitutes a restriction of the freedom of establishment. Such a description is essential for the purposes of this thesis, as it provides necessary information of how to approach the question of whether the Swedish rules on interest deduction limitations restrict the freedom of establishment.

## 6.2 The non-discrimination approach

The principle of equal treatment is in close relation with *the principle of non-discrimination*. There are several provisions in the Treaty, giving expression to the latter principle to greater or lesser degree. *Article 25 TFEU (ex Article 12 TEC)* contains a general prohibition of discrimination on the ground of nationality. The general prohibition is supplemented by prohibition provisions targeting certain areas of EU law, such as Article 49 TFEU regarding the freedom of establishment.<sup>140</sup> The Court of Justice has declared that Article 25 TFEU is only to be directly applied on matters, which are not governed by any specific non-discrimination provisions.<sup>141</sup> Accordingly, in matters concerning the freedom of establishment, Article 49 TFEU is to be applied.

### 6.2.1 Definition of discrimination

In order to be able to determine the presence of discriminatory treatment, the meaning of the term *discrimination* has to, of course, first be distinguished. Traditionally, the concept of discrimination within the meaning of EU law has been defined as *different treatment of comparable situations or equal treatment of non-comparable situations*.<sup>142</sup> The term can be divided into two different forms of discrimination, viz. direct and indirect discrimination. *Direct discrimination* is at hand when a national rule expressly stipulates the criterion of nationality, whereas *indirect discrimination* extends to situations where a national rule uses a criterion

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<sup>140</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 64.

<sup>141</sup> Joined cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others, Hoechst AG and Hoechst (UK) Ltd v Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727, para. 38.

<sup>142</sup> Hilling, Maria. “*Free movement and Tax Treaties in the Internal Market*”, Uppsala: Iustus Förlag, 2005, p. 80.



other than nationality but has the same effect as if nationality had been the criterion used.<sup>143</sup>

Generally, cases of *direct discrimination* are, by their nature, quite easily detected. The *Bosman*<sup>144</sup> case, concerning the free movement of workers, provides an illustrative example of national rules resulting in direct discrimination. The case challenged the legality of the system of transfers for football players and the existence of so-called *quota systems*, whereby only a limited number of non-German players were allowed to play in a club match. Obviously, the quota systems were limiting the freedom to contract of professional soccer players who were not German nationals.<sup>145</sup> However, rules that are discriminatory in an *indirect* way may be harder to discover, as they are neutral in their wording. It is not required that a rule, in order to be described as indirectly discriminatory, was *intended* to have such effects – the effect alone is sufficient.<sup>146</sup> Furthermore, according to the Court’s holding in the *O’Flynn*<sup>147</sup> case, a statutory provision need only *be liable* to result in less advantageous treatment to be deemed indirectly discriminatory.<sup>148</sup>

As regards matters of direct taxation, national rules generally do not refer to nationality as a differentiating criterion, but *the residence of the tax subject* or *the source of the income*. Thus, indirect discrimination is common in direct tax matters.<sup>149</sup> However, in respect of corporate taxation, the applications of rules, distinguishing on the basis of *seat* between domestic and foreign companies, which result in unfavourable treatment of the foreign company, are *directly* discriminatory.<sup>150</sup> This follows from the fact that the seat, according to Article 54 TFEU, is the criterion connecting a company to the legal system of a particular Member State.<sup>151</sup> The distinction between the two concepts is not only conceptual, as direct discrimination, in contrast to indirect discrimination, can only be justified on grounds explicitly provided for in the Treaty.<sup>152</sup> Typically, both forms of discrimination will concern the legislation in the host state, but it can also occur in the home state, e.g. in respect of foreign inbound source taxation.<sup>153</sup>

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<sup>143</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 63.

<sup>144</sup> C-415/93 *Union Royale Belge des Sociétés de Football Association ASBL & others v Jean-Marc Bosman* [1995] ECR I-4921.

<sup>145</sup> C-415/93 *Union Royale Belge des Sociétés de Football Association ASBL & others v Jean-Marc Bosman* [1995] ECR I-4921, para. 115.

<sup>146</sup> Hilling, Maria. “*Free movement and Tax Treaties in the Internal Market*”, Uppsala: Iustus Förlag, 2005, p. 84.

<sup>147</sup> C-237/94 *O’Flynn v Adjudication Officer* [1996] ECR I-2517.

<sup>148</sup> C-237/94 *O’Flynn v Adjudication Officer* [1996] ECR I-2517, para. 21.

<sup>149</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 98.

<sup>150</sup> C-311/97 *Royal Bank of Scotland v Greece* [1999] ECR I-265, para. 31.

<sup>151</sup> See Paragraph 5.2.1.

<sup>152</sup> See Paragraph 8.3.

<sup>153</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 64.

## 6.2.2 Objectively comparable situations

As mentioned in the previous paragraph, in order for the non-discrimination principle to apply, it is required that the two compared situations are comparable.<sup>154</sup> The majority of the *comparability-tests* performed by the Court of Justice have concerned the situation of residents compared to the one of non-residents.<sup>155</sup> Generally, according to the Court's case law, the situations of residents and non-residents are *not* comparable. In a number of cases, the Court has held that the reason behind such a general rule is that there are objective differences between residents and non-residents from the point of view of *the source of the income* and *the possibility of taking account of their ability to pay tax*.<sup>156</sup> However, as regards the discrimination analysis applied to companies, the comparison appears, in principle, to be focused on whether a company has been granted the same beneficial tax treatment rather than the company's general situation.<sup>157</sup>

However, the general rule stating that residents and non-residents are not in comparable situations have in the Court's case law, been subjected to several exceptions, largely diminishing its scope. For example, in the case *Royal Bank of Scotland*<sup>158</sup>, the Court of Justice concluded that Greek rules regarding taxation of banks were contrary to the freedom of establishment, as companies seated in a state other than Greece were taxed at a higher rate. The Court declared that there were no objective differences between resident banks and banks established in Greece through branches. The fact that resident banks had unlimited tax liability whereas the tax liability of branches was limited did not prevent the two categories of companies from being considered, all other things being equal, as being in a comparable situation.<sup>159</sup>

The Court has, in a number of cases reiterated its reasoning in *Royal Bank of Scotland*, i.e. that the mere fact that resident companies have unlimited tax liability whereas non-resident companies have limited tax liability does not preclude that these two categories of companies are in objectively comparable situations.<sup>160</sup> In other words, in so far as a Member State asserts

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<sup>154</sup> Barnad, Catherine. *"The substantive law of the EU: the Four Freedoms"*, Oxford: Oxford University Press, 2007, p. 347.

<sup>155</sup> Dahlberg, Mattias. *"Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital"*, The Hague: Kluwer Law International, 2005, p. 100.

<sup>156</sup> See e.g. C-279/93 *Schumacker* [1995] ECR I-225, para. 31-32, C-80/94 *Wielockx* [1995] ECR I-2493, para. 18 and C-311/97 *Royal Bank of Scotland v Greece* [1999] ECR I-265, para. 31. As far as it concerns individuals, as the *Schumacker* and *Wielockx* cases, the ECJ also considers the *personal and family circumstances* of the taxpayer when performing the comparability-test.

<sup>157</sup> Dahlberg, Mattias. *"Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital"*, The Hague: Kluwer Law International, 2005, p. 100.

<sup>158</sup> C-311/97 *Royal Bank of Scotland v Greece* [1999] ECR I-265.

<sup>159</sup> C-311/97 *Royal Bank of Scotland v Greece* [1999] ECR I-265, para. 29.

<sup>160</sup> See e.g. C-307/97 *Compagnie de Saint-Gobain, Zweignieder-lassung Deutschland v Finanzamt Aachen-Innstadt* [1999] ECR I-6161, para. 46-48.

taxing jurisdiction over non-residents, it must, in principle, ensure equality as compared to residents.<sup>161</sup>

### 6.3 The non-restriction approach

As is evident from the more recent case law of the Court of Justice, the Court has tended to gradually extend the prohibition of discriminatory rules to prohibitions of rules that otherwise have a restrictive effect on cross-border movements within the Union.<sup>162</sup> The Court has referred to rules, which have been found to have such effects, as *obstacles*, *hindrances* or *restrictions* to the freedom of establishment.<sup>163</sup> In the following, the term restrictions will be used to describe rules or measures that have restrictive effects on the free movement without constituting discrimination.

One might argue that an extension of the prohibition to also include restrictions is a necessity for the achievement of the overall objectives of the European Union, as prohibition on grounds of discrimination may be considered as too limited.<sup>164</sup> The prohibition of discrimination due to nationality is, in literature, often described as equality-based whereas the prohibition of restrictions is designed as liberty rights.<sup>165</sup> However, it is common that the Court, when applying the non-restriction approach, makes a comparison between a domestic situation, which does not involve the freedom of establishment, and a situation where this freedom has been exercised.<sup>166</sup> The non-restriction approach has i.a. been applied in situations where national disadvantageous measures has not directly affected foreign companies exercising its right to establishment, but their resident subsidiaries.<sup>167</sup> Restrictive measures can occur in both the host state and the home state.<sup>168</sup>

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<sup>161</sup> Ståhl, Kristina and Roger Persson Österman. "EG-skatterätt", Uppsala: Iustus Förlag, 2006, p. 100.

<sup>162</sup> Cordewener, Axel. "Personal Income Taxation of Non-residents and the Increasing Impact of the EC Treaty Freedoms" in *The Influence of European Law on Direct Taxation*, edited by Dennis Weber, Alphen aan den Rijn: Kluwer Law, 2007, p. 35.

<sup>163</sup> Barnad, Catherine. "The substantive law of the EU: "The Four Freedoms", Oxford: Oxford University Press, 2007, p. 349.

<sup>164</sup> Hilling, Maria. "Free movement and Tax Treaties in the Internal Market", Uppsala: Iustus Förlag, 2005, p. 86.

<sup>165</sup> Lehner, Moris. "Limitations of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty" in *EC Tax Review 2000/1*, p. 7.

<sup>166</sup> Hilling, Maria. "Free movement and Tax Treaties in the Internal Market", Uppsala: Iustus Förlag, 2005, p. 87.

<sup>167</sup> Ståhl, Kristina and Roger Persson Österman. "EG-skatterätt", Uppsala: Iustus Förlag, 2006, p. 95.

<sup>168</sup> Dahlberg, Mattias. "Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital", The Hague: Kluwer Law International, 2005, p. 107.

# 7 The Swedish Rules and Possible Limiting Effects on the Freedom of Establishment

## 7.1 Overview

In this Chapter, I will examine and provide an answer to the first question required to achieve the purpose of this thesis:

- Are the Swedish rules on limitations of the deductibility of intra-group interest payments in breach of Articles 49 and 54 TFEU on the freedom of establishment?<sup>169</sup>

In the following paragraph, I will, in order to put the propounded question in the relevant context, shortly summarize the findings of the previous chapters.

## 7.2 Approaching the problem

In approaching the question outlined in the previous paragraph, I will be primarily focusing on the tax planning scheme depicted in *Figure 1*, namely the situation where interest is paid by a Swedish subsidiary (*New AB*) to its low-taxed foreign parent (*Company A*). *New AB* has obtained the loan from *Company A* in order to finance the acquisition of *Company B*, a Swedish profit-making company member of the same group.<sup>170</sup> It is presupposed that all companies involved are capital share companies.

By establishing itself in another Member State through a subsidiary, *Company A* has exercised its right to primary establishment as provided for by the freedom of establishment. Hence, the host state, in this case Sweden, must ensure the enjoyment of *national treatment* to *Company A*.<sup>171</sup> A primary establishment, like *New AB*, is a legal person of its own and its profits will therefore be subject to tax in the state of establishment. The profits of a subsidiary are only subject to tax at the level of the parent company if they are somehow distributed there. With that being said, it should be emphasized that it is the parent company that has exercised its right to establishment and, consequently, is able to invoke the rights provided for by the Treaty – *not* the subsidiary.

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<sup>169</sup> See Paragraph 1.2 "Purpose and question formulation." The second and third question required to achieve the purpose of this thesis will be jointly examined in *Chapter 9*.

<sup>170</sup> See Paragraph 2.1.

<sup>171</sup> See Paragraph 5.2.

The right to national treatment precludes the application of tax rules, which are limiting the parent company from exercising the freedom of establishment, i.e. tax rules that are either *discriminatory in their application* or *otherwise constitute a restriction* of the freedom of establishment. A rule is discriminatory if it distinguishes on the basis of a company's seat (*direct discrimination*) or residence (*indirect discrimination*). The concept of restriction is wider in its application, covering rules that, although not discriminatory, otherwise have restrictive effects on cross-border movements within the Union. In either case, a limitation is at hand when *comparable situations are treated differently* as well as when *non-comparable situations are treated equally*.<sup>172</sup>

## 7.2.1 The Swedish legislation at issue

The Swedish legislation regarding limitations of the deductibility of intra-group interest payments is found in Chapter 24, Paragraphs 10a – 10e of the Swedish Income Tax Act. In Paragraph 10a, the meaning of the expression *affiliated companies* is defined.<sup>173</sup> Paragraphs 10b and 10c contain the *principle rules*, stating that interest expenses are not deductible if attributable to an intra-group loan obtained for the purposes of acquiring shares of another company within the same group as well as *back-to-back* and *interim loans* obtained to circumvent the interest deduction limitation.<sup>174</sup>

Nevertheless, interest payments, which are attributable to loans falling within the scope of the general rules, are deductible provided that any of the two *exception rules* in Paragraphs 10d and 10e is applicable. The first exception rule – the “ten percent”-rule – precludes the application of the general rules in cases where the corresponding interest income is taxed, in the hands of the receiver, at a minimum tax rate of ten percent. In cases where the corresponding interest income is taxed at a lower rate, the second exception rule precludes an application of the general rules if the transaction at issue is *principally business motivated*.<sup>175</sup>

Based on the information above, it can be concluded that the principal rules alone do *not* contain a prerequisite distinguishing either on the basis of seat, nor on the basis of residency. Thus, the principal rules apply in the same manner in relation to interest paid to domestic as well as foreign parent companies of all kinds. However, if the principal rules are read in conjunction with the “ten percent”-rule, a minimum rate of taxation of the corresponding interest income amounting to ten percent is required in order for interest payments to be deductible. Accordingly, as the present corporate tax rate in Sweden amounts to 26,3 percent,<sup>176</sup> interest payments made to

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<sup>172</sup> See Paragraphs 6.2 – 6.3.

<sup>173</sup> See Paragraph 3.2.

<sup>174</sup> See Paragraph 3.3.

<sup>175</sup> See Paragraphs 3.4.1 – 3.4.2.

<sup>176</sup> See Chapter 65, Paragraph 10 of the Swedish Income Tax Act.

parent companies, which are resident in Sweden and subjected to Swedish corporation tax, are always deductible. The question is whether such tax rules, which may, in practice, largely target interest payments to non-resident parent companies, constitute a restriction of the freedom of establishment in the eyes of EU law.

## 7.3 Relevant case law of the Court of Justice

In the following, I will give an account of four cases from the Court of Justice, providing some guidance in respect of how to answer the question whether the Swedish rules constitute a limitation of the freedom of establishment or not. The cases are referred only in so far as they concern this question, thus the parts concerning whether the rules were found to be justified or met the requirement of proportionality is left out.<sup>177</sup>

### 7.3.1 C-374/04 ACT Group Litigation

The case *ACT Group Litigation* concerned a British system of taxation known as *partial imputation*, under which, in order to avoid economic double taxation when a resident company distributed profits, part of the corporation tax paid by that company was imputed to its shareholders.

The basis of the partial imputation system was, on the one hand, advance payment of corporation tax by the company making the distribution, and, on the other hand, a tax credit granted to shareholders who had received a dividend. A payment of dividends by a resident company, granted a tax credit to the ultimate shareholders receiving the dividends on condition that they were either resident in the UK or non-residents seated in a Member State with which the UK had concluded a DTC providing for such a tax credit. However, the rules did not grant a tax credit to other non-resident companies receiving such dividends.

The Court of Justice declared that national tax systems, for the prevention or mitigation of chain taxation in respect of dividends, must apply in the same way in relation to residents as well as to non-residents – provided that they are in objectively comparable situations. The Court stated that, as far as it concerned *inbound dividends*, the situation of resident shareholders was comparable irrespectively of if the dividends were paid from a domestic company or a company resident in another Member State. This was because both dividends deriving from a national source and those deriving from a foreign source might be subject to, *firstly*, in the case of corporate shareholders, a series of charges to tax and, *secondly*, in the case of ultimate shareholders, to economic double taxation.

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<sup>177</sup> The two latter cases, C-324/00 *Lankhorst-Hohorst* and C-524/04 *Thin Cap Group Litigation* are referred in respect these parts, i.e. justification and propotionality, in *Chapter 9*.

However, according to the Court, the same did not apply in respect of *outbound dividends*. When the company making the distribution and the shareholder receiving the dividend were *not* resident in the same Member State, the Member State of residence of the distributing company was not in the same position regarding double taxation as the Member State of residence of the recipient shareholder. The Court acknowledged that a requirement on the State of residence of the distributing company to secure that profits distributed to a non-resident is not subject to double or chain taxation, implies that that State would be obliged to renounce its right to tax a profit generated through an economic activity undertaken on its territory. Furthermore, the State of residence of the recipient shareholder was usually the best placed to determine the shareholder's ability to pay tax. Moreover, such reasoning was found to be in line with the objectives of the *Parent-Subsidiary Directive*<sup>178</sup>, which requires the Member State of the recipient (corporate) shareholder to avoid chain taxation of dividends distributed from a company resident in another Member State. The directive was not applicable in the present case, since the shareholders in question did not meet the requirement of a minimum holding of 25 percent in the capital of the distributing company.

Consequently, in a situation like the one in the present case, the Court held that it is compatible with Community law, when a resident company distributes dividends, for the Member State of residence of that company to grant tax credits only to resident recipient companies and not to non-resident recipient companies which are not taxable in that Member State. The fact that not all of the DTCs concluded between the UK and other Member States provided for a tax credit did not change the conclusion reached by the Court.

### 7.3.2 C-282/07 Truck Center

*Wickler Finances*, a company incorporated and resident in Luxembourg, was holding 48 percent of the share capital of *Truck Center*, a company incorporated and resident in Belgium. Whereas withholding tax under Belgian law was levied on interest on a loan that was paid to the Luxembourg parent, no such withholding tax would have been levied if the parent were a resident of Belgium.

The Court of Justice noted that the effect of the Belgian legislation at issue was that the procedure for the charging of the tax varied, depending on the place where the company receiving the interest had its seat. The Belgian rules therefore appeared to be discriminatory. However, the Court came to the conclusion that, in the present case, the situation of a foreign parent, receiving interest payments from a domestic subsidiary, was *not objectively comparable* to such a situation involving domestic companies only.

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<sup>178</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

Consequently, the rules were not to be seen as limiting the freedom of establishment. The conclusion was based on the following reasoning.

*Firstly*, the Court pointed out that the Belgian State was in different positions depending on whether the receiving company was a resident or a non-resident. In the former case, the Belgian State acted in its capacity as the *state of residence* of the companies concerned whereas, in the latter case, it was acting in its capacity as the *state of source*. *Secondly*, the Court noted that the two situations subject to comparison gave rise to *two distinct charges*, which rested on *separate legal bases*. The Court emphasized that, although withholding tax would not be charged on interest payments made to resident companies, those payments would still be taxed by the Belgian State as they remained subject to corporation tax in the hands of the receiving company. Furthermore, according to the Double Tax Convention between Belgium and Luxembourg, the Belgian state was entitled to tax outbound interest payments. *Finally*, the Court stressed that a resident and a non-resident company were also in different situations with regard to *recovery of the tax*. Contrary to non-resident recipient companies, resident recipient companies were directly subject to the supervision of the Belgian Tax Authorities, which could ensure compulsory recovery of taxes.

The Court of Justice also stated that difference in treatment, resulting from the Belgian tax legislation at issue, did not necessarily procure an advantage for resident recipient companies. In the view of the Court, the reason for this was *partly* that the amount of withholding tax deducted from the interest paid to a non-resident company was significantly lower than the corporation tax charged on the income of resident companies, *partly* because resident companies were obliged to make advance payments of corporation tax.

### **7.3.3 C-324/00 Lankhorst-Hohorst**

*Lankhorst-Hohorst* was a German company, which was wholly owned by the Dutch company *LH BV*. *LH BV* was, on its part, wholly owned by another Dutch company, *Lankhorst Taselbaar*. In 1996, *Lankhorst-Hohorst* obtained a loan from *Lankhorst Taselbaar*, which was repayable over 10 years in fixed annual instalments in addition to interest. The loan, which was intended as a substitute for capital, was accompanied by a *letter of support* under which *Lankhorst Taselbaar* waived repayment if third party creditors made claims against *Lankhorst-Hohorst*. The loan enabled *Lankhorst-Hohorst* to reduce part of its bank borrowing and thus to reduce its interest charges. For the years 1996 – 1998, the balance sheet of *Lankhorst-Hohorst* showed a deficit not covered by equity capital, i.e. it was “thinly” capitalized.

According to German law, interest payments, made to a shareholder with a *determining influence* and who was *not entitled to corporation tax credit*, was, under certain circumstances, regarded as a covert distribution of profits. One such circumstance was if the borrowing company was thinly



capitalized (the applied debt-to-equity ratio was 3:1). Consequently, in its corporation tax assessment notices, in respect of the years 1997 and 1998, the German Tax Authorities took the view that the interest paid to Lankhorst Taselbaar was equivalent to a covert distribution of profits and taxed Lankhorst-Hohorst on them as such at the rate of 30 percent.

The Court of Justice noted that, when examining the existence of an obstacle to the freedom of establishment, a large majority of resident parent companies received a tax credit whereas non-resident parent companies, as a rule, did not. Corporations incorporated under German law, which were exempted from corporation tax and, consequently, not entitled to tax credit were essentially legal persons governed by public law and companies carrying out their business in a specific field or performing tasks benefiting the public good. Against this background, the Court stated that it was apparent that, in principle, the interest paid by a resident subsidiary on loan capital provided by a non-resident parent company was taxed as a covert dividend, whereas, in the case of two domestic companies interest paid was treated as expenditure.

The Court concluded that such a difference in treatment between resident subsidiary companies, based on the seat of their parent company, constituted a *restriction* of the freedom of establishment, which was prohibited by Article 43 TEC (*now* Article 49 TFEU). The fact that the rules also applied in relation to interest payments to resident companies was, in this case, irrelevant. Because of the specific characteristics of the resident companies not entitled to tax credit they could not be validly compared to non-resident companies, like Lankhorst Taselbaar, carrying out its business for profit and subjected to corporation tax.

### **7.3.4 C-524/04 Thin Cap Group Litigation**

The Court, in the *Thin Cap Group Litigation* case, reiterates the reasoning in *Lankhorst-Hohorst*. The case concerned UK thin capitalisation rules, similar to those at issue in *Lankhorst-Hohorst* case. The rules provided that interest paid to a company belonging to the same group, under certain circumstances, was treated as distribution, to the extent that the interest represented more than a reasonable commercial return on the loan. However, interest paid to a non-resident company was treated as distribution, even if the interest was market orientated.

The Court noted that the fact that interest paid to an affiliated company was treated as distribution was capable of increasing the liability of the borrowing company to tax because taxable profits could not be reduced. The UK Government argued, on its part, that the legislation at issue did not constitute a direct and certain obstacle to the freedom of establishment, since it had neither the object nor the effect of making it less attractive for foreign companies to establish themselves in the United Kingdom. Rather, the UK legislation merely distinguished between situations, which were not

comparable. The UK Government held that it was only in a multinational context that a group of companies, by financing a UK subsidiary by loan rather than equity capital, could organise a transfer of profits to a low tax jurisdiction, thereby avoiding UK taxation.

The Court agreed that the risk of tax avoidance through transfer of profits might be higher in a multinational group. However, that did not mean that rules, adopted by Member States for the purposes of dealing with the situation of multinational groups, would not, in some cases, constitute a restriction on the freedom of establishment. Accordingly, the UK rules were found to constitute a restriction of the freedom of establishment, since they made it less attractive for companies established in other Member States to exercise this right and they might, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the UK. The Court stressed that it was sufficient that the rules were *capable* of restricting the exercise of the freedom of establishment and it was *not* necessary that they *actually had the effect* of leading some companies to refrain from acquiring, creating or maintaining a subsidiary in another Member State.

## 7.4 Aspects of EU law in the preparatory work

As mentioned in the introduction chapter,<sup>179</sup> the Swedish rules on interest deduction limitations were criticised for not being compatible with EU law during the legislative process. As a matter of fact, neither the proposal of the Swedish Tax Agency nor the memorandum of the Ministry of Finance contained an analysis from an EU-perspective at all.<sup>180</sup> However, in the Government Bill such an analysis was included, in which the Swedish Government concludes that the rules on interest deduction at issue are *not* in conflict with EU law.<sup>181</sup>

In the bill, the Swedish Government argues that the rules do not involve the application of *different rules in comparable situations* nor do they involve the application of the *same rule in different situations*. According to the Government, the limitation of the deductibility of intra-group interest payments applies irrespectively of whether the lending company is resident in Sweden or in another Member State. Furthermore, the rules are not different in their application in respect of whether the company making the deductions has limited or unlimited tax liability in Sweden. It is stressed by the Swedish Government that the two complementary rules were not introduced due to concerns from an EU perspective. Rather, the incentive was to simplify for the companies and make sure that “normal” business activities were not obstructed.<sup>182</sup>

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<sup>179</sup> See Paragraph 1.1 “*Problem background.*”

<sup>180</sup> See *e.g.* Consideration of the Swedish Bar Association regarding Fi2008/4093, issued 2008-09-01.

<sup>181</sup> Government Bill 2008/09:65, p. 71.

<sup>182</sup> Government Bill 2008/09:65, p. 71.

Several of the *consultive bodies* had an opinion contrary to the one of the Swedish Government, stressing the fact that the rules did in fact have restrictive effects on cross-border movements within the Union.<sup>183</sup> In their opinion, the Swedish rules had obvious similarities with the German legislation at issue in *Lankhorst-Hohorst* and, according to the reasoning in that case, such rules constituted a restriction to the freedom of establishment.<sup>184</sup>

## 7.5 Swedish case law of relevance

Owing to the recent introduction into the Swedish law of the rules limiting the deductibility of intra-group interest payments, case law of the Swedish Courts on the issue is scarce. However, to date, the *Council for Advance Tax Rulings*<sup>185</sup> has dealt with the question on two occasions,<sup>186</sup> of which one is of particular interest from an EU perspective.

### 7.5.1 The Council for Advance Tax Rulings

Delivered on 30 November 2009, the advance ruling in question concerned interest to be paid by *X AB*, a Swedish share company, to *Company Z*, a Belgian company member of the same group as *X AB*. *X AB* was planning to obtain two loans from the Belgian company for the purposes of acquiring shares in two other members of the group, *Company Y* and *Company A* respectively. The question referred to the Council was whether *X AB* would be able to deduct interest payments attributable to those loans, considering the Swedish rules on interest deduction limitations.

The answer to the referred question was partly dependent on whether the rules could be considered as complying with the freedom of establishment. In its decision, the Council refers to the *Truck Center* judgment, which it interprets as expressing the view that national legislation complies with the freedom of establishment, as long as the Member State in question does *not* tax foreign-source income and non-residents in a less favourable way than domestic-source income and residents. From this follows, in the view of the Council, that a requirement prescribing that the interest expense is subject to tax in the other Member State is not contrary to the freedom of establishment. References were in this respect also made to the case *ACT Group Litigation*. The advance ruling has been appealed by the applicant as well as the Swedish Tax Agency.<sup>187</sup>

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<sup>183</sup> See e.g. Consideration of Svenska Bankföreningen, Svenska Fondhandlareföreningen and Finansbolagens Förening regarding Fi2008/4093, issued 2008-09-01.

<sup>184</sup> See e.g. Consideration of Svenskt Näringsliv regarding Fi2008/4093, issued 2008-09-29.

<sup>185</sup> In Swedish: "Skatterättsnämnden."

<sup>186</sup> Advance ruling delivered on 2009-07-06, No 15-09/D and Advance ruling delivered on 2009-11-30, No 13-09/D.

<sup>187</sup> [www.skatterattsnamnden.se/skatterattsnamnden/forhandsbesked/2009/forhandsbesked/2009/inkomstskattskrantesnurra.5.6704c7931254eefbe718000907.html](http://www.skatterattsnamnden.se/skatterattsnamnden/forhandsbesked/2009/forhandsbesked/2009/inkomstskattskrantesnurra.5.6704c7931254eefbe718000907.html), visited 2010-01-17.

### 7.5.1.1 Divergent opinions

The decision of the Council for Advance Rulings was, however, not unanimous. *Dahlberg*, *Hellenius* and *Påhlson* are, with the concurrence of *Alfreds*, of a divergent opinion regarding the question of whether the rules had limiting effects on the freedom of establishment. By referring to the cases *Lankhorst-Hohorst* and *Eurowings*<sup>188</sup>, the divergent members of the Council stated that, even though the rules did not directly differentiate between nationals and non-nationals, in practice, they only affected foreign legal subjects, which constituted a hindrance to the freedom of establishment.

It is noted by the divergent members that, the Swedish rules on interest deduction limitations apply in relation to resident as well as non-resident companies. However, as regards interest payments made to resident companies, the rules at issue only limit the deductibility of those payments if made to companies allowed to deduct dividends paid or legal persons exempted from tax, like e.g. municipalities. In the divergent opinion, it is therefore concluded that the Swedish rules in the majority of cases will affect interest payments to foreign parent companies. Thus, obtaining a loan from a company not resident in Sweden may lead to the disadvantage of not being able to deduct the interest payments and this in turn means that companies may deter from establishing subsidiaries in Sweden or, if the receiving company is another subsidiary within the group, other Member States with low tax rates. Accordingly, the divergent members concluded that the rules constituted a restriction of the freedom of establishment prohibited by the Treaty, unless validly justified.

## 7.6 Analysis

The cases referred in this chapter express two different lines of reasoning, which lead to opposite conclusions in respect of how to determine whether a national tax measure complies with the freedom of establishment. In the following, I will discuss which line of reasoning that ought to be applicable in respect of the Swedish rules regarding limitations of the deductibility of interest on certain loans.

### 7.6.1 The first line of reasoning; *not objectively comparable situations*

The Council for Advance Tax Rulings interpreted the cases *ACT Group Litigation* and *Truck Center* as implying that a national tax measure, which did *not* place non-residents in a less-favourable tax position than residents, complied with the freedom of establishment. Since the “ten percent”-rule was found to apply in the same way to residents as well as non-residents, the

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<sup>188</sup> C-294/97 *Eurowings Luftverkehrs AG* [1999] ECR I-7995.

Council concluded that the Swedish rules on interest deduction limitations did *not* constitute an obstacle to the freedom of establishment. However, in my opinion, the Council's interpretation can be questioned, since the Court in both cases, in fact, *did* find the national measures at issue to place non-residents in a less favourable tax position than residents. In *ACT Group Litigation*, non-residents were placed in a less favourable position since they could not benefit from the partial imputation system and in *Truck Center* since withholding taxes were only levied on interest payments to non-residents. The reason for, that the national rules at issue in the respective cases, did not constitute a restriction of the freedom of establishment was that the situation of residents and non-residents were considered as *not objectively comparable* – *not* because the rules applied in the same way to both residents and non-residents.

Nevertheless, it is true that the Court of Justice, in the *Truck Center* judgment, noticed that the difference in treatment resulting from the Belgian tax legislation at issue did not, for various reasons, necessarily procure an advantage for resident companies compared to non-resident companies in practice. However, this is, as far as I am concerned, a mere observation of the Court and was not the reason that rendered it possible for the Belgian state to subject foreigners to special treatment.

Accordingly, the crucial point to why the national measures in *ACT Group Litigation* and *Truck Center* did *not* constitute a restriction to the freedom of establishment was that residents and non-residents were *not* in *objectively comparable situations*. Therefore, I will continue to examine whether the reasoning in *ACT Group Litigation* and *Truck Center*, in respect of how to perform the comparability-test, can be transferred to the context of the Swedish rules on interest deduction limitations.

### **7.6.1.1 Distinguishing the ACT Group Litigation case**

In the case *ACT Group Litigation*, the point of departure for the reasoning of the Court of Justice was the position of the United Kingdom in its capacity as the state of residence of the company paying the dividends. As far as *domestic dividends* was concerned, the imputation system functioned as intended in that it prevented the dividends from being subject to chain taxation, nevertheless ensuring the United Kingdom the right to tax the profits once. However, in case of *outbound dividends*, an application of the imputation system would result in a transfer of the profits to the tax jurisdiction of the shareholder, without being subject to tax in the United Kingdom. Based on those differences, the Court concluded that the situation of a resident shareholder, receiving dividends from a resident company, was *not comparable* to the situation of a non-resident shareholder, receiving dividends from the same company

Provided that the Court's reasoning in the *ACT Group Litigation* case could be transferred to the context of the Swedish rules regarding interest deduction limitations, the upholding of those rules could be vindicated by

the fact that non-resident parent companies, which receives interest payments from a resident subsidiary, would not be considered as being in a situation objectively comparable to that of resident parent companies. However, as an initial remark, one should be careful to give too wide a meaning to the statements of the Court of Justice. The Court interprets the law on a case-by-case basis, wherefore statements in a specific case, although general in their wording, not necessarily are valid in other cases concerning national measures of another kind or where the relevant circumstances differ.

In my opinion, the fact that a state, depending on whether the recipient company is resident or not, finds itself in either the position of the state of source or in the position of the state of residence, merely describes the basic differences between resident and non-resident taxation. If these differences were to be generally decisive, then residents and non-resident would never be in comparable situations and, as is evident from the Court's case law, such an interpretation is not correct.<sup>189</sup> Consequently, the reasoning in *ACT Group Litigation* in terms of the comparability-test can only be applied in certain situations, one apparently being the situation of resident and non-resident shareholders in respect of *outbound dividends*. Hence, the question is whether it can also apply to the situation of parent companies in respect of *outbound interest payments*.

Even though similar at a first glance, there are, as far as I can see, several non-trifling differences between the payment of dividends and the payment of interest. For instance, the payment of interest reduces the taxable income of the paying company, whereas the payment of dividends does not. Furthermore, it can be argued that the views regarding which state that is entitled to exercise its taxing power are different in respect of dividends and interest respectively. On the one hand, the general standpoint in international tax law, in respect of *dividends*, ought to be *source state entitlement*, i.e. the state in which territory the profits are generated (*the principle of territoriality*). On the other hand, as regards *interest*, the general standpoint ought to be *residence state entitlement*, i.e. the state in which the creditor is resident (*the domicile principle*).<sup>190</sup> These standpoints are also in line with views expressed in the *Parent-Subsidiary* and the *Interest-Royalty Directive* respectively. Moreover, the Swedish and British rules in question do not have the same overall purpose. While the Swedish rules aim to prevent tax avoidance, the intention of the British rules is to prevent economic double taxation. As a consequence, the rules are designed differently, which renders it difficult to make comparisons regarding the situations of the taxpayers in relation to the application of these respective set of tax rules.

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<sup>189</sup> See Paragraph 6.2.2.

<sup>190</sup> See e.g. Kemmeren, Eric C.C.M. "*The Principle of Origin in Tax Conventions – A Re-thinking of Models*", University of Tilburg Ph.D. Thesis, 2001, p 531 and Weber, Dennis. "*Tax Avoidance and the EC Treaty Freedoms: A Study of the Limitations under European Law to the Prevention of Tax Avoidance*", the Hague: Kluwer Law, 2005, p. 110-112.

In the light of the argumentation above, the reasoning of the Court in *ACT Group Litigation* case, which concerns a dividend imputation system, cannot be directly transferred to a situation concerning limitations of the deductibility of interest payments. However, the Court has assumed a similar position, as in the *ACT Group Litigation* case, in the *Truck Center* case, which, indeed, is a case concerning outbound interest payments.

### 7.6.1.2 Distinguishing the Truck Center case

As described in *Paragraph 7.3.2*, the *Truck Center* case concerned Belgian tax rules stating that interest paid to a non-resident company was subject to withholding tax, whereas interest paid to a resident company was not. The Court did not find the rules to restrict the freedom of establishment, as the resident and non-resident recipient companies were not in objectively comparable situations. Just as in the *ACT Group Litigation* case, the position of the Belgian state served as a starting point for the Court's argumentation. Depending on whether the recipient company was resident in Belgium or not, the Belgian state acted either in its capacity as the *state of residence* or in its capacity as the *state of source*. Furthermore, in the *Truck Center* case, the Court observed two additional reasons to why the situation of a resident and a non-resident company is not comparable, namely that the two situations gave rise to two different charges, which rested on different legal bases and that the situation of residents and non-residents differed in respect of the recovery of the tax.

However, even though concerning outbound interest payments, the line of argument in *Truck Center* case is, in my view, *not* transmissible to a situation involving the Swedish rules subject to examination in this thesis. Firstly, although withholding taxes are withheld and directly paid by the debtor, it is the creditor who is subjected to the tax. Accordingly, in case of withholding taxes, the Member States has extended their tax jurisdiction as to include non-residents in terms of interest income, which is *not* the case regarding the Swedish rules on interest deduction limitations. Furthermore, the events in the *Truck Center* case date from the time prior to the entering into force of the *Interest-Royalty Directive*. Today, the directive, in principle, prohibits national measures involving the levying of withholding taxes on interest payments.<sup>191</sup>

Moreover, the two additional reasons delivered by the Court are not convincing. As regards the differences in terms of the recovery of the tax, these are, to my mind, only a consequence of the basic differences between resident and non-resident taxation. These basic differences are not independently decisive, when determining whether a resident and non-resident are in comparable situations.<sup>192</sup> Furthermore, taking the position that a resident and a non-resident are in different situations because they are taxed on separate legal bases implies that once the legal situations are different, even if only to a small extent, the legislator is permitted to treat

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<sup>191</sup> See Article 1 (1) of the Interest-Royalty Directive.

<sup>192</sup> See Paragraph 7.6.1.1.

residents and non-residents completely different. Anyhow, the Swedish tax measure at issue does not involve separate legal bases. With that being said, I will in the following paragraph continue to examine whether the second line of reasoning, which rests upon the cases *Lankhorst-Hohorst* and *Thin Cap Group Litigation*, is more suitable in respect of the Swedish rules regarding interest deduction limitations.

## 7.6.2 The second line of reasoning; objectively comparable situations are at hand

The cases *Lankhorst-Hohorst* and *Thin Cap Group Litigation* concerned German and UK thin capitalization rules respectively. Both sets of rules prescribed that interest, under certain circumstances, was regarded as covert distribution, depriving the paying company the possibility of making deductions for the interest paid. The Court, in both cases, concluded that the rules constituted a restriction of the freedom of establishment.

The German and UK rules are from several different aspects similar to the Swedish rules on interest deduction limitations. Firstly, the aim of the thin capitalization rules at issue in both *Lankhorst-Hohorst* and *Thin Cap Group Litigation* was to prevent the same type of tax planning scheme as the Swedish rules aim to prevent, viz. preventing multinational groups from transferring profits by arranging for interest payments to be deducted in a high or normal tax rate jurisdiction and for the corresponding interest receipts to be taxed in a lower rate jurisdiction. Furthermore, all three sets of rules seek to prevent this type of tax planning by *limiting the deductibility* of interest payments on loans that have *not* been taken out based on *sound business reasons*.

Nevertheless, the rules are different in that while the thin capitalization rules are limiting the deductibility through a re-characterization of the interest payments, the Swedish rules constitute a mere disallowance of interest deductions. However, this does not, as I see it, constitute such a difference, which precludes the Court's reasoning in *Lankhorst-Hohorst* and *Thin Cap Group Litigation*, from being applied in respect of the Swedish rules, since the latter rules have the same *effect* as the former. My conclusion is based on the following reasoning.

According to the UK thin capitalization rules in *Thin Cap Group Litigation*, interest was regarded as covert distributions to the extent that the interest represented more than a reasonable commercial return on the loan. However, interest paid to a non-resident company was always treated as distribution, even if the interest was arm's length. The Swedish rules do not, like the UK rules, *expressively* differentiate between residents and non-residents, since the "ten percent"-rules applies in the same way in either case. However, as can be deduced from *Lankhorst-Hohorst* case, an express differentiation is not necessary in order for a set of rules to be found contrary to the freedom of establishment. The German rules in *Lankhorst-*



*Hohorst* regarded interest as covert distribution provided that the receiving company was not entitled to corporation tax credit in Germany. Even though objective in their application on the surface, the German rules were found to, in practice, affect non-residents to a larger extent than residents, as the former were deemed not to fulfil the requirement of corporate tax credit entitlement. Since a majority of the Swedish resident companies are subjected to Swedish corporation tax exceeding ten percent, interest payments made to such companies are, in principle, always deductible, whereas the same do not necessarily apply to non-resident companies. Hence, as the application of the “ten percent”-rule give rise to the same effect as the German rules, they ought to constitute a restriction of the freedom of establishment in the eyes of EU law.

One might argue that the effect of the Swedish rules is less tangible than the one of the German thin capitalization rules. For a company to be entitled to corporate tax credit it had to be subject to German corporate taxation (i.e. have unlimited liability to tax), resulting in that it was practically impossible for *all* non-residents companies to meet this requirement. Comparatively, a requirement, like the one in the Swedish rules, prescribing that the corresponding interest income has to be taxed by at least ten percent is only affecting *some* of the non-resident companies, i.e. those resident in low-tax jurisdictions. However, the fact that the scope of a tax rule is narrow, resulting in that only a few taxpayers would be affected by the application of it, is not a fact that, in itself, is capable to render it possible for Member States to subject foreigners to special treatment. Furthermore, as the Court emphasized in *Thin Cap Group Litigation*, it is sufficient that the national tax measure is *capable* of restricting the exercise of the freedom of establishment and it is not necessary that it *actually had the effect* of leading companies from establishing a subsidiary in another Member State.

The Court of Justice did not provide any substantial information regarding *why* the situations of a resident and a non-resident parent company are comparable in respect of interest deduction limitations, but merely concluded that a difference in treatment between resident subsidiary companies, based on the seat of their parent company, constituted a restriction of the freedom of establishment. However, the Court provided two circumstances, which did *not* lead to the conclusion that, if those circumstances were at hand, a resident and non-resident company could *not* be objectively compared.

*Firstly*, in *Lankhorst-Hohorst* the Court declared that, the fact that not *all* German corporations were entitled to corporation tax credit did not preclude the possibility of a resident company being in a situation comparable to the one of a non-resident company. This was because the situation of the corporations, which were not entitled to corporation tax credit, could not be validly compared to that of a company carrying on a business for profits and subjected to corporation tax. The German corporations, which were not entitled to corporation tax credit, were essentially legal persons governed by public law or carrying out business in a specific field. Consequently, the fact

that the Swedish rules affect certain resident corporations as well, such as municipalities and investment companies, does not preclude that residents and non-residents are viewed as being in the same situation.

*Secondly*, in *Thin Cap Group Litigation*, the Court stated that the position of companies belonging to a multinational group is not necessarily different to the situation of companies belonging to a purely domestic group. This applies even though tax planning with interest deduction could, in principle, only be carried out in a multinational context. Accordingly, even though the tax planning practice, which the Swedish rules aim to prevent, is, in principle, only feasible in a multinational group, the situation of non-resident parent companies belonging to such a group is not, in respect of interest payments, not different to the one of resident parent companies.

On account to the arguing above, I am bound to agree with the consultive bodies and the divergent members of the Council for Advance Tax Ruling in that, on the basis of the reasoning in the cases *Lankhorst-Horhorst* and *Thin Cap Group Litigation*, the Swedish rules on interest deduction limitations appears to be in breach of the freedom of establishment. It might be added that the case *Eurowings*,<sup>193</sup> referred to by the divergent members of the Council for Advance Tax Ruling, supports such a standpoint, as the reasoning in that case is very similar to the one in both *Lankhorst-Horhorst* and *Thin Cap Group Litigation*.

## 7.7 Conclusion

The conclusion is that the Swedish rules on limitations of the deductibility of intra-group interest payments *are* in breach of Articles 49 and 54 TFEU on the freedom of establishment. Even though the rules appear to be objective in their application, they have the *effect* of affecting only non-resident parent companies with resident subsidiaries. Since the situation of such companies is *objectively comparable* to the one of resident parent companies with resident subsidiaries, special treatment is prohibited.

The conclusion above rests primarily upon the reasoning of the Court of Justice in the cases *Lankhorst-Horhorst* and *Thin Cap Group Litigation*. The reasoning in those cases is suited to be transferred to the context of the Swedish rules, as they aim to prevent the same type of tax planning using the same method.

The reasoning in the cases *ACT Group Litigation* and *Truck Center* can be distinguished from being applicable in the context of the Swedish rules, since it concerns tax measures of a different kind and with a different aim.

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<sup>193</sup> The case is not referred in detail, as it concerns *the freedom to provide services*. Therefore, *Lankhorst-Horhorst* and *Thin Cap Group Litigation*, which concern the freedom of establishment, therefore stood out as the two better cases to refer in a more extensive way.

# 8 Grounds of Justification

## 8.1 Overview

A national measure found to be in breach of the freedom of establishment can still be upheld, if there is a valid justification ground applicable. This chapter contains a description of the different justification grounds recognised by EU law, as they appear in the Treaty as well as those developed in the case law of the Court of Justice.

## 8.2 Justification grounds in the Treaty

Article 52 TFEU (ex Article 46 TEC) provides an express possibility to the Member States to apply provisions in its national legislation that constitute derogation from the freedom of establishment. According to the Article in question, foreign nationals can be subjected to different treatment, on condition that the different treatment is motivated by *public policy*, *public security* or *public health*. Article 52 TFEU is applicable to all kinds of obstacles to the freedom of establishment, i.e. both directly and indirectly discriminatory measures as well as restrictions.<sup>194</sup>

The Court has from the outset stressed that the exceptions contained in Article 52 TFEU must be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without being subject to any control by the European Union's institutions. Those situations, where a tax measure would fall within the material scope of Article 52 TFEU, ought to be rare and, to date; there are no cases where the Court of Justice has justified national tax rules in breach of the freedom of establishment on the ground of this Article.<sup>195</sup>

## 8.3 The rule-of-reason doctrine

In its case law, the Court has introduced new grounds for justifying obstacles to the fundamental freedoms into what has become known as *the rule-of-reason doctrine*.<sup>196</sup> In the *Gebhard*<sup>197</sup> case, the Court has specified four necessary requirements for an obstacle in the national legislation of a Member State to be justified. *Firstly*, the national measure has to be applied

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<sup>194</sup> Hilling, Maria. "Free movement and Tax Treaties in the Internal Market", Uppsala: Iustus Förlag, 2005, p. 95.

<sup>195</sup> Ståhl, Kristina and Roger Persson Österman. "EG-skatterätt", Uppsala: Iustus Förlag, 2006, p. 142.

<sup>196</sup> Dahlberg, Mattias. "Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital", The Hague: Kluwer Law International, 2005, p. 118.

<sup>197</sup> C-55/94 *Gebhard v Consiglio dell' Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

in a non-discriminatory manner. *Secondly*, it must be justified by imperative requirements in the general interest. *Thirdly*, the measure must be suitable for securing the attainment of the objective that it pursues and, *finally*, not go beyond what is necessary in order to attain it (*the principle of proportionality*).<sup>198</sup> The general standpoint in literature is that a justification ground, which has developed as part of the rule-of-reason doctrine, does *not* apply in relation to *direct discrimination*. A literal interpretation of the first requirement outlined above supports such a standpoint.<sup>199</sup> However, with reference to the Court's case law, it is evident that the rule-of-reason doctrine applies in relation to *indirect discrimination*.<sup>200</sup>

As regards indirect discriminatory and restrictive tax measures, a number of grounds of justifications have been put forward before the Court of Justice. However, only the Court has only accepted a handful of those grounds, which will be examined in the following paragraphs.

### 8.3.1 Effectiveness of fiscal control

The Court of Justice has, at least in principle, accepted the *need of an effective fiscal control* as a valid justification ground. In practice, no tax rule has hitherto been justified on this ground, although recognised as a possible ground of justification in i.a. the case *Futura Participations*.<sup>201</sup> In the *Futura Participations* case Luxembourgian tax rules, which required branches to keep an extra set of accounts in order to carry losses forward, could be justified by the need of an effective fiscal control. In the view of the Court, the accounts kept by the “principal company” in its home state did not guarantee that the Luxembourgian Tax Authorities were provided with sufficient information in order to make a correct tax assessment in respect of the branch.

However, the Court did not find the Luxembourgian rules to be proportional, as they required the accounts to be kept in compilation with Luxembourgian law. The Court held that it was sufficient that the taxpayer in question was able to demonstrate the losses he sought to carry forward in a clear and precise way and that it was not essential that the means, by which he demonstrated it, were limited to those provided for by Luxembourg law.<sup>202</sup> The Court also referred to the possibility of exchanging

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<sup>198</sup> C-55/94 *Gebhard v Consiglio dell' Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 32.

<sup>199</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 120.

<sup>200</sup> See e.g. C-204/90 *Bachmann v Belgian State* [1992] ECR I-249 (referred to in more detail in Paragraph 8.3.3) and C-300/90 *Commission v Belgium* [1992] ECR I-305.

<sup>201</sup> C-250/95 *Futura Participation SA & Singer v Administration des Contributions (Luxembourg)* [1997] ECR I-2471.

<sup>202</sup> C-250/95 *Futura Participation SA & Singer v Administration des Contributions (Luxembourg)* [1997] ECR I-2471, paras. 40-43.

information between tax authorities according to *the Mutual Assistance Directive*.<sup>203</sup>

In several subsequent cases, the Court has found national measures, with the objective to consolidate the effectiveness of fiscal control, not required or that they did not meet the test of proportionality. The Court is also stressing that the Mutual Assistance Directive generally provides the Member States with sufficient tools to exchange necessary information. Furthermore, it has been argued that this ground of justification is not, in itself, capable of justifying *material tax rules*, but is only certain *procedural requirements*, like the *burden and level of proof*.<sup>204</sup>

### 8.3.2 The principle of territoriality

The *Futura Participations*<sup>205</sup> case also introduced the fiscal *principle of territoriality* as a ground of justification. The Court of Justice concluded that the principle of territoriality justified the requirement under Luxembourgian law prescribing that losses incurred by a branch of a foreign company, in order to be carried forward, had to be attributable to the branch state.<sup>206</sup> The Court, in the subsequent *Bosal Holding*<sup>207</sup> case, narrowed the scope of the principle, stating that the territoriality defence was limited to situations involving *one taxpayer and one type of tax only*.<sup>208</sup>

However, in the *Marks & Spencer*<sup>209</sup> case, concerning cross border group relief, the principle reappeared in a situation involving two taxpayers. On condition that the rules were proportionate, the Court accepted the principle to justify British rules that excluded (non-definite) losses of foreign subsidiaries from attribution to a domestic parent company, even though losses of domestic subsidiaries could be so transferred.<sup>210</sup> The Court has in the case *N. v Inspecteur*<sup>211</sup> confirmed the reasoning put forward in *Marks & Spencer*.<sup>212</sup>

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<sup>203</sup> Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation.

<sup>204</sup> Ståhl, Kristina and Roger Persson Österman. "EG-skatterätt", Uppsala: Iustus Förlag, 2006, p. 147.

<sup>205</sup> C-250/95 *Futura Participation SA & Singer v Administration des Contributions (Luxembourg)* [1997] ECR I-2471.

<sup>206</sup> C-250/95 *Futura Participation SA & Singer v Administration des Contributions (Luxembourg)* [1997] ECR I-2471, paras. 20-22.

<sup>207</sup> C-168/01 *Bosal Holding BV v. Staatssecretaris van Financien* [2003] ECR I-9409.

<sup>208</sup> C-168/01 *Bosal Holding BV v. Staatssecretaris van Financien* [2003] ECR I-9409, paras. 38-39.

<sup>209</sup> C-446/03 *Marks & Spencer v Hasley (Her Majesty's Inspector of Taxes)* [2005] ECR I-10837.

<sup>210</sup> C-446/03 *Marks & Spencer v Hasley (Her Majesty's Inspector of Taxes)* [2005] ECR I-10837, para. 39.

<sup>211</sup> C-470/04 *N v. Inspecteur van de Belastingdienst Oost/kantoor Alelo* [2005] ECR, I-7409.

<sup>212</sup> C-470/04 *N v. Inspecteur van de Belastingdienst Oost/kantoor Alelo* [2005] ECR, I-7409, paras. 41-42.

### 8.3.3 Fiscal coherence

*Coherence of the fiscal system* is another ground of justification that has been accepted by the Court. Fiscal coherence as a justification ground first appeared in the *Bachmann*<sup>213</sup> case. The case concerned Belgian tax rules allowing a deduction of payments for life insurance contracts, under condition that the payments were made to a Belgian insurer. Mr Bachman was a German national working in Belgium. Mr Bachman was insured by a German insurer, wherefore the Belgian Tax Authorities denied him to deduct his insurance contributions.<sup>214</sup>

The Court argued that since natural persons would normally take out insurance in the state of residence, natural persons working in Belgium but resident in another Member State would be indirectly discriminated against, as they were not allowed to deduct such insurance contributions.<sup>215</sup> The Court then went on to examine whether the rules could be justified. It found that the deductibility of insurance contributions was linked to the liability to tax on sums paid out by the insurer under pension and life insurances. The sums paid out were, according to Belgian law, exempted from tax if there had been no deductions of contributions. It could therefore be justified, on the ground of the need to preserve fiscal coherence, to deny Mr Bachmann a deduction for his insurance contributions, as the sums payable on his German insurance would not be taxable in Belgium.<sup>216</sup>

If interpreted broadly, the *Bachmann* case implies a total upholding of the *principle of reciprocity*, i.e. that deductions in computing income are possible only if the corresponding payments are taxable within the same tax jurisdiction.<sup>217</sup> However, as is evident from subsequent cases on the matter, such broad interpretation is not correct, as the Court has since emphasized the importance of an existing *direct link* between the deduction of e.g. insurance contributions and the taxation of the payable sums from that insurance.<sup>218</sup> The scope of the fiscal cohesion defence has been sized down further by the cases *Wielockx*<sup>219</sup> and *Verkooijen*<sup>220</sup>, from which follows that the application of fiscal coherence as a ground of justification presupposes that the tax rules at issue only concerns *one type of tax as well as only one tax subject*.<sup>221</sup>

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<sup>213</sup> C-204/90 *Bachmann v Belgian State* [1992] ECR I-249.

<sup>214</sup> C-204/90 *Bachmann v Belgian State* [1992] ECR I-249, para. 10.

<sup>215</sup> C-204/90 *Bachmann v Belgian State* [1992] ECR I-249, para. 9.

<sup>216</sup> C-204/90 *Bachmann v Belgian State* [1992] ECR I-249, para. 28.

<sup>217</sup> Knobbe-Keuk, Brigitte. “Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions – Ban and Justification” in EC Tax Review 3/1994, p. 72.

<sup>218</sup> Dahlberg, Mattias. “Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital”, The Hague: Kluwer Law International, 2005, p. 131.

<sup>219</sup> C-80/94 *Wielockx* [1995] ECR I-2493.

<sup>220</sup> C-35/98 *Staatssecretaris van Financiën v BGM Verkooijen* [2000] ECR I-4071.

<sup>221</sup> Terra, Ben J.M. and Peter J. Wattel. “European Tax Law”, Amsterdam: Kluwer Law, 2008, p. 765.

### 8.3.4 Balanced allocation of taxing power

The case *Marks & Spencer*<sup>222</sup>, mentioned in Paragraph 8.3.2 on the principle of territoriality, also introduced the *need to preserve a balanced allocation of taxing power* as a valid justification ground. The Court of Justice stated:

45. (...) the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses.

46. In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.

The concept of balanced allocation of taxing power is, according to *Terra* and *Wattel*, closely linked with both the principle of territoriality and fiscal cohesion, making this ground of justification rather impalpable. In their opinion, the concept in question refers to the legitimate need of tax connecting factors, resulting in a match of tax base reductions and corresponding increases within the same jurisdiction. The close connection to the territoriality principle implies source country over resident country entitlement.<sup>223</sup>

### 8.3.5 Prevention of abuse

The Court of Justice has also accepted loss of tax revenues due to abusive measures on behalf of the taxpayer, such as *tax avoidance* and *tax evasion*, as a valid ground of justification.<sup>224</sup> The case *ICI plc v Colomer*<sup>225</sup> concerned a British tax measure, which allowed joint venture subsidiaries to carry over losses to their parent companies, under condition that the British parent was wholly or mainly holding shares in subsidiaries resident in the United Kingdom. The Court of Justice found the rules to be in breach of the freedom of establishment. The United Kingdom Government argued that the rules at issue were designed to prevent members of a consortium from directing losses of non-resident subsidiaries to resident ones, making the UK a loss dumping ground. Furthermore, the rules aimed, as the other side of

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<sup>222</sup> C-446/03 *Marks & Spencer v Hasley (Her Majesty's Inspector of Taxes)* [2005] ECR I-10837.

<sup>223</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 768.

<sup>224</sup> Pistone, Pasquale. “*European direct tax law; que vadis?*” in *Accounting and Taxation & Assessment of ECJ Case Law*, edited by Michael Lang and Frans Vanistendael. Amsterdam: EATLP International Tax Law Series, 2008. Accessible through: <http://www.eatlp.org/uploads/public/Pistone%20European%20direct%20tax%20law%20quo%20vadis%20-%20version%203.pdf>, visited 2010-01-08.

<sup>225</sup> C-264/96 *ICI plc v Colomer* [1998] ECR I-469.

the same coin, to prevent profits of resident subsidiaries to be accrued to non-resident subsidiaries, thereby escaping taxation in the UK.<sup>226</sup>

While examining the rules, the Court found that they did *not* have the specific purpose of preventing *wholly artificial arrangements*, set up to circumvent the UK tax legislation, from attracting tax benefits. Rather, the rules applied generally to all situations in which the majority of the subsidiaries of the consortium were established abroad – irrespectively of the reasons why. The Court emphasized the fact that the establishment of a subsidiary outside the United Kingdom did not, in itself, necessarily constitute tax avoidance, since the company will in any event be subject to the tax legislation of the state of establishment.<sup>227</sup>

To summarize, the following conditions, for a national measure to constitute an anti-abuse measure capable to justify free movement restrictions, can be deduced from the Court argumentation. *Firstly*, the measure has to specifically target *wholly artificial arrangements*. *Secondly*, it may not be general in its application in that it covers anti-avoidance schemes as well as transactions motivated by sound reasons from a business economic point of view. *Thirdly*, the establishment of a company in another Member State does not entail tax avoidance *per se*. Furthermore, the measure must, of course, also comply with the proportionality test.<sup>228</sup>

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<sup>226</sup> C-264/96 *ICI plc v Colomer* [1998] ECR I-469, para. 23 – 25.

<sup>227</sup> C-264/96 *ICI plc v Colomer* [1998] ECR I-469, para. 26

<sup>228</sup> Dahlberg, Mattias. “*Direct Taxation in Relation to the Freedom of establishment and the Free Movement of Capital*”, The Hague: Kluwer Law International, 2005, p. 240.



# 9 The Swedish Rules and Possible Grounds of Justification

## 9.1 Overview

As concluded in Chapter 7, the Swedish legislation on limitations of the deductibility of intra-group interest payments is in breach of the freedom of establishment. In this Chapter, I will address the second and third question required to achieve the purpose of this thesis:

- Is there a valid ground of justification curing the breach?
- If validly justified, are the rules proportionate?

## 9.2 Approaching the problem

The Swedish rules on interest deduction limitation in Chapter 24, Paragraphs 10a – 10e of the Swedish Income Tax Act were found to constitute a limitation of the freedom of establishment since they were found to affect non-resident companies to a greater extent than resident companies.<sup>229</sup> However, the rules may still be applied, provided that they can be justified by an overriding public interest recognised by EU law.<sup>230</sup> Furthermore, the rules have to meet the requirements of proportionality, meaning that the rules have to be suitable to obtain the objective for which they were adopted as well as not go beyond what is necessary in order to attain that objective.<sup>231</sup>

The Swedish rules at issue aim to prevent the use of a certain type of tax planning, involving intra-group tax planning with interest deductions.<sup>232</sup> The scope of the *general rules* in Chapter 24, Paragraph 10b – 10c of the Swedish Income Tax Act extends to certain types of loan situations, identified by the Swedish Tax Agency as being frequently used in the set up of such tax planning practices that the rules aim to prevent. The textbook example of such a loan situation is the financing of an acquisition of shares in an affiliated company with an intra-group loan.<sup>233</sup>

The purpose of the two complementary rules in Chapter 24, Paragraph 10d – 10e of the Swedish Income Tax Act is to preclude transactions, which are not performed for tax reasons only, from the application of the interest deduction prohibition. According to the “*ten percent*”-rule, interest paid on

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<sup>229</sup> See Paragraph 7.7.

<sup>230</sup> See Paragraph 8.1.

<sup>231</sup> See Paragraph 8.3.

<sup>232</sup> See Paragraph 2.1.

<sup>233</sup> See Paragraph 3.3.

loans where the corresponding interest income is taxed at a minimum rate of ten percent is always deductible. If the corresponding interest income is taxed at a lower rate, interest paid is still deductible provided that the transaction, i.e. the loan as well as the acquisition, is principally business motivated, meaning that the businesslike reasons have to amount to 75 percent.<sup>234</sup> The burden of proof in respect of whether any of the complementary rules apply is, in principle, born by the taxpayer, save where the taxpayer in question is an investment company.<sup>235</sup>

## 9.2.1 Possible grounds of justification applicable in the present case

The Treaty, in *Article 52 TFEU* provides an express possibility to the Member States to apply provisions in its national legislation that constitute a limitation of the freedom of establishment. However, the Article in question is restrictive in its application and has, to date, never justified national tax rules, which are contrary to the freedom of establishment.<sup>236</sup> Against this background, it is highly unlikely that the Swedish legislation on limitations of the deductibility of intra-group interest deductions is justified by virtue of Article 52 TFEU. Accordingly, possible justification grounds remain to be found in the Court's rule of reason doctrine.

As regards *coherence of the fiscal system*<sup>237</sup>, the scope of this defence is limited to *one-tax-one-subject-situations* only. For that reason, it cannot be applied in the present case, since the Swedish rules involve two different tax subjects; the borrowing company and the lending company. Furthermore, the benefit of being able to deduct interest expenses in Sweden is *not directly linked* to the disadvantage of being taxed on the corresponding interest income. Quite the reverse, the Swedish legislation, in principle, does *not* contain a requirement that the corresponding interest income is taxed at the level of the receiver.

Considering that, the Swedish rules were introduced for the purposes of combating a certain type of tax planning, it lies near at hand to plead the *need to prevent abuse*<sup>238</sup> defence. According to the preparatory work, the rules aim to prevent a *specific* tax planning scheme with interest deductions *set up to circumvent* the Swedish legislation for the purposes of attaining more favourable tax treatment. Accordingly, at first glance, the need to prevent abuse appears to be a possible ground of justification, but in order to make a definitive conclusion the issue has to be investigated further (see below).

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<sup>234</sup> See Paragraph 3.3.

<sup>235</sup> See Paragraph 3.5.

<sup>236</sup> See Paragraph 8.2.

<sup>237</sup> See Paragraph 8.3.3.

<sup>238</sup> See Paragraph 8.3.5.

As mentioned in *Paragraph 8.3.1*, the Court has hitherto not justified a *material tax rule* due to the need to ensure an *effective fiscal control*<sup>239</sup> and there is no reason to believe it would apply in respect of the Swedish rules regarding interest deduction limitations, as their application does not primarily lead to tax assessment entanglements. However, argumentation on an effectiveness of fiscal control basis may lead to the justification of certain *procedural requirements*, like i.e. the *burden of proof*.

It can be argued that the Swedish rules on interest deduction limitations may be justified on the basis of the *principle of territoriality*<sup>240</sup>, as their aim is to prevent resident subsidiaries from transferring their profits abroad by means of interest deductions. However, in situations involving abuse, the territoriality defence normally gives way to the prevention of abuse defence, as the latter provides an opportunity to deal with the intent of the taxpayer. The same reasoning applies in respect of the *need to preserve a balanced allocation of taxing power*,<sup>241</sup> considering the close connection between this ground of justification and the principle of territoriality.<sup>242</sup>

## 9.3 Relevant case law of the Court of Justice on abuse

As concluded in the previous paragraph, the *need to prevent abuse* may justify the application of the Swedish rules on interest deduction limitations. In order to be able to examine this further, three cases from the Court of Justice concerning abuse will be referred to in the following paragraphs. The cases are referred to only in so far as they concern the question regarding justification and proportionality.

### 9.3.1 C-324/00 Lankhorst-Hohorst

The case *Lankhorst-Hohorst* concerned German thin capitalization rules that were found to be in breach of the freedom of establishment provisions.<sup>243</sup> As regards possible grounds of justification, the German Government argued that the thin capitalization rules could be justified by the overriding interest in the public interest to prevent abuse of tax law.<sup>244</sup> The government in question submitted that the national measure at issue was intended to combat tax evasion through the financing of a subsidiary through a loan instead of capital contributions, thereby transferring the profit of the

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<sup>239</sup> See Paragraph 8.3.1.

<sup>240</sup> See Paragraphs 8.3.2.

<sup>241</sup> See Paragraph 8.3.4.

<sup>242</sup> Terra, Ben J.M. and Peter J. Wattel. “*European Tax Law*”, Amsterdam: Kluwer Law, 2008, p. 746 and 759-764.

<sup>243</sup> The facts of the case is referred to in more detail in *Paragraph 7.3.1.3*.

<sup>244</sup> The German Government also submitted that the rules could be justified by the concern to ensure effectiveness of fiscal supervision as well as the need to preserve the coherence of the tax system. However, it failed to provide any arguments to *why* those justifications grounds were applicable in the present case.

subsidiary to the parent in the form of interest, which, contrary to dividends, is deductible in calculating the subsidiaries profit.

The Court of Justice noted that the German thin capitalization rules did not have the *specific* purpose of preventing wholly artificial arrangements, but applied generally to any situation in which the parent company had its seat, for whatever reason, in a Member State other than Germany. The Court concluded that the fact that the parent had its seat abroad did not, in itself, entail a risk of tax evasion, since the parent would in any event be subject to the tax legislation in its state of residence. Moreover, no abuse on behalf of the Lankhorst group had been proven in the case, as the loan obtained by Lankhorst-Hohorst did, in fact, result in reducing the company's interest burden.

### 9.3.2 C-196/04 Cadbury Schweppes

The case *Cadbury Schweppes* concerns a UK group, which for the purposes of raising and provide finance to other subsidiaries in the group had set up two subsidiaries in Ireland. The profits made by the Irish subsidiaries were subject to tax at 10 percent under the rules then applicable to companies established in the *International Financial Services Centre* in Dublin, the so-called *IFSC-regime*. The UK applied its CFC-legislation and taxed the UK parent for the profit of the subsidiaries on an arising basis as if it were a branch, crediting the corporation tax paid in Ireland.

The Court of Justice, after concluding that the CFC-rules constituted a restriction on the freedom of establishment, looked into the question of whether the rules could be justified by the need to prevent tax avoidance. It was agreed by the parties that the subsidiaries in Ireland were set up to enable the profit from the intra-group financing transactions to benefit from the low tax regime in Ireland. However, whereas the UK Government argued that the subsidiaries were solely incorporated to avoid UK taxation, the Cadbury Schweppes group maintained that the subsidiaries conducted a commercial business of raising and lending money.

The Court stated that, although appreciating that the subsidiaries were controlled as well as benefiting from a special low tax regime, the establishment of the two subsidiaries did not constitute abuse as long as they were not *wholly artificial arrangements*. As regards the question of how to determine whether an establishment is wholly artificial or not, the Court held that an establishment is to be regarded as genuine where, based on an evaluation of *objective factors* which are *ascertainable by third parties*. According to the Court, such objective factors constituted of particular evidence of physical existence in terms of premises, staff and equipment, i.e. an actual establishment carrying on *genuine economic activities* and not a mere "*letterbox*" or "*front*" subsidiary. Furthermore, the national measure has to have the objective of specifically targeting such artificial arrangement as well as being suitable to achieve that objective.

The Court found the rules to be suitable for achieving their objective, namely the rules made it possible to thwart practises, which had no purpose other than to escape the tax normally due on profits generated by activities carried on in the territory of the Member State in question. The UK CFC-legislation contained a number of exceptions where taxation of the resident company on the profit of the CFC did not apply. Accordingly, the taxpayers had the opportunity to provide information to the tax authorities, which excluded them from application of the CFC-rules. For instance, some of the exceptions exempted the resident company in situations in which the existence of a wholly artificial arrangement appeared to be excluded, e.g. if the CFC distributed a large part of its profit to the UK parent or if it performed trading activities.

If none of the exceptions were found to apply, a so-called *motive test* was performed. The UK parent then had to show that the CFC had not been established for the main purpose of achieving tax benefits. The Court of Justice left to the national court to decide whether the motive test could be interpreted as singling out artificial arrangements only. If the test did single out artificial arrangements only, the rules were justified by the need to prevent abuse.

### 9.3.3 C-524/04 Thin Cap Group Litigation

The case *Thin Cap Group Litigation* concerned British thin capitalization rules, which were found to be in breach of Articles 49 and 54 TFEU.<sup>245</sup> The UK Government held that the rules could be justified by the *need to prevent abuse*.<sup>246</sup> It submitted that, contrary to the German legislation at issue in *Lankhorst-Hohorst*, the UK thin capitalization rules were targeted at a particular form of tax avoidance designed to circumvent the tax legislation in the state of residence of the borrowing company. The rules provided that interest paid to a company belonging to the same group was treated as distribution *only if, and only so far as*, it exceeded what would have been agreed between those companies on an *arm's length* basis.

The Court agreed and stated that the legislation at issue was, in principle, an appropriate means of attaining the objective underlying its adoption. Furthermore, the Court held that the “*arm's lengths*”-test constituted an objective element, which could be independently verified, when determining whether a transaction constituted, in whole or in part, a wholly artificial arrangement. National legislation, containing such objective and verifiable elements, were not considered as going beyond what was necessary on

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<sup>245</sup> The facts of the case is referred to in more detail in *Paragraph 7.3.1.4*.

<sup>246</sup> The British Government also argued that the rules could be justified by the *need of fiscal cohesion*, as the national legislation, through DTCs that had been entered into, ensured that any increase in the taxable profit due to the application of the thin capitalization rules was offset by a corresponding reduction in the taxable profit of the lender in the state in which it is resident. However, the Court of Justice declared that the fiscal cohesion defence could not be applied in such situations.

condition that it fulfilled two conditions. *Firstly*, the taxpayer had to be given, without being subject to undue administrative constraints, the opportunity to provide evidence of commerciality of the transaction and, *secondly*, the re-characterisation of interest paid as a distribution had to be limited to the proportion of that interest exceeding arm's length commercial terms. Accordingly, although constituting a restriction of the freedom of establishment, the application of the UK thin capitalisation rules could be justified by need to prevent abuse. Furthermore, the rules fulfilled the requirements of proportionality.

## 9.4 The Commission's Communication on anti-abuse measures

The *Commission* has issued a *Communication*<sup>247</sup> on the application of anti-abuse measures in the area of direct taxation. The purpose is to provide the Member State with information of how to, in the Commission's opinion, 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 Communication principally contains an analysis of the principles flowing from the relevant case law of the Court of Justice.<sup>248</sup> A large part of the contents of the Communication has already been dealt with in the previous paragraphs of this chapter, e.g. that tax avoidance rules must target wholly artificial arrangements only and the criteria differentiating such arrangements from those carrying out economic activities which are genuine. However, some of the content shed some new light on the issue. For instance, by referring to AG Geelhoed's opinion in *Thin Cap Group Litigation*, the Commission declares that:

“...the setting out of certain *reasonable presumptive criteria* contributes to a balanced application of national anti-abuse measures as it is in the interests of both *legal certainty* for taxpayers, and *workability for tax authorities*.”<sup>249</sup>

Furthermore, the real and subjective intentions of the taxpayer can only be determined on a case-by-case basis, wherefore the entire burden of proof should be born by the taxpayer. Moreover, in the view of the Commission, increases of the taxable income due to the application of anti-avoidance rules should be limited to the extent that is attributable to the purely artificial arrangement.<sup>250</sup>

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<sup>247</sup> COM (2007) 785 final. “*The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries.*”

<sup>248</sup> COM (2007) 785 final. “*The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries*”, p. 2.

<sup>249</sup> Opinion of AG Geelhoed in C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2107, para. 66.

<sup>250</sup> COM (2007) 785 final. “*The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries*”, p. 5.

## 9.5 Aspects of EU law in the preparatory work

Since the Swedish Government is of the opinion that the rules on interest deduction limitations are *not* in conflict with EU law, the legislative bill does not provide much information in respect of the Government's view regarding possible grounds of justification as well as regarding the proportionality of the rules from an EU perspective.<sup>251</sup> However, the Government stresses that the scope of the rules is very narrow, as their application, in principle, is limited to intra-group acquisitions financed through internal loans. Furthermore, most interest payments on such loans are deductible on the basis of the "ten percent"-rule. The Swedish Government concluded that, in order to prevent tax avoidance, cause was given for high demands on the transaction being business motivated.<sup>252</sup>

The consultive bodies are primarily arguing, by referring to the case *Thin Cap Group*<sup>253</sup>, that the rules are not proportionate, as they are not targeting purely artificial arrangements only. However, the rules would fit the proportionality requirements if the word *principally* was removed from the wording of the second complementary rule in Chapter 24, Paragraph 10e of the Swedish Income Tax Act. The consultive bodies held that, in its present wording, the rules in question applied to business-motivated transactions if they were not business-motivated enough.<sup>254</sup>

## 9.6 The Council for Advance Tax Rulings

The Council for Advance Tax Rulings decided, in its advance ruling of 30 November 2009, that the Swedish rules regarding interest deduction limitations complied with the freedom of establishment. Consequently, the Council did not have to examine the question of whether the rules could be justified.<sup>255</sup> However, the members of the Council having a divergent opinion state that the rule could be justified on the ground of the need to prevent abuse, but in their current design, the rules are not proportionate, as they are not targeting purely artificial arrangements only. The divergent members refer on this part to the cases *Cadbury Schweppes* and *Thin Cap Group Litigation*.<sup>256</sup>

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<sup>251</sup> See Paragraph 7.4.

<sup>252</sup> Government Bill 2008/09:65, p 68.

<sup>253</sup> See Paragraph 9.3.3.

<sup>254</sup> Government Bill 2008/09:65, p. 66.

<sup>255</sup> See Paragraph 7.5.1.

<sup>256</sup> Advance ruling delivered on 2009-07-06, No 15-09/D and Advance ruling delivered on 2009-11-30, No 13-09/D.

## 9.7 Analysis

In the following, I will discuss whether the Swedish rules regarding limitations of the deductibility of intra-group interest payments can be justified and whether they are proportional. Since the question of proportionality to a large extent concurs with, or at least is enclosed within, the question of justification, these two questions will be jointly dealt with.

In order for national tax rules, which have been found contrary to EU law, to be justified by need to prevent abuse, the rules have to have the objective to prevent *specific abusive measures*. As already concluded in *Paragraph 9.2.1*, the Swedish rules regarding limitations of the deductibility of intra-group interest payments do have such a purpose, as they aim to prevent a certain type of tax planning based on the unlimited deductibility of interest. However, a justification also requires that the rules are *suitable for securing the attainment of the objective that they pursue*. Moreover, the rules also have to be *proportionate*, in that they do *not go beyond what is necessary* in order to attain the objective in question.

Contrary to what might be inferred from the *Lankhorst-Hohorst* ruling, the Court in *Thin Cap Group Litigation* held that thin capitalization rules, in principle, were effective as a tool in preventing the diversion of profits. As discussed in *Paragraph 7.6.2*, the Swedish rules on interest deduction limitations aim to prevent the *same type of tax planning* as the rules at issue in *Lankhorst-Hohorst* and *Thin Cap Group Litigation*. Furthermore, the *means* by which such tax planning is thwarted are the same as well, i.e. limiting the deductibility of interest expenses. Considering this one can conclude, that tax planning with interest deduction constitutes such an abusive measure whose prevention may justify the application of rules, which are otherwise prohibited as they are contemplated as contrary to EU law. Moreover, one can expect the method of prevention contained in the Swedish rules to be accepted, in principle, as a suitable means to combat such tax planning practices.

Nevertheless, as the Court has held on numerous occasions, anti-avoidance rules are only compatible with EC law in so far as they apply to *purely artificial arrangements* entered into for tax reasons alone. In order to differentiate the wholly artificial arrangements from the ones motivated by business reasons, the Swedish rules allows interest to be deducted in cases where the transaction in question either falls within the scope of the “*ten percent*”-rule or is *principally business motivated*.

With reference to the Court’s statements in respect of the British rules at issue in *Cadbury Schweppes*, the “*ten percent*”-rule ought to qualify as “...an objective element which can be independently verified in order to determine whether the transaction in question represents, in whole or in part,



a purely artificial arrangement.”<sup>257</sup> Accordingly, the “ten percent”-rule contributes to, as AG Geelhoed pointed out in his opinion in *Thin Cap Group Litigation*, legal certainty for taxpayers as well as a more workable and efficient tax assessment. Furthermore, the threshold of ten percent is, as I see it, a *reasonable criterion*, as the incentives of setting up tax planning practices with interest deduction ought to be substantially reduced in case the recipient company is subject to a tax rate higher than that.

However, as is evident from the Court’s case law, rules that distinguish on the basis of presumptive criteria only, no matter how reasonable they may be, do not meet the test of proportionality, as the taxpayers must be given the opportunity to overthrow the presumption. The second complementary rule contained in the Swedish rules, stating that interest is still deductible on condition that the transaction is principally business motivated, does provide the taxpayers with such an opportunity. The rule in question has obvious similarities with the *motive test* contained in the British CFC-legislation at issue in *Cadbury Schweppes*. In *Cadbury Schweppes*, the Court declared that the British CFC-rules could only be justified by the need to prevent abuse on condition that the motive test could be interpreted as singling out *wholly artificial arrangements* only. Hence, the question is whether the Swedish rule, requiring the transaction to be principally business motivated, excludes *wholly artificial arrangement* only.

According to statements in the preparatory work, the expression *principally business motivated* extends to transactions, where the businesslike reasons are clearly superior to any other reasons to perform the transaction, such as appropriating oneself tax benefits. Hence, even though subject to critic, the expression *business motivated* in the wording of the rules is used as a diametrical opposite to the expression *motivated by tax reasons*. In order for a transaction to be classified as principally business motivated, the businesslike reasons have to amount to 75 percent.<sup>258</sup> In the government bill it is advocated that the degree of business likeness is determined through an overall assessment of all relevant circumstances. However, the government bill does not offer any *explicit* guidance on the criteria of how to determine and quantify the level of commerciality.<sup>259</sup>

The use of the expression *business motivated* as signifying the complete opposite to *tax motivated* is not entirely in accordance with the usage of those expressions within EU law. In *Cadbury Schweppes*, the Court of Justice expressively confirmed that it is quite legitimate for tax considerations to play a role in the decision on e.g. where to establish a subsidiary. The Court held that, the objective to minimize the total expenditure, including tax expenses, was in itself a valid commercial

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<sup>257</sup> C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-2107, para. 81.

<sup>258</sup> See Paragraph 3.4.2.

<sup>259</sup> The memorandum of the Swedish Ministry of Finance provides some examples of organisational restructures, which, in principle, are to be considered as being business motivated, see Paragraph 3.4.2.

consideration. However, the commerciality of that objective had its limits. An arrangement could not be considered as commercial if it amounted to artificial transfers of profits. If, in the *Cadbury Schweppes* case, the Irish subsidiaries were incorporated *solely* to avoid UK taxation, they were to constitute wholly artificial arrangements, whereas they were not considered as such provided that they were otherwise conducting a commercial business of some sort. Hence, in order for an establishment or a transaction to be considered as wholly artificial, a *total* lack of business purposes is required.

Based on the reasoning above, one could conclude that there is an obvious discrepancy between not allowing a deduction unless a transaction is *principally business motivated* and not allowing a deduction because a transaction is *not business motivated at all*. In its present wording, the Swedish rules on interest deduction limitation will affect transactions, which are business motivated, although not business motivated *enough*. Accordingly, since the second complementary rule, in the view of EU law, goes beyond what is necessary to attain the objective that they pursue, they are not proportional. However, this deficiency can be rectified by removing the word *principally* from the wording of the rule.

Furthermore, I would like to draw attention to the conclusion made by the Court of Justice in *Thin Cap Group Litigation* that the re-characterisation of interest paid had to be limited to the proportion of that interest exceeding arm's length commercial terms. This implies that adjustments to the taxable income, resulting from the application of the anti-abuse rules, should be limited to the extent that is attributable to the purely artificial arrangement. Such a requirement stands out as legitimate, since the application of the rules then puts the taxpayer in the same position as if he had carried out his business genuinely, i.e. if he had not relied on abusive measures.

As regards the *Thin Cap Group Litigation* case, the paying company would be allowed to deduct interest to the same extent as if it had obtained the loan from a third party, whereas the rest would be taxed as profits paid as dividends. In its state of residence, the receiving company would be taxed on the part classified as interest on the same footing as the rest of its profits, whereas it would not be taxed on the part classified as dividends by application of the Parent-Subsidiary Directive. Accordingly, the taxpayers are placed in the same position as if they had carried out their business genuinely from a *group perspective* as well. The same applies in the *Cadbury Schweppes* case, where the British parent would be taxed on the profit of the subsidiaries, but also credited the corporation tax paid in Ireland. However, this is *not* the case with the Swedish rules on interest deduction limitations, according to which interest deductions are denied as a whole. This puts the taxpayers, at least at a group level, in a position worse than if they would not have resorted to abusive measures. This is because the taxable income of the subsidiary will not be reduced if interest deductions are denied, whereas the receiving company will still be taxed on the corresponding interest income.

Moreover, I would like to comment the interpretation of the Swedish Tax Agency in respect of the second complementary rule requiring both the acquisition and the loan to be principally motivated. In an official standpoint, the Swedish Tax Agency has interpreted the rule as calling for businesslike reasons on behalf of the borrowing *as well as* the lending company.<sup>260</sup> In my view, there are reasons to argue that an examination of the motives of the *lending company* is superfluous – or maybe even in conflict with the principle of proportionality. As concluded above, national anti-abuse rules may target wholly artificial arrangements only in order to be justified in the eyes of EU law. As long as the intentions of the borrowing company are found to be business motivated, even if only to a small extent, an interest deduction cannot be denied because the lending company has no such intentions, since the transaction would then not be wholly artificial.

As a last remark, I would like to shortly point out some procedural implications of the rules and, in particular, difficulties in respect of the providing of evidence. As described in *Paragraph 3.5*, the burden of proof, in order for any of the two complementary rules to apply, falls on the taxpayer. From the an effectiveness of fiscal control perspective, there are legitimate reasons for placing the burden of proof on the taxpayers in question, as they are, obviously, the most fitted to acquire such evidence. It is only the taxpayers themselves who know what intentions that underlie the performance of certain transactions.

However, the taxpayers cannot be subject to *undue administrative constraints* in producing the evidence. Even though it is emphasized in the preparatory work that the word *principally* is not referring to the *level of proof*, one may still fear that the assessment of whether a transaction is principally business-motivated or not may give rise to difficulties in respect of the providing of evidence. Not least, considering the many circumstances the Swedish Tax Agency regards as necessary in making such assessment.<sup>261</sup> Furthermore, it can be questioned whether the level of commerciality of a certain transaction can be quantified at all, without risking that such assessments are in a too subjective and discretionary way.

## 9.8 Conclusion

The conclusion is that the Swedish rules regarding limitation of the deductibility of intra-group interest payments *can be validly justified* by the need to prevent abuse, since the rules aim to prevent a specific abusive measure and the means by which such abusive measures are thwarted are suitable for securing the attainment of that objective.

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<sup>260</sup> See Paragraph 3.4.2.

<sup>261</sup> Ibid.

However, the rules are *not proportionate*, as they go beyond what is necessary to attain the objective in question. In order for anti-avoidance rules to be proportional, they can only target wholly artificial arrangements entered into for *tax purposes only*. The second complementary rule prescribes that a transaction has to be *principally business motivated*, meaning that the transaction has to be business motivated to 75 percent. Considering this, the rules will affect business-motivated transactions, which do not meet the requirement of commerciality on 75 percent but still do *not* constitute wholly artificial arrangements. This deficiency could be rectified by removing the word *principally* from the wording of the rule.

The conclusion above rests upon the reasoning of the Court of Justice in the cases *Lankhorst-Horst*, *Cadbury Schweppes* and *Thin Cap Group Litigation*.

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- C-6/60 *Humblet v Belgian State* [1960] ECR 559.

## **Opinions of the Advocate General**

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## **Rulings of the Council for Advance Tax Rulings**

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Advance ruling delivered on 2009-07-06, No 15-09/D