LUND UNIVERSITY
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Interest Deduction Limitation Rules in Sweden and Germany

A Comparison Regarding EU Law Compatibility and Appropriateness

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List of Abbreviations

Art.	Article
BV	*Beslooten vennootschap met beperkte aansprakelijkheid*, Dutch limited liability company
Ch.	Chapter
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
ECJ	European Court of Justice
ECR	European Court Reports
EEA	European Economic Area
EU	European Union
EUR	Euro
E.g.	Exempli gratia, for example
I.e.	*Id est*, that is
GAAP	General Accepted Accounting Principles
GCITA	German Corporate Income Tax Act (*Körperschaftsteuergesetz*)
GITA	German Income Tax Act (*Einkommensteuergesetz*)
GmbH	*Gesellschaft mit beschränkter Haftung*, German limited liability company
IFRS	International Financial Reporting Standards
M	Million
N.	(Foot-)Note
No.	Number
P.	Page
Para.	Paragraph
Paras.	Paragraphs
Pp.	Pages
Sec.	Section
Secs.	Sections
SITA	Swedish Income Tax Act (*Inkomstskattelag*)
TFEU	Treaty on the Functioning of the European Union

UK	United Kingdom
US	United States of America
V	Versus
Vol.	Volume

1. Introduction

1.1 Background

A common feature of tax law is to distinguish between debt and equity and provide for asymmetric tax treatment. Under domestic tax law the return on equity, *i.e.* dividends, is in general not deductible for the distributing company. This non-deductibility of equity returns is supposed to encourage companies to reinvest distributable profits. However, to avoid economic double taxation on received dividends, usually some relief is given for the shareholder by way of credit or exemption method. Return on debt, *i.e.* interest, on the other hand is in general deductible for the borrower and taxed at the level of the lender.[1] International taxation also distinguishes between debt and equity, as dividends are primarily taxed in the source state and interest in the residence state and lower withholding taxes are levied on interest than on dividends.[2] In conclusion, tax law gives incentives for debt financing.

However, the distinction between debt and equity stems from corporate law and accounting provisions. Tax law is not about the function of debt as a safeguard for third party liabilities.[3] But as debt financing is subject to preferential tax treatment, it can be used as a tax avoidance scheme against the background of tax competition and lack of harmonization to shift profits from high-tax jurisdiction to low-tax jurisdictions. Profits are transferred by way of debt with the interest expenses being deductible in the high-tax jurisdiction and the corresponding interest income being taxable in a low-tax jurisdiction. For groups this can significantly lower the overall effective taxation.[4] Empirical evidence has shown that subsidiaries in high-tax jurisdictions are more often financed by intra-group debt. As the decision-making of companies is affected by the tax-preferential treatment of debt financing, it can lead to artificial tax-driven financing structures which might not be at arm's length and lead to tax revenues losses.[5] As tax authorities want to protect their tax revenues, they implement legislation to prevent the erosion of the tax base and consequential tax revenues losses, e.g.

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[1] A Storck, 'The Financing of Multinational Companies and Taxes: An Overview of the Issues and Suggestions for Solutions and Improvements', *Bulletin for International Taxation*, vol. 65, no. 1, 2011, p. 27, retrieved 28 January 2013, IBFD Tax Research Platform, C P Knöller, 'The Efficacy of Thin Capitalization Rules and Their Barriers: An Analysis from the UK and German Perspective', *INTERTAX*, vol. 39, no. 6/7, 2011, p. 319, retrieved 13 March 2013, Kluwer Law International Online and T J C van Dongen, 'Thin Capitalization Legislation and the EU Corporate Tax Directives', *European Taxation*, vol. 52, no. 1, 2012, p. 20, retrieved 21 January 2013, IBFD Tax Research Platform.

[2] A Cordewener, 'Company Taxation, Cross-Border Financing and Thin Capitalization in the EU Internal Market: Some Comments on *Lankhorst-Hohorst GmbH*', *European Taxation*, vol. 43, no. 4, 2003, p. 113, retrieved 21 March 2013, IBFD Tax Research Platform, A Storck (n. 1), p. 27, A Hilling, 'Sweden', *IFA Cahier – The Debt Equity Conundrum*, vol. 97B, 2012, p. 693, retrieved 6 May 2013, IBFD Tax Research Platform and W Schön, 'The Distinct Equity of the Debt-Equity Distinction', *Bulletin for International Taxation*, vol. 66, no. 9, 2012, p. 494, retrieved 27 January 2013, IBFD Tax Research Platform.

[3] W Schön (n. 2), p. 496.

[4] C P Knöller (n. 1), pp. 319 – 320.

[5] S Webber, 'Thin Capitalization and Interest Deduction Rules: A Worldwide Survey', *Tax Notes International*, vol. 60, 2010, p. 689, retrieved 4 April 2013, Tax Analysts and C P Knöller (n. 1), pp. 320 - 321.

thin capitalization rules, interest barriers or general anti-avoidance legislation.[6] The terms 'thin' capitalization and 'hidden' capitalization refer in tax law to excessive intra-group debt financing, which is in substance equity, as tax avoidance scheme.[7] Therefore thin capitalization rules are implemented to prevent excessive debt financing.[8] Despite substantial differences in the design of such rules, their common purpose is the reduction of the distortive effect of tax-favoured debt financing.[9]

In the 1990s many industrialized countries introduced such thin capitalization rules as anti-avoidance measure for abusive debt financing. The early thin capitalization rules focused on debt loaned or guaranteed by foreign group companies.[10] Due to potential export of interest income, thin capitalization is especially problematic in cross-border situations, whereas extending the scope of thin capitalization rules to domestic situations, leads to unnecessary constraints on domestic taxpayers.[11] However, this is often discriminatory and therefore not compatible with EU Law, as will be discussed in this paper. Some thin capitalization regimes focus on resident and non-resident affiliated companies, like Sweden, whereas others apply in general to all debt, like in Germany. As all thin capitalization regimes, interest deduction limitation rules in their role as specific anti-avoidance legislation also face the problem to distinguish between legitimate and abusive financing structures. In its case law, the ECJ has developed the principle of the prohibition of abuse.[12] Thus, legislators face the challenge to implement appropriate and proportional thin capitalization provisions that do not distort legitimate financial decision-making.[13]

1.2 Purpose

In light of the recent inquiry by the European Commission in January 2013 concerning the compatibility of the Swedish interest deduction limitations rules, an EU law compatibility analysis proves to be relevant.[14] Additionally the Swedish Companies' Committee (*Företagskommittén*) was in 2011 assigned the task to research whether a fundamental change

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[6] L Brosens, 'Thin Capitalization Rules and EU Law', *EC Tax Review*, vol. 13, no. 4, 2004, p. 188, retrieved 13 March 2013, Kluwer Law International Online, A Storck (n. 1), p. 28 and C Elliffe, 'Unfinished Business: Domestic Thin Capitalization Rules and the Non-Discrimination Article in the OECD Model', *Bulletin for International Taxation*, vol. 67, no. 1, 2013, p. 28, retrieved 21 January 2013, IBFD Tax Research Platform.

[7] C Brokelind, 'Cross Border Intra-Group Financing in France after the *Conseil d'Etat* Decisions of 30 December 2003', *EC Tax Review*, vol. 13, no. 4, 2004, p. 181, retrieved 13 March 2013, Kluwer Law International Online and C Elliffe (n. 6), p. 26.

[8] L Brosens (n. 6), p. 188 and C Elliffe (n. 6), p. 28.

[9] A Storck (n. 1), p. 36 and C P Knöller (n. 1), p. 321.

[10] K Nakhai, R Stricof and O Thoemmes, 'Thin Capitalization Rules and the Non-Discrimination Principles – An Analysis of Thin Capitalization Rules in Light of the Non-Discrimination Principle in the EC Treaty, Double Tax Treaties and Friendship Treaties', *INTERTAX*, vol. 32, no. 3, 2004, p. 126, retrieved 21 March 2013, Kluwer Law International Online and K von Brocke and E G Perez, 'Group Financing: From Thin Capitalization to Interest Deduction Limitation Rules', *International Transfer Pricing Journal*, vol. 16, no. 1, 2009, p. 29, retrieved 21 January 2013, IBFD Tax Research Platform.

[11] C P Knöller (n. 1), p. 322 and C Elliffe (n. 6), p. 28.

[12] Case C-110/99 *Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas* [2000] ECR I-01569 and R de la Feria, 'Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law Through Tax', *Common Market Law Review*, vol. 45, no. 2, 2008, pp. 395 – 441, retrieved 4 April 2013, Kluwer Law International Online.

[13] C P Knöller (n. 1), pp. 317-318, 320.

[14] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013.

of the Swedish interest deduction limitation would be more appropriate. Any results and a potential proposal are expected to be published by 31 March 2014.[15] During the preparatory work to the amendments of the Swedish interest deduction limitation rules as of 1 January 2013, several parties have argued in favour of a shift to an EBITDA-model.[16] Such an approach to limit interest deductibility has growing popularity and has been implemented in Germany in an innovative manner.

The purpose of this paper is to investigate the relevant provisions of Swedish and German tax law and to study the case law of the ECJ in order to analyze whether the rules potentially infringe EU law. The paper also analyzes how appropriate the interest deduction limitation rules are to fulfil the legislators' intended purpose to prevent tax base erosion.

1.3 Method and Materials

This paper will conduct a traditional comparative law analysis by studying how the conflicts of tax base erosion by preferred debt-financing are resolved in two different countries and will ask how appropriate the solutions are to their intended purpose. Experience in this field has shown that it is best to first present the relevant legal provisions without judgment as a basis for a critical comparison.[17] The primary focus of this paper is the compatibility with EU law. This will be based on an analysis of ECJ case law. The choice of case law is based on their relevancy for the analysis of interest deduction limitation rules. The relevancy of the cases has been derived from the discussion of the cases in articles devoted to thin capitalization and interest deduction limitation rules.

The relevant domestic law provisions were the starting point for this paper. Despite the German law provision, all material used in this paper was written in English or Swedish to guarantee that sources can be reviewed. The author is aware that the lack of German literature on the German interest deduction limitation rules affects the results of this paper's comparison. The thesis will analyse domestic sources of law, ECJ case law and material, such as preparatory work and scholars' and practitioners' articles, devoted to the topic in order to assess the compatibility of the rules and enable a critical comparison. In order to assess the appropriateness of the domestic interest deduction limitation rules the author will consider how appropriate the domestic interest deduction limitation rules are for protecting the domestic tax base. Therefore it will be considered whether the rules can easily be circumvented and in how far the rules apply to non-abusive arrangements.

1.4 Delimitations

The selection of the compared countries is not random. Within the framework of the recent amendments of the Swedish interest deduction limitations rules as of 1 January 2013 and the

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[15] Regeringen, *Kommittédirektiv 2011:1*, 13 January 2011, p. 4, retrieved 4 April 2013, http://www.regeringen.se and Regeringen, *Tilläggsdirektiv till Företagsskattekommittén 2011:1*, 15 November 2012, retrieved 22 May 2013, http://www.regereringen.se.

[16] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 38. EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is a performance measure based on a company's financial accounting.

[17] Kötz and K Zweigert, *Introduction to Comparative Law*, 1995, 3rd edn., Oxford: Clarendon Press, pp. 4, 6.

research of the Swedish Companies' Committee for a fundamental change of the interest deduction limitation rules, an EBITDA-model has been suggested.[18] Such an EBITDA-model has been introduced in Germany in late 2007. Following the German model other countries, e.g. Italy, Spain and Portugal, have also introduced EBITDA-based interest deduction limitation rules. The German rules have been chosen for the comparison with the Swedish rules as they are implemented over a relatively long period without any fundamental amendments. The German rules are therefore already widely discussed in literature which provides a good research basis for a comparison. Additionally, both Sweden and Germany are civil law countries and high-tax jurisdictions that face the challenge of dealing with significant tax base erosion in the framework of EU law.

The author acknowledges that not the whole picture of interest deduction limitation rules can be covered. It is also not in the scope of this paper to define and discuss what 'interests' are under the domestic legislations at issue. Due to the enquiry by the European Commission against Sweden and the ECJ case law on thin capitalization, this paper will focus on the freedom of establishment and will not discuss the free movement of capital. It will deliberately omit possible consequences of tax treaties, as these are not part of EU law. It is also not in scope of this paper to discuss the compatibility of thin capitalization regimes with the Parent and Subsidiary Directive[19] or the Interest and Royalties Directive[20]. Although thin capitalization rules are *per se* different than interest deduction limitation rules, they are responses to the same problem. In Germany, for example, the interest deduction limitation rules substituted the previous thin capitalization rules. Therefore, for the purpose of this paper, the term 'thin capitalization (regime)' will also cover interest deduction limitation rules. The paper is based on research until 9 May 2013 and therefore considers only material published up to that date.

1.5 Outline

In line with the comparative legal method, following the introduction the national law provisions of Sweden and Germany will be presented in *Chapter 2*. Following this, *Chapter 3* will provide an overview of the relevant ECJ case law and then assess the compatibility with EU law of the Swedish and German interest deduction limitation rules. In *Chapter 4* it will be analysed in how far the provisions are proportionate and appropriate to the purpose intended by the legislator. A critical comparison, being the purpose of this paper, will be conducted in *Chapter 5* and the conclusion of the author will be drawn in *Chapter 6*.

2. Domestic Law Provisions

The thin capitalization rules of the 1990s usually set up debt-equity ratios, which could also operate as 'safe havens'. If the ratio was exceeded, the deductibility of interest expenses was

[18] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 38.
[19] Parents-Subsidiary Directive 2003/123/EC.
[20] Interests and Royalties Directive 2003/49/EC.

either directly disallowed or indirectly through reclassification as dividends.[21] However, reclassification may lead to double taxation due to qualification conflicts between countries.[22] But fixed debt-equity ratios have also been criticized as they apply automatically without distinguishing between the nature and situation of businesses or whether the financing is abusive.[23] Even upon combination with the arm's length principle, it has been questioned in how far fixed ratios can prevent abusive debt financing.[24] Multinational groups, as studies have shown, can easily circumvent thin capitalization rules based on fixed ratios, e.g. by temporarily increasing the equity just before the balance sheet date. Instead of trying to control the capital structure of companies by fixed debt-equity ratios, it is more straight-forward to limit the deductibility of interest expenses in order to retain tax revenues.[25] Such interest deduction limitation rules have been implemented, *inter alia*, in Germany and Sweden. In order to assess the Swedish and German approach to interest deduction limitation, the legislation in force will be presented.

2.1 Swedish Law

Compared with many other industrialized states[26], Sweden was rather late with introducing legislation specifically targeted at abusive debt-financing[27]. After the Swedish Supreme Administrative Court held in late 2007[28] that the Swedish general anti-avoidance legislation is not applicable to certain tax planning schemes with interest expenses, Sweden faced an immediate need for thin capitalization rules to prevent such tax avoidance[29]. Due to this sudden need for thin capitalization rules, based on research conducted primarily by the Swedish tax authorities, which had shown that tax in Sweden was avoided with help of interest expenses at a large scale, Sweden introduced interest deduction limitation rules (*Ränteavdragsbegränsningsreglerna*) as of 1 January 2009.[30] The Swedish approach focuses on limiting the deduction of interest expenses incurred on debt that finances intra-group acquisitions of shareholdings. Contrary to the tax authorities' initial proposal, following massive critique, the rules include two exceptions to ensure that non-abusive transactions

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[21] L Brosens (n. 6), p. 190, K Nakhai, R Stricof and O Thoemmes (n. 10), p. 126 and K von Brocke and E G Perez (n. 10), p. 29.

[22] E.g. the shareholder's state might not recognize the reclassification or the subsidiary's state might levy the higher withholding tax applicable to dividends. L Brosens (n. 6), p. 203, K Nakhai, R Stricof and O Thoemmes (n. 10), p. 126 and T J C van Dongen (n. 1), pp. 20 – 21.

[23] L Brosens (n. 6), p. 190, S Webber (n. 5), p. 684 and C P Knöller (n. 1), p. 335.

[24] L Brosens (n. 6), p. 211.

[25] K von Brocke and E G Perez (n. 10), p. 29 and S Webber (n. 5), pp. 703 – 704.

[26] K von Brocke and E G Perez (n. 10), p. 29.

[27] Regeringen, *Budgetproposition 2012/13:1*, 20 September 2012, p. 241, retrieved 4 April 2013, http://www.regeringen.se.

[28] Regeringsrätten, RÅ 2007, ref. 84-85 ('Industrivärdendomarna').

[29] L Samuelson, 'HFD Avvaktar EU-Domstolen om Ränteavdragsbegränsning', *Svensk Skattetidning*, no. 6/7, 2011, p. 558, retrieved 21 March 2013, Zeteo, M Dahlberg, 'Sweden's Proposal on the Deduction of Interest on Intercorporate Loans', *Tax Notes International*, vol. 66, 2012, p. 1037, retrieved 4 April 2013, Tax Analysts, A Hilling (n. 2), p. 699 and A Hultqvist, 'Affärsmässigt Motiverad', *Svensk Skattetidning*, no. 2, 2012, p. 122, retrieved 21 March 2013, Zeteo.

[30] Regeringen, *Budgetproposition 2012/13:1*, 20 September 2012, p. 241, retrieved 4 April 2013, http://www.regeringen.se, M Dahlberg, 'Sweden: Court OKs Limitations on Deductibility of Intercompany Interest', *Tax Notes International*, vol. 65, 2012, p. 276, retrieved 4 April 2013, Tax Analysts and M Hilling, 'Är Det Möjligt Att Utforma EU-Förenliga Skatteflyktsregler?', *Svensk Skattetidning*, no. 10, 2012, p. 823, retrieved 21 March 2013, Zeteo.

should not be affected.[31] However, both the tax authorities and the government, came to the conclusion that the rules still offer many opportunities for tax planning with interest expenses. Therefore, with the amendments as of 1 January 2013 the rules were restricted even more, which is only one in a line of amendments to the rules.[32] Further restrictions on interest deductibility broaden the tax base and help to counter-finance the reduction of the corporate tax rate.[33] As the government sees an immediate need to amend the rules especially with regard to intra-group debt it concluded that there is no time to wait for the proposal from the Companies' Committee.[34]

Swedish tax law (ch. 16 para. 1 SITA) generally provides for full deduction of interest expenses. However, ch. 24 paras. 10a – 10f SITA limit the deductibility. According to the main rule in para. 10b interest payments to affiliated companies are not deductible, unless one of the exceptions provided for in paras. 10d and 10e applies. Companies are seen as affiliated if either one of the companies, directly or indirectly, has a substantial influence over the other company, or if the companies are under common control.[35] Previously the rules required 'determinative' influence over a company. Therefore, the scope of the rules has been expanded and will also affect cases of shareholdings just below 50%.[36]

Interest expenses on intra-group debt, whose deductibility is prohibited by para. 10b, can nevertheless be deducted if the corresponding interest income is taxed with at least 10% in the residence state of the beneficial owner if it was his only income. As of 1 January 2013 even companies that do not fulfil this hypothetical 10%-test can deduct their interest expenses if the beneficial owner is subject to Swedish yield tax or a comparable tax, provided that during the tax year the debt's interest rate has on average not exceeded 250% of the average state bond interest rate of the previous calendar year. The extension of the 10%-rule is targeted at Swedish life insurance companies and pension trusts subject to Swedish yield tax. However, these exceptions do not apply if the obligation is mainly motivated by tax reasons of the group.[37] The counter-exception has been introduced because tax planning schemes have been structured in such way that the 10%-test is fulfilled.[38]

If the 10%-rule is not applicable, intra-group interest expenses can still be deductible if the interest expenses are primarily based on sound business reasons.[39] The second exception,

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[31] R Hellenius, 'De Nya Ränteavdragsbegränsningarna', *Svensk Skattetidning*, no. 2, 2009, pp. 166 – 167, retrieved 21 March 2013, Zeteo, T Andersson and C Carneborn, 'Något om Ränteavdragsbegränsnings-reglernas Räckvidd och Innebörd', *Svensk Skattetidning*, no. 10, 2010, p. 972, retrieved 4 April, Zeteo and T Andersson, 'Ränteavdragsbegränsning i Bolagssektorn, Några Erfarenheter Två År Senare', *Svensk Skattetidning*, no. 4, 2011, p. 358, retrieved 21 March 2013, Zeteo.

[32] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 1 and Regeringen, *Budgetproposition 2012/13:1*, *supra* n. 32, p. 229.

[33] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 6.

[34] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 3.

[35] Ch. 24, para. 10a SITA.

[36] Regeringen, *Budgetproposition 2012/13:1*, *supra* n. 32, p. 239.

[37] Ch. 24 para. 10d SITA. There is no general consensus on what is meant by the term 'beneficial owner'. The term 'beneficial owner' in general describes a person or entity that obtains economic benefits, e.g. interest income, without legal ownership.

[38] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 38 and Regeringen, *Budgetproposition 2012/13:1*, *supra* n. 32, p. 219.

[39] Ch. 24, para. 10e SITA.

which is a business purpose test, only applies to beneficial owners that are resident within the EEA or in a state that has concluded a double tax treaty with Sweden covering all income by which he is covered.[40] If the underlying debt financed the acquisition of a company that was or became afterwards a group company, the exception is only applicable if the acquisition itself was also primarily based on sound business reasons. This also covers an intra-group debt that replaces a third-party debt used for financing such an acquisition.[41] Upon assessing business reasons, it should be taken into account whether contribution by the lender or any other affiliated company could have been used for financing.[42] This exception should prevent the exceptional cases where transactions are commercially motivated despite very low taxation to be included in the anti-abuse legislation.[43]

The general prohibition of deduction also applies, unless the exception under para. 10f is applicable, to interest payments to non-affiliated companies, if the lender or an affiliated company of the lender is indebted to the borrower or an affiliated company of the borrower, if the underlying debt is given in connection with the other obligation and is financing the acquisition of shares in company that either before or after the acquisition is a group company ('back-to-back' loans).[44] Interest payments with regard to back-to-back loans are nevertheless deductible, if either the corresponding interest income is taxed in accordance with para. 10d and the debt is not primarily tax-driven, or if both acquisition and interest expenses have mainly business reasons. However, this business purpose test also only applies to beneficial owners that are resident within the EEA or in a state that has concluded a double tax treaty with Sweden covering all income by which he is covered.[45]

2.2 German Law

Just like Sweden, Germany tried to deal with thin capitalization cases with the help of general anti-avoidance provisions in the beginning. After such practice was ruled unlawful by the Federal Tax Court in 1992, specific thin capitalization rules were introduced as of 1 January 1994.[46] The thin capitalization rules until 2003 were targeted at abusive financing by foreign shareholders and related parties.[47] The rules in force in 1997/1998, that were slightly amended in 2001 upon change from the imputation system to a classical corporation tax system, were at issue in *Lankhorst-Hohorst*[48], the most relevant case for thin capitalization before the ECJ.[49] Because the ECJ ruled that the German thin capitalization rules infringed the freedom of establishment, they were amended as of 1 January 2004 and applied to both domestic and cross-border situations. However, it was argued that they were no longer targeted at preventing abusive financing structures.[50] Under these rules interest payments made to

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[40] Ch. 24, para. 10e SITA.
[41] Ch. 24, para. 10e SITA.
[42] Ch. 24, para. 10e SITA.
[43] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 64.
[44] Ch. 24 para. 10c SITA.
[45] Ch. 24 para. 10f SITA.
[46] A Cordewener (n. 2), p. 107.
[47] K von Brocke and E G Perez (n. 10), p. 30.
[48] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779.
[49] K Nakhai, R Stricof and O Thoemmes (n. 10), p. 127.
[50] K Nakhai, R Stricof and O Thoemmes (n. 10), p. 127 and K von Brocke and E G Perez (n. 10), p. 31.

shareholders holding more than 25% of shares were reclassified as dividends, unless they were at arm's length. These rules applied to interest payment above EUR 250,000 and if the safe haven debt-equity ratio of 1.5:1 was exceeded.[51] As the rules were not changed in substance, it was common consensus that *Lankhorst-Hohorst* also applied to the amended rules.[52] In addition was the difference in treatment between resident and non-resident lenders not fully removed as deemed dividends paid to German shareholders were tax exempt to 95%, whereas foreign lenders were subject to withholding tax at 25% or the reduced treaty withholding tax rate.[53]

Following the critique, Germany introduced an innovative interest deduction limitation rule as of 25 June 2007. With the new rule, the German government followed a trend in international tax law away from reclassification of interest for the sake of restricting deductibility of interest payments when certain conditions are met.[54] The 'interest barrier' (*Zinsschranke*) was introduced in the framework of the 2008 Tax Reform that aimed at increasing incentives for investments and doing business in Germany. The enacted tax reliefs, *inter alia* a reduction of the tax rate, were partially to be financed by broadening the tax base with the help of the new interest deduction limitation rule, although such a rule should be intended as anti-abuse legislation.[55]

The German thin capitalization rules are embedded in sec. 4h GITA in combination with sec. 8a GCITA. According to the general rule, any interest expenses that exceed the amount of incurred interest income (so-called 'net interest expenses') are limited in their deductibility as a business expense up to an amount of 30% of taxable EBITDA.[56] Contrary to the old rules the interest barrier limits the deductibility of interest expenses on debt from all sources. However, for corporations subject to sec. 8a GCITA related party debt is treated more restrictively. The German thin capitalization rules look at the interest expense of a 'business'. The term 'business' is used to describe a corporation or a partnership. However, companies forming a German fiscal unity (*Organschaft*) are also regarded as single business.[57]

The rules provide for an EBITDA carry-forward, *i.e.* the rules allow to carry forward any part of the 30% taxable EBITDA that has not been utilized by net interest expenses for five financial years.[58] The EBITDA carry-forward was introduced retrospectively due to the

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[51] A Perdelwitz and R Resch, 'The German Tax Reform 2008 – Part 2', *European Taxation*, vol. 48, no. 4, 2008, p. 159, retrieved 4 April 2013, IBFD Tax Research Platform and C P Knöller (n. 1), p. 323.

[52] O F Kerssenbrock, 'In the Wake of *Lankhorst-Hohorst*', *INTERTAX*, vol. 32, no. 6/7, 2004, p. 306, retrieved 21 March 2013, Kluwer Law International Online and K Nakhai, R Stricof and O Thoemmes (n. 10), p. 127.

[53] K von Brocke and E G Perez (n. 10), p. 31 and C P Knöller (n. 1), p. 324.

[54] R Eicke and W Kessler, 'New German Thin Cap Rules – Too Thin the Cap', *Tax Notes International*, vol. 47, no. 3, 2007, p. 266, retrieved 2 April 2013, Tax Analysts, N Herzig, B Liekenbrock and U Lochmann, 'Impact Study of the New German Interest Capping Rule', *INTERTAX*, vol. 36, no. 12, 2008, p. 577, retrieved 21 March 2013, Kluwer Law International Online and K von Brocke and E G Perez (n. 10), p. 31.

[55] Deutscher Bundestag, *Drucksache 16/4841 – Entwurf eines Unternehmensteuerreformgesetzes 2008*, 27 March 2007, pp. 1, 29 – 30, 35, retrieved 9 May 2013, http://www.bundestag.de and T Müller-Duttiné and M P Scheunemann, 'New German Tax Rules on Financing Expenses', *INTERTAX*, vol. 35, no. 8/9, 2007, p. 518, retrieved 4 April 2013, Kluwer Law International Online.

[56] Sec. 4h para.1 GITA.

[57] Sec. 15 para. 1 (3) GCITA.

[58] Sec. 4h para. 1 GITA.

financial crisis in order to relieve companies that were previously profitable.[59] It is up to date still in place and has not been abandoned. If however the net interest expenses exceed the 30% taxable EBITDA threshold, the exceeding net interest expenses can be carried forward indefinitely.[60] Thus, the deductibility of interest is only denied temporarily. But any non-utilized carry-forwards will be forfeited upon ceasing or transfer of the business.[61]

Interest expenses are nonetheless fully deductible if any of the three exceptions in sec. 4h para. 2 GITA applies. In order to relieve the burden on small businesses, a *de minimis* exemption provides for full deductibility if the net interest expenses do not exceed EUR 3m.[62] Upon introduction the threshold was EUR 1m but was retrospectively increased due to the financial crisis. Although initially limited to 2008 and 2009, the new government implemented the increased threshold indefinitely to make the interest deduction limitation rules less strict.[63] The main rule limiting deductibility is also not applicable if the non-group affiliation exemption in sec. 4h para. 2 (b) GITA is fulfilled. This exception applies if the business does not or only partially belong to a group of companies. In this context the term 'group' does not refer to a tax group, but a business belongs to a group if it is or could be included in a group's consolidated financial statements. Companies are also part of a group if they are under common control.[64] The third exemption, the escape clause, applies if the business's equity ratio is either equal or higher than the group's overall equity ratio. However, an equity ratio that is by 2 percentage points lower is tolerated. The equity ratios are calculated based on the previous balance sheets that are uniformly reported in accordance with IFRS, or any EU- or US-GAAP.[65]

Corporations are subject to additional restrictions. The two counter exceptions of sec. 8a GCITA disallow the application of the non-affiliation exception and the equity comparison in case of harmful shareholder debt financing. This is given when the business cannot provide evidence that less than 10% of the net interest expenses are paid to shareholders that, directly or indirectly, hold more than 25% of shares in the business or any related party of such a shareholder, as well as any third party that has recourse to the former two parties. Moreover can the escape clause only be applied if none of the legal entities, domestic and foreign, of the group provides for harmful shareholder debt financing, excluding intra-group financing.[66]

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[59] C P Knöller (n. 1), p. 324.
[60] Sec. 4h para. 1 GITA.
[61] Sec. 4h para. 5 GITA.
[62] Sec. 4h para.2 (a) GITA.
[63] C P Knöller (n. 1), pp. 325, 327.
[64] Sec. 4h para. 3 GITA.
[65] Sec. 4h para. 2 (c) GITA.
[66] Sec. 8a GCITA.

3. Compatibility with EU Law

3.1 EU Law Framework

Currently there is no secondary EU law, e.g. a directive, on thin capitalization. Therefore most insight on the effect of EU Law on interest deduction limitation rules can be gained from the ECJ's case law. As already mentioned, *Lankhorst-Hohorst* is the most relevant case for thin capitalization and interest deduction limitation rules. The ECJ ruled that the German thin capitalization rules in force in 1997/1998 infringed the freedom of establishment.[67] The freedom of establishment is one of the fundamental Treaty freedoms set out in Art. 49 TFEU.[68] It prohibits not only discrimination, but any restriction that prohibits, impedes, or renders less attractive the exercise of the freedom of establishment.[69]

In *Lankhorst-Hohorst* the German company Lankhorst-Hohorst GmbH paid interest to its Dutch grandparent Lankhorst Taselaar BV on a loan granted in order to rescue it due to its highly indebtedness. The tax authorities argued that such a loan that was given without securities and supported by a letter of support waiving repayment in favour of third party claims could not have been obtained from a third party, *i.e.* it was in fact equity.[70] The interest expenses were, upon exceeding a certain debt-equity ratio, reclassified as dividend. Although this reclassification was not directly linked to nationality, the ECJ ruled that the rules were discriminatory and were an unjustifiable obstacle to the freedom of establishment.[71] Interest paying subsidiaries were treated differently based on the residency of their parent company, because the reclassification only applied to interest payment to companies not entitled to corporation tax credit. Foreign companies as well as German corporations exempt from corporate income tax were not entitled to such a tax credit.[72] Although the rules also applied to certain German taxpayers, the rules applied in practice primarily to foreign shareholders and were thus discriminatory.[73]

It can be concluded from *Lankhorst-Hohorst* that even thin capitalization rules that indirectly discriminate resident and non-resident creditors can infringe the freedom of establishment.[74] Following this judgment, several Member States amended their thin capitalization rules as it was common to apply rules only to interest payments made to non-residents.[75] In order to

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[67] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, para. 32.
[68] Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Official Journal of the European Communities, C 83, 30 March 2012, pp. 1 – 403.
[69] Settled case law, e.g. Case C-439/99 *Commission of the European Communities v Italian Republic* [2002] ECR I-00305, para. 22.
[70] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, paras. 6 - 8, 12 - 14.
[71] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, paras. 8, 22, 36 – 38, 43.
[72] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, para. 4, 22, 27.
[73] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, para. 18, N Vinther and E Werlauff, 'The Need For Fresh Thinking About Tax Rules on Thin Capitalization: The Consequences of the Judgment of the ECJ in *Lankhorst-Hohorst*', *EC Tax Review*, vol. 12, no. 2, 2003, p. 99, retrieved 13 March 2013, Kluwer Law International Online and L Brosens (n. 6), p. 193.
[74] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779.
[75] L Brosens (n. 6), p. 192 and K Nakhai, R Sticof and O Thoemmes (n. 10), p. 192.

comply with EU law, EU-resident companies have to be treated equally disadvantageously.[76] Therefore the legislators in the EU Member States have to choose between either accepting tax planning with interest expenses within the EU or restricting domestic cases.[77]

For the understanding of the second case regarding thin capitalization rules, *Thin Cap Group*[78] it is important to first take a look at *Cadbury Schweppes*[79] which is the leading direct tax case for the EU law principle of prohibition of abuse.[80] As was already mentioned, many thin capitalization rules try to distinguish between legitimate use and misuse of interest deduction provisions. The legal issue in *Cadbury Schweppes* was whether the establishment of companies in another Member States, which was regarded as a low-tax jurisdiction, was abusive.[81] The ECJ transferred from the corporate law case *Centros*[82] that companies may not take advantage of EU law, here the freedom of establishment, to circumvent their domestic provisions.[83] However, a foreign establishment, or by extension the interest payment to a foreign establishment, cannot *in itself* give a presumption of abuse.[84] The ECJ ruled that national measures can be justified by preventing tax avoidance, provided that they only apply to wholly artificial arrangements that are aimed at circumventing domestic legislation.[85] Therefore, in line with *Cadbury Schweppes*, a transaction is legitimate if it reflects economic reality, despite potential underlying tax motives.[86] To determine whether an arrangement is artificial, it has to be assessed whether the accrual of the tax advantage (*subjective criteria*) is in compliance with the purpose of the provision (*objective criteria*). The objective criteria have to be ascertainable by third parties.[87]

The justification ground of preventing abuse was accepted in *Thin Cap Group* which concerned interest payments from UK resident companies to non-resident group companies.[88] Generally the deductibility of interest payments was not limited in the same way if the

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[76] A Körner, 'The ECJ's *Lankhorst-Hohorst* Judgment – Incompatibility of Thin Capitalization Rules with European Law and Further Consequences', *INTERTAX*, vol. 31, no. 4, 2003, p. 165, retrieved 21 March 2013, Kluwer Law International Online.

[77] C P Knöller (n. 1), p. 335.

[78] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107.

[79] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995.

[80] R de la Feria (n. 12), pp. 395 – 441.

[81] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, paras. 22, 34.

[82] Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-01459.

[83] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, para. 35 and Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-01459, para. 24.

[84] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, paras. 37, 50 and Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-01459, para. 18.

[85] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, paras. 51, 55.

[86] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, para. 65.

[87] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, paras. 64, 67.

[88] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, para. 2.

creditor was a domestic group company.[89] In the test cases interest was paid to non-residents (EU or third state ultimate parents) with certain shareholdings that exceeded 75% that were affected by the recharacterization and following non-deductibility of interest payments.[90] As the tax treatment differed depending on the residency of the related party, such measure restricts the freedom of establishment for EU-resident lenders.[91] Contrary to *Lankhorst-Hohorst* the British thin capitalization rules were justifiable as measures specifically targeting wholly artificial arrangements that do not reflect economic reality are allowed. But the ECJ stressed that foreign residency of a lender cannot give a general presumption of abuse.[92] Although the UK measure was appropriate to its underlying objective, the measure was not proportional.[93] For thin capitalization rules to be proportional, two conditions were laid out. First, the taxpayer needs to be given the opportunity to provide evidence without unreasonable administrative requisites that the arrangement was commercially justified.[94] Second, reclassification of interest payments is only proportional for the amount that exceeds arm's length.[95]

Thus, from *Thin Cap Group* it can be concluded that thin capitalization rules can be justified by the prevention of tax avoidance. The problem with the German rules in *Lankhorst-Hohorst* was that they applied automatically without considering whether any actual abuse was present as they were not specifically targeted to prevent wholly artificial arrangements.[96] The ECJ generally considers abuse to be given when an artificial arrangement is created to fulfil formal compliance with a provision's conditions to obtain the advantages despite not being in line with the purpose of the law provision.[97] It is, however, as the ECJ stated in *Eurowings*[98] not abusive if taxpayers arrange their affairs in a way to profit from taxing differences between Member States, as long as such arrangements are not artificial.[99] It follows from *Thin Cap Group* that deductibility of interest payment to affiliated companies cannot be denied if it the lender has a genuine economic activity and the interest is at arm's length.[100] In summary, thin capitalization rules must be limited to wholly artificial arrangement. However, neither intra-group loans nor loans by foreign lenders in themselves can lead to a general avoidance

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[89] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, para. 4.
[90] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 5, 17 – 19, 38.
[91] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 40, 63.
[92] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 72 – 74.
[93] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 77, 82.
[94] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 77, 82.
[95] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, para. 83.
[96] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, para. 37 and N Vinther and E Werlauff (n. 73), p. 105.
[97] Case C-110/99 *Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas* [2000] ECR I-01569 paras. 52 – 53.
[98] Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-07447.
[99] Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-07447, para. 44.
[100] T Andersson, 'Något om Föreslagen Utvidgning av Ränteavdragsbegränsningsreglerna', *Svensk Skattetidning*, no. 9, 2012, p. 731, retrieved 21 March 2013, Zeteo.

presumption.[101] As both rulings deal with reclassified interest, it is even argued that such rules in general cannot comply with EU law which speaks in favour of interest deduction limitation rules.[102]

The questions in *Thin Cap Group* were also referred under the free movement of capital.[103] Contrary to the freedom of establishment, the free movement of capital applies in third country situations. However, the ECJ ruled that thin capitalization rules affect shareholdings giving definite influence on company's decisions and thus the freedom of establishment applies primarily. Any restrictions of the free movement of capital are an unavoidable consequence of the restricted freedom of establishment. Thus, the ECJ denied a separate examination.[104]

Another case that has indirect relevance as it touched upon interest payments to non-residents is *Scheuten Solar*[105]. The case is interesting with regard to thin capitalization as the ECJ stated that the provisions of the Interests and Royalties Directive[106] only concern the tax position of the lender, *i.e.* the interest creditor.[107] The rule that was disputed in *Scheuten Solar*, which lead to economic double taxation, related to the interest debtor only. Therefore the Directive was not applicable and did not prohibit the legislation.[108] As thin capitalization also leads to partial economic double taxation and applies to the interest debtor only, the ruling has an indirect impact which leads to the conclusion that thin capitalization rules are not covered by this Directive.[109] In addition it is intended that the benefits of the Interest and Royalty Directive are not applicable to fraudulent or abusive arrangements.[110]

3.2 EU Law Compatibility of the Swedish Rules

Concerns regarding the compatibility of the Swedish interest deduction limitation rules with EU law have been raised already upon their introduction in 2009.[111] The Swedish government has disclaimed any conflict of the Swedish rules with EU law. Due to several complaints, the European Commission has in January 2013 officially questioned Sweden about the EU law compliance of the national measure. The Swedish government continued to insist that the freedom of establishment is not restricted by the interest deduction limitation rules.[112]

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[101] L Brosens (n. 6), p. 208, C P Knöller (n. 1), p. 322 and G L Mozo, 'Thin Capitalization: An Unanswered Question Following Recent Spanish Amendments', *European Taxation*, vol. 52, no. 8, 2012, p. 418, retrieved 21 January 2013, IBFD Tax Research Platform.
[102] L Brosens (n. 6), pp. 209 – 210.
[103] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 1, 18 – 19.
[104] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 27, 32, 34.
[105] Case C-397/09 *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen Süd* [2011].
[106] Interests and Royalties Directive 2003/49/EC.
[107] Case C-397/09 *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen Süd* [2011] para. 28.
[108] Case C-397/09 *Scheuten Solar Technology GmbH v Finanzamt Gelsenkirchen Süd* [2011] paras. 22, 30, 36.
[109] T J C van Dongen (n. 1), pp. 23 - 24 and G L Mozo (n. 101), p. 416.
[110] Interests and Royalties Directive 2003/49/EC, Art. 5 para. 2.
[111] L Samuelson (n. 29), p. 558 and M Hilling (n. 30), p. 823.
[112] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 6 and European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013.

The Swedish Supreme Administrative Court (*Högsta Förvältningsdomstolen*) has already dealt with the EU law compliance of the Swedish interest deduction limitation rules in several cases on which judgments were rendered on 30 November 2011. Against the background of the ECJ's ruling in *Scheuten Solar* the Swedish Court confirmed that the Swedish rules do not infringe the Interest and Royalties Directive as they apply to the interest debtor.[113] More importantly was the Swedish Court of the opinion that only the 10%-rule might infringe the freedom of establishment.[114] However, the Swedish Court concluded that the 10%-rule does not pose an obstacle to the freedom of establishment as, with *Lankhorst-Hohorst* in mind, the taxation of the corresponding interest income in Sweden is not required.[115] But as the reasoning is based on *Oy AA*[116] and *Schempp*[117], whose relevance for such rules can be questioned, without even considering *Thin Cap Group*, the value of these rulings for interest deduction is rather questionable.[118] As a matter of course the Swedish government supports the importance of these favourable rulings for the current rules.[119] The European Commission on the other hand is not convinced by the 2011 rulings. Even though, as pointed out by the Swedish Court, the Swedish rules do not directly discriminate by differentiating between residents and non-residents, it is clear since *Lankhorst-Hohorst* that indirect discrimination also restricts the freedom of establishment.[120]

The Commission has received complaints about indirect discrimination of cross-border groups. It is in line with the discussion in literature and the Swedish Supreme Administrative Court's rulings that the 10%-rule is problematic due to its practical effect on non-resident affiliated companies. Under the Swedish rules interest payments to domestic companies, with the exception of investment companies and municipalities, are always deductible according to the 10%-rule as they are taxable to Swedish corporate income tax at 22%.[121] In *Lankhorst-Hohorst* discrimination was based on different treatment of the interest paying subsidiaries based on the residency of their parent company.[122] Just like in *Lankhorst-Hohorst* some domestic companies are also treated differently, but in practice essentially interest paid to non-resident creditors is affected.[123] In practice for example especially Swedish debtors with Belgian creditors are affected, whereas only a minor number of Swedish companies are

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[113] Högsta Förvaltningsdomstolen, 2011, mål nr. 4797-10, mål nr. 4798-10, mål nr. 4800-10 and mål nr 7648-09 and Regeringen, *Budgetproposition 2012/13:1*, *supra* n. 32, p. 268.

[114] Högsta Förvaltningsdomstolen, 2011, mål nr. 4797-10, mål nr. 4798-10, mål nr. 4800-10 and mål nr 7648-09 and T Andersson and C Carneborn, 'HFD:s Domar den 30 November 2011 Avseende Ränteavdrags-begränsningsreglerna – En Kommentar', *Svensk Skattetidning*, no. 1, 2012, p. 65, retrieved 21 March 2013, Zeteo.

[115] Högsta Förvaltningsdomstolen, 2011, mål nr. 4797-10, mål nr. 4798-10, mål nr. 4800-10 and mål nr 7648-09 and Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 7.

[116] Case C-231/05 *Oy AA* [2007] ECR I-06373.

[117] Case C-403/03 *Egon Schempp v Finanzamt München V* [2005] ECR I-06421.

[118] T Andersson and C Carneborn 'HFD:s Domar'(n. 114), p. 71 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 730.

[119] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 7.

[120] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 4.

[121] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 5 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 731.

[122] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, paras. 22, 27.

[123] C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779, paras. 4, 18 and European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, pp. 4 – 5.

affected.[124] The Swedish government defends that any differences in cross-border situations are caused by the differences in Member States' legislation for received payments and thus, would not be discriminatory.[125] However, the ECJ case law only goes so far as the Member State, here Sweden, cannot be required to take into account disparities arising from particularities of another Member States' legislation.[126] This is however not the case with the Swedish rules and therefore the government's argument is not very strong and convincing. Moreover the government does not agree with the Commission's understanding that in practice only non-resident creditors are affected as contrary to the German rules in *Lankhorst-Hohorst* the Swedish rules do not even indirectly require that for the 10%-rule the interest income is taxed in Sweden. Sweden also points to the counter-exception that interests are despite not fulfilling the 10%-rule deductible, if the interest payments are motivated by sound business reasons.[127] However, it is questionable in how far the tax authorities in practice might accept any business reasons despite a low tax rate leading to a tax benefit for the group. The government on the other hand claims that no different treatment between resident and non-resident companies is applied upon assessment whether a transaction is economically justified.[128] But Swedish companies taking up loans from foreign affiliated companies are more likely to be required to prove that the corresponding interest income is hypothetically taxed at 10% in the hands of the beneficial owner. Additionally it has to be proven that the group does not obtain a substantial tax advantage. Even though certain administrative constraints are acceptable under EU law, it can be questioned if they are unnecessarily strict on companies with foreign debtors. It can also be questioned why the hypothetical test is of relevance if it can be proved that the effective taxation of interest income exceeds 10%. Although the 10%-rule leads to a general presumption of abuse, the Swedish rules allow in line with *Thin Cap Group* that the debtor can provide economic justification for loans from residents in low-tax jurisdictions. The Commission also argues that it appears unlikely that the tax authorities consider domestic intra-group loans being motivated by significant tax benefits.[129] Swedish group companies do not need to employ interest payments to shift profits between domestic companies to benefit from tax benefits and immediate cash-flow advantages as Swedish tax law provides for the group contribution scheme.

In case of discrimination, the Swedish government states that the measure is justified by balanced allocation of taxing powers and prevention of tax avoidance.[130] However, under the tax avoidance justification, as in *Thin Cap Group*, the rules have to be specifically targeted at preventing tax avoidance and only apply to wholly artificial arrangements to be proportional. The proportionality of the Swedish rules is questionable as minor tax reasons in themselves can already lead to non-deductibility of interest expenses. This is not in line with ECJ case law which clearly refers to wholly artificial arrangements and does not require that arrangements are primarily motivated by business purpose but have to be non-artificial. Even

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[124] T Andersson and C Carneborn 'HFD:s Domar'(n. 114), pp. 68 – 69.
[125] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 9.
[126] Case C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061, paras. 42 – 45, 49.
[127] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, pp. 5, 9.
[128] T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 718.
[129] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, pp. 5 – 6.
[130] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 14.

though tax purposes cannot be seen as business purposes, tax advantages cannot in themselves presuppose abusive transactions.[131] According to the ECJ, deduction for interest payments to affiliated companies cannot be denied if the foreign recipient is a genuinely economically active establishment, irrespective of taxation in the creditor's state.[132] Although the business purpose counter exceptions try to exclude economically justifiable transactions from the scope of the interest deduction limitation rule, they are not as appropriate as they should be, as will be discussed in this paper. As mentioned before, *Eurowings* makes it clear that taxpayers can profit from taxing differences between Member States unless they set up artificial arrangements.[133] The Swedish rules even disallow deduction of interest expenses at arm's length when they are not primarily economically motivated.[134] Therefore the Swedish rules are stricter than what can be drawn from case law.[135]

The Commission also criticized that no administrative guidance has been given on several issues which leads to uncertainty. However, legal uncertainty is not an issue for an EU law compliance analysis. On the one hand have complaints been raised about the burden of proof, as the taxpayer bears the burden to prove that a transaction has to at least 75% been motivated by business purposes whereas the tax authorities do not have to provide evidence of abuse.[136] In the proportionality analysis in *SIAT*[137] the ECJ did not accept that the burden of proof was shifted to the taxpayer.[138] But the rules are in line with *Cadbury Schweppes*, where the ECJ decided that the resident taxpayer is in the best position to provide evidence for non-abuse.[139]

Another discriminatory feature of the Swedish rules is newly added yield tax exception. It is rather obvious that a resident debtor is in comparable situation if he is paying interest to a resident pension fund and a non-resident pension fund. Although the rules in theory allow the deduction of interest payment to affiliated non-resident pension funds, it favours in practice primarily resident pension funds as non-resident pension funds are required to be taxed at the same or higher rate and similarly to the "very particular Swedish yield tax system" [140].

Overall are the responses of the government not very convincing as they are not well funded. In line with the Commission, several problems regarding EU law compliance were pointed out. Primarily the indirect discrimination in practice of the 10% rule is likely to infringe the freedom of establishment. Although it is argued that the discrimination can be justified by the

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[131] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 72 – 74, Case C-318/10 *Société d'Investissement Pour l'Agriculture Tropicale SA (SIAT) v Belgian State* [2012] para. 51 and European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, pp. 5 - 6.

[132] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), pp. 731 – 732.

[133] Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-07447, para. 44.

[134] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 6.

[135] T Andersson, 'Ränteavdragsbegränsning i Bolagssektorn' (n. 31), p. 363 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), pp. 731 - 732.

[136] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 6.

[137] Case C-318/10 *Société d'Investissement Pour l'Agriculture Tropicale SA (SIAT) v Belgian State* [2012].

[138] Case C-318/10 *Société d'Investissement Pour l'Agriculture Tropicale SA (SIAT) v Belgian State* [2012] paras. 55 – 59.

[139] Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-07995, para. 70.

[140] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 5.

need to prevent tax avoidance and the balancing allocation of taxing powers,[141] the Swedish interest deduction limitation rules also face problems regarding their proportionality under EU law, in case of justification.

3.3 EU Law Compatibility of the German Rules

The compliance of the German interest barrier with EU law also has been questioned.[142] Although the German interest deduction limitation rules do not directly distinguish between resident and non-residents, the freedom of establishment might nevertheless be infringed by hidden discrimination. The literature seems to be of the consistent opinion that the favourable treatment of the domestic fiscal unity under the non-affiliation exemption indirectly discriminates non-residents companies and thus infringes the freedom of establishment.[143] Under the non-affiliation exemption, companies that do not or only partially belong to a group are exempted from the application of the interest deduction limitation rule.[144] Problematic with regard to EU law is that companies that form a German fiscal unity for tax purposes (*Organschaft*) are regarded as a single business for the purpose of the non-affiliation exemption.[145] The problem arises as the eligibility for the fiscal unity was primarily limited to domestic companies leading the European Commission to initiate an infringement procedure against Germany.[146] As a reaction, amendments of the German fiscal unity were passed on 20 February 2013 to broaden the scope for EU and EEA resident companies.[147] It is yet to see in how far the amendments actually remove the discrimination of non-resident companies for eligibility of the fiscal unity and by extension of the non-affiliation exemption for the German interest deduction limitation rules. The exemption is therefore in practice, at least under the fiscal unity regime before the amendments, not available to the same extent for multinational groups with non-resident companies. A group with all group companies organised under a fiscal unity can avoid application of the interest barrier at all.[148] In addition is the income of the fiscal unity according to sec. 15 para. 3 GCITA consolidated which increases the EBITDA and thus the amount of interest expenses that can be deducted.

The practical effect that resident companies are subject to more beneficial treatment gave rise to serious doubts regarding the EU law compliance of the German interest barrier. But as this special feature is set out in the provisions on the fiscal unity (Secs. 14 – 19 GCITA) and does not form part of the interest deduction limitation rules *per se*, it is more likely that any EU law problem of the interest deduction limitation rules will be removed once the German fiscal

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[141] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 14 and M Hilling (n. 30), pp. 824 – 825.

[142] E.g. A van den Berg van Saparoea, 'Optimizing the Interest Deduction Rules – A Never-Ending Story', *European Taxation*, vol. 49, no. 1, 2009, p. 9, retrieved 14 March 2013, IBFD Tax Research Platform and K von Brocke and E G Perez, (n. 10), p. 34.

[143] R Eicke and W Kessler (n. 54), p. 266, T Müller-Duttiné and M P Scheunemann (n. 55), p. 521, K von Brocke and E G Perez (n. 10), p. 34 and C P Knöller (n. 1), p. 328.

[144] Sec. 4h para. 2 (b) GITA.

[145] Sec. 15 (3) GCITA.

[146] European Commission v Germany, IP/12/283, *Commission refers Germany to Court Over Tax Treatment of Group Companies*, 22 March 2012, retrieved 4 April 2013, Case 2008/4909, http://ec.europa.eu.

[147] Bundessteuerblatt I 2013, p. 192 and secs. 14 – 19 GCITA.

[148] R Eicke and W Kessler (n. 54), p. 266, T Müller-Duttiné and M P Scheunemann (n. 55), p. 521, A van den Berg van Saparoea (n. 142), p. 8 and C P Knöller (n. 1), pp. 328 – 329.

unity complies with the freedom of establishment and thus will most likely not lead to a separate examination of the interest barrier. But so far, the European Commission has not withdrawn its reference to the ECJ regarding the infringement of the freedom of establishment by the German fiscal unity provisions.

Further doubts are raised regarding the justification of such indirect discrimination by the prevention of tax avoidance or balanced allocation of taxing powers.[149] However, more issues arise regarding the proportionality of the interest barrier. The German rules are rather unique in applying in general to all debt, irrespective of its nature. By this the interest barrier leads to double taxation without specifically targeting abusive behaviour.[150] This is underlined by the fact that the German interest deduction limitation rules do not provide for any safe haven or require any arm's length proof. As pointed out in *Cadbury Schweppes* anti-abuse measures must be limited to tax-driven wholly artificial arrangements. It is argued that the German interest barrier is not compatible with EU law in this regard.[151] It cannot be denied that the scope of the interest barrier is too broad to be proportional under the tax avoidance prevention justification.[152] However, it is questionable if the German provision any longer can be categorized as anti-abuse provision.

In *Thin Cap Group* the ECJ decided that thin capitalization rules are only proportional if only the amount exceeding arm's length is non-deductible.[153] The *de minimis* exception of the interest barrier, however, follows an "all-or-nothing condition"[154] which upon exceeding the threshold leads to non-deductibility of all net interest expense under the general rule. The interest barrier might therefore not be proportional, assuming that it would be justifiable. In *Thin Cap Group* unnecessary administrative constraints were also not accepted under the proportionality analysis.[155] Even though the counter exceptions lead to rather high and complex demands regarding the burden of proof for harmful shareholder debt-financing, especially for large corporate groups[156], whereas the tax authorities are not required to prove abuse[157], it can be argued to qualify as being necessary. It is rather difficult to assess what the ECJ would consider unnecessary administrative constraints. Another part of the rules that might pose unnecessary administrative constraints on the taxpayer is the equity comparison which requires that the financial statements to be submitted have to be set up in German or in a certified translation in addition to necessary adjustments.[158]

In summary it seems unlikely that the German interest deduction limitation rules will be subject to a case before the ECJ, unless regarding their proportionality as anti-abuse

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[149] R Eicke and W Kessler (n. 54), p. 266, T Müller-Duttiné and M P Scheunemann (n. 55), p. 521 and C P Knöller (n. 1), p. 329.
[150] R Eicke and W Kessler (n. 54), p. 267.
[151] R Eicke and W Kessler (n. 54), p. 266.
[152] C P Knöller (n. 1), p. 328.
[153] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, para. 83.
[154] A Perdelwitz and R Resch (n. 51), p. 160.
[155] Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue* [2007] ECR I-02107, paras. 77, 82.
[156] C P Knöller (n. 1), p. 326.
[157] N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 581.
[158] T Müller-Duttiné and M P Scheunemann (n. 55), p. 522.

provision, as their indirect discrimination stems from the allegedly non-compliant fiscal unity regime. The infringement of the fiscal unity regime has in itself already been referred to the ECJ by the European Commission and has lead to small reform of the fiscal unity regime in 2013.[159]

4. Appropriateness and Proportionality Analysis

To enable a proper critical comparison, it has to be assessed in how far the interest deduction rules are appropriate to fulfil their purpose as both anti-abuse provisions and measures to prevent tax base erosion.

4.1 Appropriateness and Proportionality of the Swedish Rules

The Swedish set of interest deduction limitation rules are in their substance an anti-avoidance legislation that targets the circumventing of taxation by debt financing with a focus on intra-group loans and back-to-back loans. However, the government stresses that the rules do not primarily aim at preventing tax avoidance but at preventing an erosion of the Swedish tax base.[160] The basic problem is the incentives for intra-group debt created by the tax-beneficial treatment of debt. Already in its preparatory work before the implementation of the interest deduction limitation rules in 2009, tax planning in connection with acquisition of shareholdings in non-affiliated companies and third party loans was identified as a potential serious threat to the Swedish tax base.[161]

Assessing the appropriateness of the Swedish rules, it has to be considered in how far they can be circumvented and in how far they apply to non-abusive arrangements The relevant issue is to assess how appropriate the Swedish rules are for protecting the Swedish tax base by targeting tax avoidance and in how far sound business arrangements are affected by the rules. The main problem regarding the appropriateness of the Swedish rules is their legal uncertainty for both the taxpayers and the tax authorities. Especially from the viewpoint of the tax authorities the tax base is not predictable and it is more difficult for them to assess whether arrangements are abusive and therefore under the law enable the application of the interest deduction limitation rules which in turn increase the tax base. Uncertainty results from several imprecise and unclear terms that lead to a demand for guidance, especially on the interpretation of the exceptions.[162] The rules provide for two exceptions to avoid as much as possible that debt financing with sound business reasons is affected.[163] It is important with regard to appropriateness and proportionality that the rules in order to increase the tax base as an anti-abuse provision only apply to abusive arrangements. In ch. 24 para. 10a SITA it is unclear what is meant by ‘substantial influence’ (*väsentligt inflytande*). Although the

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[159] European Commission v Germany, IP/12/283, *Commission refers Germany to Court Over Tax Treatment of Group Companies*, 22 March 2012, retrieved 4 April 2013, Case 2008/4909, http://ec.europa.eu and Bundessteuerblatt I 2013, p. 192.

[160] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 12.

[161] Regeringen, *Proposition 2008/09:65*, 28 October 2008, p. 45, retrieved 4 April 2013, http://www.regeringen.se and Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 6.

[162] L Samuelson (n. 29), p. 558 and A Hilling (n. 2), p. 700.

[163] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 6.

government made it clear that this intends to cover shareholdings *just* under 50%, it is unclear in which other ways than shareholdings such substantial influence can be exercised. According to the government this general design and imprecise terminology intends to cover that not all situations can be foreseen. Although this is a comprehensible reasoning, this leads to uncertainty for any tax planning activity of the taxpayer.[164] Especially companies with shareholdings just under 50% cannot predict whether deduction of interest expenses will be limited and such companies are more likely to be subject to more thorough assessment by the tax authorities trying to prove substantial influence.

However, even more considerable uncertainty is created by the impreciseness of the exceptions. An important factor of uncertainty is the assessment of business reasons of an arrangement for the purpose of the exceptions. The exception rules, *i.e.* the 10%-rule and the yield tax rule as well as the business purpose rule, are implemented to exclude certain transactions from the general rule's scope that disallow deduction of interest expenses.[165] However, it is questionable in how far these exceptions can ensure that the interest deduction limitation rules are targeted at artificial and abusive arrangements. Under the 10%-rule a counter-exception disallows the application of the exception from the general rule when the underlying debt is motivated by obtaining a tax benefit for the group.[166] The burden of proof that an arrangement has mainly business motives lies with the taxpayer, whereas the tax authorities have to show that wrong information was given or that an arrangement that fulfils the formal conditions of the 10%-rule has been entered to obtain a significant tax benefit for the group.[167] As already mentioned, did the ECJ not accept the shift of the burden of proof on the taxpayer in *SIAT*.[168] The government tries to defend the shift of the burden of proof by pointing out differences between the *SIAT* case and the Swedish rules.[169] However, this 'reversed safety value' is pointed out to be the weakest point of the rules regarding their appropriateness as it is very difficult for the Swedish tax authorities to determine whether or not an arrangement has a sound business purpose.[170]

Additionally are the rules criticized for being unforeseeable and leading to legal uncertainty because the tax authorities are entitled to change their tax assessment for several years.[171] This cannot be considered acceptable with regard to well-targeted anti-abuse legislation. It might also discourage investments in Sweden which indirectly also erodes the tax base.

Not only the tax authorities might have problems gaining all information necessary, but the taxpayers as well when he has to prove that the hypothetical 10%-test has been fulfilled. As not the effective taxation, which could rather easily be derived from the annual tax returns, is decisive but the hypothetical taxation, this requires certain knowledge of a different

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[164] R Hellenius (n. 31), p. 163 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 721.
[165] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, pp. 3 – 4.
[166] Ch. 24 para. 10d SITA.
[167] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 6 and Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, pp. 15 - 16.
[168] Case C-318/10 *Société d'Investissement Pour l'Agriculture Tropicale SA (SIAT) v Belgian State* [2012] paras. 55 – 59.
[169] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, pp. 16 - 18.
[170] M Dahlberg, 'Sweden's Proposal' (n. 29), p. 1038.
[171] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, pp. 56 – 57.

jurisdiction's tax laws. Such an assessment of the hypothetical taxation by the Swedish taxpayers also requires cooperation which might not be given with all group companies and is even less likely with regard to creditors of back-to-back loans.. As the tax authorities' reports have shown, the 10%-test leads to considerably higher compliance costs which should be avoided for principally sound business arrangements.[172] For the 10%-rule it is decisive to determine who the beneficial owner is. The reasoning behind this requirement is to prevent structures where the interest income is passed through intermediary companies to a company in a low-tax jurisdiction.[173] However, the term 'beneficial owner' is problematic and widely discussed in literature. It is stated in commentaries that not only the legal right to the interest income is decisive, but the economic beneficiary who enjoys the economic advantages.[174] In complex group structures this might be rather difficult to establish, for both the tax authorities and the taxpayer. The 10%-rule is in its basic form a very interesting approach from an EU law perspective as it is not discriminatory *per se* as a certain tax arbitrage is accepted as being not harmful despite eroding the Swedish tax base. The issue is, however, which limit is appropriate and that such a fixed percentage entails similar problems as fixed debt-equity ratios.[175]

The business-purpose exception allows deduction even though the 10%-rule is not fulfilled, if the underlying debt, and, if applicable, the acquisition is principally motivated by sound business reasons.[176] According to the government, debt and acquisition are regarded as principally business driven under ch. 24 paras. 10d and 10e SITA if the business purposes amount to more than 75% of the overall reasons behind the debt and the acquisition. Tax reasons are not being accepted as business reasons.[177] In its rulings rendered on 30 November 2011 the Swedish Supreme Administrative Court differentiated between organisational and business purposes and considered organisational purposes not qualifying as business reasons for the purpose of the interest deduction limitation rules.[178] Therefore can business purposes be very difficult to prove, especially for intra-group acquisitions of shareholdings.[179] From an appropriateness viewpoint this can be considered positively with regard to targeting abusive arrangements where fictional business reasons are hard to fabricate due to the strict requirement. However, the rules are so rigid that non-abusive arrangements are also affected and have to face difficulties in proving their commercial justification. It is also quite contradicting that the taxation level of the interest income has an impact on the assessment of the business purpose of the underlying debt,[180] although the business-purpose exception is meant to cover cases of economically justifiable arrangements that do not fulfil the 10%-rule.

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[172] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 21, European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 6 and T Andersson and C Carneborn, 'Något om Ränteavdragsbegränsningsreglernas' (n. 31), pp. 973 – 974.
[173] T Andersson and C Carneborn, 'Något om Ränteavdragsbegränsningsreglernas' (n. 31), p. 975.
[174] R Hellenius (n. 31), p. 168.
[175] A Storck (n. 1), p. 35.
[176] Ch. 24 para. 10e SITA.
[177] European Commission, *EU Pilot 4437/13/TAXU – Sweden*, 9 January 2013, p. 6, A Storck (n. 1), p. 35 and T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), pp. 714 -715.
[178] Högsta Förvaltningsdomstolen, 2011, mål nr. 4797-10, mål nr. 4798-10, mål nr. 4800-10 and mål nr 7648-09 and A Hultqvist (n. 29), p. 124.
[179] A Storck (n. 1), p. 35.
[180] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 61.

Moreover might it prove impossible in practice to determine whether a debt was taken up in order to finance an acquisition or whether a third party provides a back-to-back loan.[181] It is not clear which reasons are accepted as business reasons which further complicates legitimate tax planning activities for the taxpayer. It is furthermore questionable how reasons are to be quantified and to be weighed against each other. The preparatory work indicates that an analysis has to be made on a case-by-case basis.[182] The terminology used (*skuldförhållandet*) indicates that the situation of both the lender and the borrower are to be assessed.[183] A case-by-case analysis implies arbitrary treatment depending on tax authorities' random assessment not supported by any guidelines. Such legal uncertainty is a high burden on a taxpayer with regard to his planning activities and prediction of financial funds. Furthermore is arbitrary treatment likely to be disadvantageous for foreign investments and opens the possibility for corruption of tax authorities.

In addition the taxpayer is required to show that the financing could not instead have been arranged by way of contribution.[184] Upon assessing this aspect, even indirect parent companies and other group companies have to be taken into consideration. This in itself presents a heavy administrative burden for large corporate groups.[185] Another major issue with the interest deduction limitation rules is the uncertainty they create by potentially applying retrospectively. As loans and acquisitions entered into before the introduction or amendments of the rules are also included in the scope of the rules, they are subject to a stricter assessment of their commercial justification as when they were entered into. It is questionable in how far this amount to retrospective legislation.[186]

Overall is the terminology used in the Swedish rules rather vague and it is a hard task even for non-abusive taxpayers to fulfil.[187] Regarding legal certainty it is questionable how both the taxpayer and the tax authorities are, on a regular basis, supposed to reach the same conclusion, especially in complex situations, without permanently relying on decisions of national tax courts.[188] The rules can also be considered as being overly strict as they do not provide for a *de minimis* exemption which would considerably lower the compliance cost on small businesses and no safe haven under which taxpayers with considerate certainty can rely on the deduction of their interest expenses. On the one hand this makes it harder on arrangements with sound business purposes but on the other hand it is more appropriate in preventing tax avoidance scheme designed to abuse any safe haven.

4.2 Appropriateness and Proportionality of the German Rules

It has been doubted whether the German interest barrier is an appropriate anti-avoidance rule preventing the erosion of the tax base. The problem, it is argued, is that the rules go far

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[181] R Hellenius (n. 31), p. 171.
[182] T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 722.
[183] T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), pp. 714 – 715.
[184] Ch. 24, para. 10e SITA.
[185] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, pp. 71 – 72.
[186] R Hellenius (n. 31), p. 171, T Andersson, 'Ränteavdragsbegränsning i Bolagssektorn' (n. 31), p. 362 and A Hultqvist (n. 29), p. 139.
[187] M Hilling (n. 30), p. 825.
[188] T Andersson, 'Något om Föreslagen Utvidgning' (n. 100), p. 723.

beyond what was intended by the legislator. The rules are being criticized for their broad scope which would affect unnecessarily many companies.[189] Due to the broad scope, the German rules in general do not differentiate based on the kind of debt, *i.e.* whether the creditor is an affiliated company, a third party or even a bank. The rules also do not provide for a safe haven accepting higher indebtedness based on the arm's length of a loan. However, the amount of interest expenses, a company's equity ratio and potential shareholder debt financing have to be considered. The question is how appropriate the German interest deduction limitation rules are for securing the domestic tax base and whether tax avoidance is combated at the price of sound business loans.

With the broad scope Germany intended to make the determination of abusive financing structure more objective. However, the rules' scope might be broader than necessary for preventing tax avoidance. In addition the taxpayer cannot rebut the avoidance presumption.[190] But, here again, it has to be pointed out that the German rules might no longer be a classical anti-avoidance legislation that restricts deduction of interest expenses, but more a new approach towards disallowing deduction of interest payments in general to achieve assimilation with equity and only allowing deductibility under certain circumstances.

The German rule is one of the so-called EBITDA-rules as the deductibility of interest expenses depends on a company's EBITDA. At first sight the flexibility and adaptability of this approach is intriguing. EBITDA is a figure from the financial statements, whereas the German rules are orientated at the taxable EBITDA which can significantly deviate in some cases, e.g. for holding companies. Due to the almost full tax exemption (95%) of capital gains and dividends, holding companies usually have a rather low taxable EBITDA. Another example is a company with foreign permanent establishment whose income is usually due to double tax treaties tax exempt and therefore not contained in the taxable EBITDA.[191] Or companies which are incurring high research and development expenses which are not considered in the taxable EBITDA.[192] A problem is that EBITDA is a rather volatile figure on which the deductibility of usually relatively constant interest expenses depends.[193] Contrary to fixed debt-equity ratios, it is rather difficult to predict the deductibility of interest expenses under a dynamic EBITDA-rule.[194] The argumentation that the recovery of financially trouble companies is aggravated by the EBITDA-approach[195] has to be disregarded, as the effect of the volatility of EBITDA is damped by the EBITDA carry-forward. This is helpful for companies who only have temporarily lower EBITDAs. For companies who are in long-term financial troubles, the limited deductibility of interest expenses is most likely only an indirect burden by not increasing the tax loss carry-forwards. Only if the earnings before the deduction of interests (and depreciation and amortization) are negative, non-deductibility of net interest expenses is given and will therefore not impose a tax payment on the taxpayer. Taxpayers

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[189] A van den Berg van Saparoea (n. 142), p. 6 and C P Knöller (n. 1), pp. 317, 326.
[190] C P Knöller (n. 1), pp. 324, 328.
[191] T Müller-Duttiné and M P Scheunemann (n. 55), p. 519 and N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 578.
[192] K von Brocke and E G Perez (n. 10), p. 34.
[193] N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 578.
[194] T Müller-Duttiné and M P Scheunemann (n. 55), p. 519 and C P Knöller (n. 1), p. 327.
[195] T Müller-Duttiné and M P Scheunemann, (n. 55), p. 518 and R Eicke and W Kessler (n. 54), p. 276.

may also increase their EBITDA, e.g. by a step-up in value or by realizing hidden reserves.[196] However, such behaviour grants an earlier interest deduction and thus temporary benefits, but in turn also increases the tax base which is compliant with the legislator's intention.

The German interest deduction limitation rules contain three exceptions to distinguish between excessive debt-financing and sound business financing. Generally small and medium-sized companies, unaffiliated companies and affiliated companies with a group-average equity ratio are exempted from the scope of the interest deduction limitation rules.[197] The rationale of the *de minimis* exception is the assumption that small and medium-sized enterprises do not need to be targeted by anti-abuse legislation due to their lower impact on the German tax base and as they are less likely to set up cross-border arrangements. Even though a certain threshold is in principle to be seen as positive as it relieves smaller businesses from unnecessary compliance costs, it is questionable whether the threshold might be set too high. The threshold was initially set at EUR 1m and was only intended to be increased temporarily due to the financial crisis.[198] Tax avoidance is not presupposed unless the net interest expenses exceed EUR 3m with a theoretical corporate income tax value of EUR 450,000.[199] Assuming an interest rate between 5% and 10% and no interest income, this amounts to debt financing between EUR 30m and EUR 60m. It is questionable in how far companies with balance sheet sum exceeding at least EUR 30m, plus equity and provisions, really need to be assumed to be small and medium enterprises not engaging in abusive arrangements. A lower threshold would also reduce incentives for group companies to circumvent the interest barrier by splitting their debt financing over several businesses. For circumvention of the interest barrier, it might even make sense for groups to abolish a fiscal unity. The *de minimis* exception is even more attractive for tax planning strategies as the counter-exception for harmful shareholder debt-financing does not apply.[200]

Another opportunity for tax planning is provided by the non-group affiliation exemption, as the fiscal unity is regarded as one business. As already discussed, was this opportunity so far limited to domestic groups and potentially infringed EU law. An opening of the fiscal unity regime for EU resident companies might in turn discourage the German legislator to hold on to the non-group affiliation exemption for the fiscal unity. For determining the existence of a group the facts at the end of the last fiscal year are assessed, unless a company is newly incorporated.[201] Therefore a newly formed group can benefit from full deductibility of interest expenses under the non-group affiliation exemption during the first fiscal year. However, this is a one-time-only possibility.

The most relevant exemption for multinational groups is the equity comparison. However doubts are casted on its effectiveness. A study[202] upon introduction of the interest deduction limitation rules has shown that tax planning activities with regard to the group-wide equity ratio are not very relevant to taxpayers. Usually adjustments have to be made to the financial

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[196] C P Knöller (n. 1), p. 327.
[197] Sec. 4h para. 2 GITA and N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 577.
[198] C P Knöller (n. 1), p. 325.
[199] Simplified calculation at corporate income tax rate of 15% for 2013: 3,000,000 x 15% = 450,000.
[200] N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 579 and C P Knöller (n. 1), p. 328.
[201] K von Brocke and E G Perez (n. 10), p. 32.
[202] N Herzig, B Liekenbrock and U Lochmann (n. 54), pp. 581 – 582.

statements to determine the decisive equity ratios, resulting in high compliance and monitoring costs. Obstacles of practical and conceptual nature significantly restrict the application of the escape clause and it is therefore relatively resistant to tax planning.[203] But it has to be highlighted that instead of relying on a fixed equity ratio, the approach provides flexibility to adapt to the situation of every group.

The additional restrictions on corporations regarding harmful shareholder debt-financing are in principal a good approach to combat tax avoidance. In many cases it leads to unsuccessful application of the former two exceptions.[204] As any excessive interest payment from a non-group shareholder affects the whole group, high compliance and monitoring costs are incurred upon recalculation business plans and analysing group financing structures.[205]

The suitability of the exemptions, the low amount of deductible interest expenses and the high level of complexity are among the issues that are criticized by tax practitioners.[206] It is argued that the exemptions are relatively resistant against any tax planning, which on the one hand poses an obstacle to multinational groups, but on the other hand is a sign of appropriateness of the rules.[207] A study showed that three different tax planning approaches were considered by German companies: adjusting the interest expenses, e.g. by export of expenses to other high-tax jurisdictions or import of interest income or substitution by other financial instruments not subject to the interest barrier, adjusting the EBITDA, e.g. by shifting income to Germany, or adjusting the group structure. The German rules, hence, actually create incentives for tax planning alternatives that increase the German tax base. As intended by the legislator the German interest deduction limitation rules can indeed, at least partially, counter-finance the tax rate reduction.[208] Despite the reduction of the corporate tax rate, Germany is still a high-tax jurisdiction whose attractiveness for international investments and multinational groups is negatively affected by the strict and rigid interest deduction limitation rules. It can be doubted whether the attractiveness has improved at all compared to the old thin capitalization regime. Therefore the appropriateness in preventing tax base erosion might be made at the cost of discouraging investors.[209]

Overall appears the German interest barrier not to be a well-targeted anti avoidance provision and is a considerable obstacle for multinational groups operating in several tax jurisdictions, high leveraged companies, holding companies and other companies with low taxable EBITDA, certain unprofitable companies and growing start-up companies. However, financially sound companies should be able to deduct their interest expenses despite potentially high compliance costs.[210]

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[203] N Herzig, B Liekenbrock and U Lochmann (n. 54), pp. 581 – 582 and C P Knöller (n. 1), p. 327.
[204] Sec. 8a GCITA and N Herzig, B Liekenbrock and U Lochmann (n. 55), p. 582.
[205] R Eicke and W Kessler (n. 54), p. 264 and N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 583.
[206] K von Brocke and E G Perez (n. 10), p. 34.
[207] C P Knöller (n. 1), p. 328.
[208] N Herzig, B Liekenbrock and U Lochmann (n. 54), pp. 579, 583.
[209] C P Knöller (n. 1), p. 327.
[210] R Eicke and W Kessler (n. 54), pp. 266 – 267, T Müller-Duttiné and M P Scheunemann (n. 55), p. 518, N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 578 and C P Knöller (n. 1), pp. 327 – 328.

5. Comparison

The capping of interest deductibility instead of targeting the capital structure by traditional thin capitalization rules has growing attractiveness as the implementation of such interest deduction limitation rules in Spain and Portugal shows. The introduction of the rules in both Sweden and Germany was motivated by the legislators' intent to counter-finance a simultaneous reduction of the corporate income tax rate.[211] The German rules, however, seem more appropriate in regard to increasing the domestic tax base by creating incentives for tax planning that might actually increase the taxable net interest income in Germany. Sweden on the other hand accepts a certain tax arbitrage and therefore does not give incentives to shift interest income to Sweden and interest expenses out of Sweden.

In comparison to traditional thin capitalization rules, both approaches avoid the complexity of reclassifying interest expenses. Such interest deduction limitation rules seem to be more appropriate as they do not address the capital structure of a company but directly target interest payments. They also avoid the problem of which debt-equity ratio is appropriate for all kinds of businesses.[212] However, both approaches have certain fixed thresholds, *i.e.* the 10%-rule in Sweden and in Germany the *de minimis* exemption and the 10% threshold for harmful shareholder debt financing. The problem with fixed thresholds is that they can be used for tax planning strategies. In Sweden, for example, can companies take up loans especially from creditors that are taxed on the interest income just above 10% and within German groups interest expenses can be split over several companies to benefit each from the EUR 3m threshold.

The main concerns regarding the appropriateness and proportionality of the Swedish interest deduction limitations rules for their pursued purpose were raised about the business purpose tests, both in the 10%-rule and the business purpose rule. The German rules avoid this by not having an arm's length standard, which would not even make sense as the German rules also apply to third party loans and hence, a third party comparison is unnecessary as such loans are assumed to conform to the market rate.[213] As a transfer pricing analysis is not required in Germany, the complexity and costs of such an analysis are avoided, which benefits especially non-abusive taxpayers.[214] However, the German rules provide for a different safe haven in form of a minimum threshold. As long as the threshold is not exceeded, the strict interest deduction limitation rules are not applicable. However, the threshold exception is not a tax allowance, but upon exceeding the threshold by EUR 1, the interest barrier is fully applicable to all net interest expenses and is therefore overly strict.[215] Such a *de minimis* exemption is

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[211] Regeringen, *Budgetproposition 2012/13:1*, 20 September 2012, p. 272, retrieved 4 April 2013, http://www.regeringen.se and Deutscher Bundestag, *Drucksache 16/4841 – Entwurf eines Unternehmensteuerreformgesetzes 2008*, 27 March 2007, pp. 1, 29 – 30, 35, retrieved 9 May 2013, http://www.bundestag.de.

[212] S Webber (n. 5), p. 693.

[213] O F Kerssenbrock and U Kiel, 'Third Party Comparison in New German Thin Capitalization Law: is a Fourth Party Comparison Required?', *INTERTAX*, vol. 33, no. 4, 2005, pp. 179, 188, retrieved 21 March 2013, Kluwer Law International Online.

[214] K von Brocke and E G Perez (n. 10), p. 34 and C P Knöller (n. 1), pp. 327 – 328.

[215] N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 579.

more favourable for small and medium businesses that usually do not have the resources for the compliance cost necessary to prove arm's length of their arrangements. On the other hand is the avoidance presumption of the German rules not rebuttable. But the Swedish rules also only offer relatively strict arm's length standards as a minor tax benefit can already disallow interest deductibility.

Another characteristic that both set of rules share is that they do not only apply in accordance with the size of shareholdings but also to shareholdings giving factual influence e.g. control over the capital or the finance and business policy of the company. The Swedish rules are stricter after their recent amendments, whereas under the German rules it would be possible that equally controlled joint-ventures that are not fully consolidated under the group account can apply the non-affiliation exception.[216] The advantage of taking into account factual influence is that it prevents circumvention of the interest deduction rules by amended shareholdings just below 50%, but as already elaborated is certain legal uncertainty created.

The approaches in both Germany and Sweden are rather complex. Sweden has chosen a specific rule targeting certain tax planning.[217] This, however, tackles the problem of thin capitalization only partially and gives way to other forms of financing to circumvent taxation in Sweden. EBITDA-rules are not focused solely on tax avoidance as they are generally designed. They even disallow interest deductibility if sound business reasons are given. As the rules are linked to the financial results, they can have negative effects in economic crisis.[218] The German approach however manages to buffer the negative effects by implementing EBITDA carry-forwards and interest carry-forwards. The advantage of a general rule disallowing interest deductibility is that it paves the way for a future alignment of debt and equity. With the objective of the Swedish Companies' Committee to align the tax treatment of debt and equity financing,[219] such an EBITDA approach can be interesting due to its general disallowance of deduction of interest expenses from all sources. An EBITDA-approach is flexible, whereas the Swedish rules with the fixed 10%-rule are relatively inflexible. As with fixed debt-equity ratios, this leads the situation that tax planning is adjusted to the rules and companies will export interest income to jurisdictions with taxation just above 10%.[220] Although the flexible EBITDA-approach makes it hard to plan sound business financing, it also impedes abusive tax planning. Both approaches make it hard to predict interest deductibility due to their exemptions. As was pointed out in the analysis of the appropriateness of the German rules, one reason that restricts predictability is the reliance on the special taxable EBITDA which is based on country-specific tax accounting rules. The complexity of the rules could be reduced, and in turn the predictability increased, when an EBITDA approach is based on the accounting EBITDA as e.g. in Italy.[221] From the point of

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[216] N Herzig, B Liekenbrock and U Lochmann (n. 54), p. 580.
[217] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 41.
[218] Finansdepartementets Lagrådsremiss, *Effektivare Ränteavdragsbegränsningar*, 7 June 2012, p. 41 and Regeringen, *Budgetproposition 2012/13:1*, 20 September 2012, p. 235, retrieved 4 April 2013, http://www.regeringen.se.
[219] Regeringen, *Kommittédirektiv 2011:1*, 13 January 2011, p. 1, retrieved 4 April 2013, http://www.regeringen.se.
[220] Regeringen, *Budgetproposition 2012/13:1*, 20 September 2012, p. 230, retrieved 4 April 2013, http://www.regeringen.se.
[221] K von Brocke and E G Perez (n. 10), p. 33 and A Storck (n. 1), p. 38.

view of the taxpayer it is positive that the German rules contrary to the Swedish rules do not *per se* lead to economic double taxation, as interest deduction is only temporarily limited thanks to the interest carry-forward, unless a major ownership share in the company is being transferred.[222] Although both rules still allow circumvention by tax planning to some extent, the German rules encourage tax planning activities that may even increase the German tax base at the cost of other tax jurisdictions.

6. Conclusion

Case law has shown that domestic thin capitalization rules are often discriminatory if they in practice primarily apply to interest payments made to foreign companies. As was shown in the EU law compatibility analysis do the Swedish rules have serious problems with indirect discrimination, whereas the German rules' main problem lies in the fiscal unity exception. Implementation of an EBITDA-approach similar to the German rules in Sweden should not raise concerns regarding EU law, as the Swedish system does not provide for a discriminatory fiscal unity regime like Germany. Combined with a minimum threshold to relieve small taxpayers from the burden of high compliance costs as well as the non-affiliation exception and the harmful shareholder debt financing counter-exception the approach would target the same tax avoidance schemes as intended by the Swedish legislator. This can be underlined by the statement of the Swedish government during the on-going Commission inquiry that a minor amount should not be considered to constitute a significant tax benefit.[223] Despite the equity comparison leading to substantial compliance costs, it functions as a rebuttable avoidance presumption which always incurs certain compliance costs. Although it can be argued that a business-purpose test is more appropriate as a rebuttable avoidance presumption, it also entails arbitrary treatment by the tax authorities which is avoided by an equity comparison.

If the Sweden legislator intends to introduce a *de minimis* exception to the interest deduction limitation rules, it is advisable that the threshold is kept rather low. Moreover it should be considered whether a *de minimis* exception should function as an all-or-nothing condition or instead apply the interest deduction limitation rules only to the exceeding amount. The challenge would be to find a threshold that is high enough to protect small businesses from unbearable compliance cost but not as high as to create incentives to split interest expenses across group companies.

It is furthermore advisable that detailed guidelines on terminology used should be published to ensure higher legal certainty for the taxpayers. Financing, especially for multinational groups, can be very complex and depends on consistent tax rules.[224] Both, the tax authorities and the taxpayers benefit from predictability of their income, *i.e.* tax revenue or profits. This can only be reached by clear formulated tax provisions. This is in line with the principle of legal certainty.[225]

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[222] Sec. 4h para. 5 GITA.
[223] Finansdepartementet, *EU Pilot 4437/13/TAXU – Sweden*, 20 March 2013, p. 18.
[224] A Storck (n. 1), p. 41.
[225] S Webber (n. 5), p. 684.

Germany has relatively consistent rules as it has not made any substantial changes in its interest barrier since its introduction in 2008, but only some amendments to make the rules less rigid, whereas the Swedish rules have undergone several amendments restricting the deductibility of interest expenses even further. For Sweden it is important to introduce a stable and consistent interest deduction limitation rules after the research of the Companies' Committee has been presented. The aim of the Companies' Committee to align the tax treatment of debt and equity should be welcomed[226] with regard to increasing the domestic tax base. Taxpayers are generally entitled to arrange their affairs in the best way possible to profit from taxing differences, as long as their arrangements are not artificial.[227] Therefore taxpayers, especially multinational groups, will always try to reduce their effective taxation. This in turn requires the legislator to close loopholes by constant improvement of their rules, while also facing the challenge to achieve legal certainty and encourage investments.[228]

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[226] Regeringen, *Kommittédirektiv 2011:1*, 13 January 2011, p. 1, retrieved 4 April 2013, http://www.regeringen.se.
[227] Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-07447, para. 44.
[228] C P Knöller (n. 1), p. 334.

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