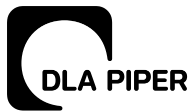

The 2019 interest deduction limitation rules in the light of the Lexel v. Skatteverket-verdict

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On March 22 this year, the verdict came in the well-known Lexel case (case no 4849-18 and 4849-18) where the 2013 interest deduction limitation rules were discussed. The case concerns whether the Swedish rules regarding interest deductions could be considered to restrict the freedom of establishment in a prohibited way. The freedom of establishment is one of the fundamental rights, established by the European Union and it can only be restricted if it is in accordance with Article 49 in the Treaty on the Functioning of the European Union (TFEU). The Swedish company Lexel AB (equivalent to a UK Ltd) was denied deduction for interest expenses paid to a French group company. The decision was appealed with regards to the freedom of establishment, after which The Supreme Administrative Court of Sweden sought a preliminary ruling from The Court of Justice of the European Union (CJEU) to clarify the question. Many law firms now have the task to interpret and evaluate the 2019 regulations in the light of the verdict and especially in the light of the preliminary ruling from the CJEU (Lexel v. Skatteverket, C-484/19, the 20th of January 2021).

The legal development /background

The interest deduction rules regulate to what extent a company's interest expenses can be deducted in the taxation of a company's business activities. For a long time, there were no restrictions in this right to deduct

interest costs, which opened up for the possibility of tax planning. This tax planning became particularly noticeable from the year 2003 when capital gains on sales of business-related shares became tax-free. An opportunity was thus created for Swedish limited companies to create intra-group loans through such sales, allowing interest costs to be deducted in a Swedish limited company while interest income was recognized in a foreign group company with no or lower taxation than Sweden. To limit this, restrictions on the right to deduct interest costs, were added in 2009 and the rules have since undergone major changes in the years 2013 and 2019.

According to the 2013 legislation, a group company may only deduct interest expenses if the interest income corresponding to the interest expense would have been taxed with a tax rate of at least ten percent at the lender company within the group that receives the interest, if the receiving company had only this as income (so-called "ten percent rule"). There was however an exception to this rule, which meant that the interest expense was not deductible if the main reason for the debt having arisen was that the group would receive a substantial tax benefit (so-called "the exception to the ten percent rule"). As Swedish companies are covered by the provisions on group contributions, the exception rule did not apply when a debt arose between Swedish companies in a group. Foreign companies could not, and cannot, apply the Swedish group contribution rules which entails a difference in the treatment of Swedish and foreign companies.

Lexel v Skatteverket, circumstances

The rules that were analyzed in the Lexel case were the 2013 interest deduction limitation rules. Summarily the case concerned the Swedish company Lexel AB, which is part of the Schneider Electric Group with parent company in France. Lexel AB was denied a deduction by the Swedish Tax Agency for interest expenses paid to a French group company with reference to the "exemption from the ten percent rule". Both the Swedish Administrative Court and the Swedish Court of Appeal agreed with the Swedish Tax Agency's assessment of the denial of deductions.

Lexel AB chose to appeal the Swedish Court of Appeal's ruling to the Supreme Administrative Court of Sweden. Before deciding the verdict, the Supreme Administrative Court sought a preliminary ruling from the CJEU to clarify the question of whether the difference in treatment between domestic and cross-border loans is compatible with European union law.

The preliminary ruling from The Court of Justice of the European Union

The question asked by the Supreme Administrative Court of Sweden was whether it was in accordance with Article 49 of the TFEU, to refuse a Swedish company interest deductions paid to a company belonging to the same group with domicile in another Member State on the ground that the main reason for the debt having arisen is that the group shall receive a substantial tax benefit, when such a tax benefit would not have been considered to exist if both companies had been established in Sweden because they would then have been covered by the provisions on group contributions.

The CJEU stated that Article 49 of the TFEU must be interpreted as precluding national legislation which provides that a company established in one Member State is not permitted to deduct interest payments made to a company belonging to the same group, established in another Member State, on the ground that the principal reason for the debt linking them appears to be the obtaining of a substantial tax benefit, whereas such a tax benefit would not have been deemed to exist if both companies had been established in the first Member State, as in that situation they would have been covered by the provisions on group contributions.

Our comments on the preliminary ruling from The Court of Justice of the European Union
We are of the opinion that it is clear from the circumstances of the case that the application of the exception rule in reality results in a difference between purely domestic and cross-border situations. If Lexel AB had been granted an intra-group loan from a Swedish company, interest expenses would have been deductible. The rule thus results in a restriction, as the CJEU found in this case. However, the CJEU can approve restrictions if they are considered justified in the matter of public interest. These circumstances have been referred to as justifications, among which "tax evasion" and "to safeguard the allocation of the power to impose taxes between the Member States" are some examples (see the reasoning in p. 48 and p. 58). Should any of these justifications be considered applicable, a proportionality test will then follow where the restriction must be considered proportionate in relation to what it intends to achieve to be permissible.

In the Lexel case, however, the CJEU was clear about its view on the restriction. They argued that in order to justify a restriction on the freedom of establishment, the specific purpose of such a restriction must be to prevent purely artificial or fictitious arrangements created with a objective to avoid tax that normally would have been due on the profits generated by activities carried out within the jurisdiction (see p. 49). The CJEU stated that the specific purpose of the Swedish exception rule was not to prevent purely artificial or fictitious arrangements since it may also cover transactions carried out on an arm’s-length basis, that is to say, in conditions analogous to those which would apply between companies which are independent of one another (see p. 53). The CJEU hence considered that the justification for the application of the Swedish exception rule was not in accordance with Article 49 of the TFEU.

CJEU's view of restrictions on freedom of establishment can therefore be seen as relatively strict. If the preliminary ruling is interpreted literal, the interest deduction limitation rules in cross-border situations should only be applied to purely artificial or fictitious arrangements.

Our comments on the 2019 regulation in the light of the Lexel verdict
As previously mentioned, the rules on interest deductions were also changed in 2019 and the current phrasing in the "exception to the ten percent rule" has been changed from "the main reason" to "exclusively or *almost* exclusively". There is also a limitation in deductions regarding acquisitions of shares among the rules on interest deduction. In the 2019 legislation, deductions for acquisition of shares may only be made if the acquisition is "*substantially* commercially justified". Thus, there is still room for commercial, non-fictitious, transactions to be restricted under the Swedish rules, which according to the CJEU's statements could be seen as an impermissible restriction on the freedom of establishment. It now remains to be seen how the Swedish Tax Agency and the Swedish courts will rule on current and future cases concerning these new interest deduction limitation rules, in the light of the Lexel verdict.

However, as a final reflection, it can be discussed whether the rules on prohibition of interest deduction on intra group loans fills a practical purpose after the Lexel verdict. In addition to the changes in the rules on prohibition of interest deduction on intra group loans, a general interest deduction limitation rule has been introduced in the 2019 legislation, the so-called EBITDA rule. The EBITDA rule applies on interest on all kinds of debt, regardless if it is an external loan or a loan between related parties. Interest expenses are defined as interest and other expenses for a credit and expenses that are comparable to interest. The definition corresponds to what follows from the Directive against tax evasion (Directive (EU) 2016/1164 of 12 July 2016) where it is more thoroughly described. In short, a negative net interest is deductible only to the extent it does not exceed 30% of EBITDA, calculated for tax purposes. With the introduction of this rule, and the preliminary ruling of the CJEU in

the Lexel case, it can be argued that the rules on prohibition of interest deduction on intra group loans can be abolished. As all non-fictitious arrangements carried out within the EU cannot be restricted with regard to the freedom of establishment, the rules on prohibition of interest deduction on intra group loans would in reality only apply to companies domiciled outside the EU. In these cases, the EBITDA rule would become applicable, and the rules on prohibition of interest deduction on intra group loans would thus lose their function. In its entirety, the abolition of these rules could therefor simplify the application of the interest deduction rules and thereby benefit both investments and acquisitions.

Tjänster	Tax