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The Swedish Interest Deduction Limitation Rules – To Be Or Not To Be?

By

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HARN60 Master Thesis

Master's Programme in European and International Tax Law

2014/2015

Autumn semester 2015

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Summary

In accordance to the Swedish Income Tax Act (1999:1229) chapter 16 article 1, Swedish resident companies have the unlimited right to deduct business expenses, including interest expenses regardless of how the corresponding interest income is taxed. In 2008 the Swedish Tax Administration presented a research on how companies could unlawfully abuse the deductibility by issuing loans to related companies. Giving the companies the possibility to lower the overall taxation by shifting the taxation of profits in low tax jurisdiction and claiming deduction in Sweden. As a consequence Sweden introduced in 2009 limitation of the general right to deduct interest expenses on loans between affiliated companies. Ever since its introduction, compatibility with EU law has been questioned and in particular the freedom of establishment. While the Swedish government and the Supreme Administrative Court have stated that they consider the rule to be inline with EU laws. The European Commission has investigated the Swedish rule and concludes that it constitutes an obstacle on the freedom of establishment by particularly treating cross-border activities disadvantageous, and that the rule goes beyond what is necessary to achieve its objective. However the Swedish government does not agree with this perception and suggests that the rules are justified and proportionate if considered as a violation. The thesis aims to investigate the performance of the Swedish interest deduction limitation rules, by examining whether the rules perform as alleged. The analysis in this thesis focus on whether the rules are compatible with EU law and under what circumstances the Swedish rule may be accepted as justified by the general grounds of public interest. By using the same method as the CJEU when investigating if a violation exists, the author comes to the conclusion that an indirect discrimination and restriction is created by the Swedish rule. However noting that such treatment may be accepted by a combination of several justification grounds. One combination of justification grounds, which the thesis highlights, is the adding of cohesion of the tax system to the arguments already brought forward by the Swedish government. The Swedish government has not considered this combination as a possibility in its defence. Nevertheless, practitioners have interpreted the justification ground cohesion of the tax system in various ways and contrary to the ruling of the CJEU, which has not been consistent in its case law on the matter. In the light of the CJEU latest case law regarding the cohesion concept it seems that this justification ground may not be permissible. If the Swedish government could not defend the cohesion of the tax system coupled with the fact that the Swedish Supreme Administrative Court has rejected any referrals for advance rulings the question remains on whether the Swedish rules could be seen as proportionate as it puts the taxpayer in a position of legal uncertainty.

Abbreviation list

BEPS	Base Erosion and Profit Shifting
CJEU	Court of Justice of the European Union
DTC	Double Tax Convention
EC	European Community
EU	European Union
GAAR	General Anti-Avoidance Rule
MNE	Multi National Enterprises
OECD	Organisation for Economic Co-operation and Development
SAAR	Special Anti-Avoidance Rules
SITA	Swedish Income Tax Act
TFEU	Treaty of The Functioning of the European Union

1 Introduction

1.1 Background

The creation of interest expenditure is a common strategy used by multinational enterprises (MNEs) with regard to international tax optimization. Intra-group debt financing and the location of external borrowing provides for cost efficient ways in which to separate profits from their origin, to send them to wherever it is suitable and to take advantage of tax rate differentials worldwide. The OECD, therefore, considers the use of interest expenditure to be one of the “key pressure areas” of the Base Erosion and Profit Shifting (BEPS) initiative.¹ As a consequence a variety of anti-avoidance rules have emerged by States to tackle the issue. With the common objective to limit the possibility of deductions on interest expenses since states want to protect their tax base.

The need for such rules is due to states different tax treatment of debt and equity. This lack of neutrality between debt and equity arises since return on equity i.e. dividend usually are subjected to some form of tax relief (an exclusion, exemption, credit, etc.) in the hands of the recipient and generally without the possibility of deduction at the hands of the sender.² Interest expenses on debt on the other hand are deductible for tax purposes and the corresponding interest income is taxed in the hands of the recipient. Hence such settings, through an economic point of view, creates incentives for debt financing rather than the use of equity for financing with regards to investment choices due the favourable treatment of debt.³ Consequently, tax planning activities can be achieved both through internal and external borrowings.⁴ One simple example involves MNEs setting up a finance operation in a low-tax jurisdiction to fund other group companies undertakings. The effect is that the expenses are deductible against the taxable profits of the high-taxed companies, while corresponding interest revenue is taxed favourably or not taxed at all at the hand of the recipient, thus resulting in a reduction of the total tax burden for the group.⁵ The Swedish Tax Authorities highlighted this issue in the so-called “Industrivärden målen”.⁶ However, the Supreme Administrative Court rejected the Tax Administrations claim to disallow deduction of interest expenses paid to affiliated companies when the corresponding interest income was not taxed or taxed with a low rate. The court stated that the Tax Authorities arguments in favour of the use of General Anti Avoidance Rules (GAAR) to tackle the issue were not

¹ OECD, Addressing Base Erosion and Profit Shifting, p. 48 (OECD 2013), International Organizations Documentation, IBFD.

² The Parent-Subsidiary directive aims to abolish withholding taxes on payments of dividend between associated companies and preventing double taxation within group companies. See: Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast).

³ OECD (2014), *Public Discussion Draft – BEPS Action 4: Interest Deduction And Other Financial Payments*, OECD Publishing, p. 6.

⁴ Jan Vleggeert: *Interest Deduction Based on the Allocation of Worldwide Debt* (feb. 2014), p. 103, Bulletin for International Taxation, IBFD.

⁵ This type of tax planning through interest deductions was considered to create a significant amount of tax revenues losses; Proposition 2008/09:65, Sänkt bolagsskatt och vissa andra skatteåtgärder för företag, 28 October 2008, p. 31.

⁶ See: RÅ 2007 ref. 84, case nr. 1774-04; RÅ 2007 ref. 85, case nr. 6699-04, 6701-04 and 6703-04.

applicable on such transactions.⁷ The outcome left the Swedish Tax Authorities with little chance to combat such transactions and subsequently Sweden introduced a Specific Anti Avoidance Rule (SAAR) in the form of national interest deduction limitation rules to prevent tax base erosion through abusive structures.⁸ Sweden's choice to not levy any withholding tax on outbound interest payments ignites the base erosion problem further.⁹

The Court of Justice of the European Union (CJEU) has in various cases dealt with different types of rules intended to limit interest deduction.¹⁰ Hence, the CJEU case law has created a framework for the scope of such rules, which states need to consider in order for the rules not to be in conflict with the Treaty freedoms. However, the court's case law also provides for under what circumstances it can be justified to violate the Treaty Freedoms, the so-called rule of reason doctrine created by the CJEU's jurisprudence.¹¹ The Swedish interest deduction limitation rules have not been referred to the CJEU for a preliminary ruling on whether the rule discriminates or restricts the Treaty freedoms. Moreover, the Swedish rules are not similar to other interest deduction limitation rules or thin capitalization rules. However, questions have been raised whether the Swedish interest deduction limitation rules are compatible with the fundamental freedoms of EU Law.¹² The Swedish Supreme Administrative Court, surprisingly and without any reference for a preliminary ruling, declared in 2012 that the rules did not constitute a discrimination or restriction on the freedom of establishment.¹³

Nevertheless, one year later the Swedish rules became subject to investigation by the European Commission. The 26 of November 2014 the Commission, in its letter of formal notice to the Swedish Government, stated that they consider the Swedish rules incompatible with the freedom of establishment protected by Treaty of the Functioning of the European Union (TFEU). However, in its respond, the Swedish Government is of a contrary opinion than the Commission, suggesting that the rules are compatible with EU law. Leaving the Commission with no choice but to proceed with a respond in a reasoned opinion to the Swedish Government where Sweden is invited to within a prescribed time period to change the rules so that they are compatible with EU law. If not changed, the Commission is likely to take Sweden to the CJEU in an infringement proceeding.

⁷ Ibid.

⁸ Proposition. 2008/09:65, *See also*: the amendments made through Regeringens, *Budgetproposition* 2012/13:1.

⁹ *See e.g.* Brokelind, C. (2015) Comment on the formal investigation against Swedish interest deduction limitation rules. *Highlights & Insights in European Taxation*, no. 5 p. 13; and Inkomstskattelagen (1999:1229), Chapter 6a.

¹⁰ C-324/00, *Lankhorst-Hohorst*, [2002] ECR I-11779; C-350/11, *Argenta Spaarbank*; C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107; and C-282/12, *Itelcar*.

¹¹ *See e.g.* C-337/08, *X Holding BV*, [2010] ECR I-01215, para. 20; C-446/04, *Test Claimants in the FII Group Litigation*, [2006] ECR I-11753, para. 167. C-55/94, *Gebhard*, [1995] ECR I-04165, para. 37.

¹² Ohlsson, F., *Dags för HFD att begära ett förhandsavgörande om ränteavdragsbegränsningarna?*, SkatteNytt, 2014, p. 659 (pp. 652-659); Hilling, M., *Är det möjligt att utforma EU-förenliga skatteflyktsregler? En analys med särskilt fokus på EU-domstolens proportionalitetsbedömning*, SvSkT, 2012, p. 826 (pp. 814-824).

¹³ *See* HFD 2011 ref. 90; HFD 2012 ref. 6; and HFD 2012 not. 3, Case no. 6062-11 & 6063-11.

1.2 Aim

The Swedish interest deduction limitation rules are scrutinised in this paper. The aim is to analyse whether the rules are compatible with EU law. This will be done, firstly, through analysing if the claims made by the European Commissions that the Swedish interest deduction limitation rules are incompatible with EU law are valid and secondly whether Sweden's arguments could justify such measures. The paper also aims at examining whether other arguments could have been lifted which would have brought clarity to the issue.

The questions that are to be answered in order to fulfil the aim is (i) whether a discrimination or restriction exists; (ii) whether it could be justified by the imperative reasons of overriding public interest and (iii) whether such rules respect the principle of proportionality.

1.3 Method and material

The method used in this paper has its origin in the thesis aim and the questions it is set out to answer. As the aim is to test the compatibility of the national legislation with the fundamental freedoms by considering the arguments brought forward by the European Commission and the Swedish government. Therefore the method of interpretation is based on a EU law method, which the CJEU follows when assessing whether a national provision is in line with the fundamental freedoms. Michael Lang et al. discuss this methodology as a scheme¹⁴, where questions need to be asked and answered before the investigation can take steps forward. By first analysing the Swedish provisions on interest deduction limitations, clearance could be found regarding the scope of the rules. Literature, articles and case law will clarify the functioning and effects of the Swedish rules. This analysis will answer the first two questions of the scheme, namely how the subject is affected and how a cross-border situation is affected. The next step in the scheme is to establish which freedom is affected. This will be done by analysing the fundamental freedoms provided for by the TFEU¹⁵, case law and literature to establish its scope and then applying the empirical findings from the analyses done of the Swedish rules to determine which freedom or freedoms are affected. The scheme then goes on to the comparable test, which the CJEU does in order to find out how the difference in treatment appears. By scrutinizing the case law and literature, conclusions can be drawn on whether the rule appears to be discriminatory or restrictive. With these steps the first question of this thesis can be answered. When established whether a discrimination or restriction appears, the scheme goes on to figure out whether such rules could be justified by the rule of reason doctrine created by the CJEU. As this is a case law base principle it is natural to find guidance through the courts case law and from doctrinal debates made by academics to get an understanding of the purpose and scope of the justifications. At this point in the analysis assumptions may be made to answer the second question. These assumptions will be built on the argumentation and empirical findings made by the analyses throughout the thesis. One cannot guarantee that these are correct assumptions as it finally is the CJEU who will evaluate the circumstances to reach a decision. The final step in the scheme answers the last question on whether national rules may be perceived as proportionate. Such examination is totally dependent on the findings in the analysis and by comparing the findings with the reasoning made by the CJEU in its case law. In order to reach independent conclusions on the final question the literature and case law will be used to

¹⁴ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 47.

¹⁵ Treaty on the Functioning of the European Union (TFEU) (consolidated version), OJ C83 (2010), EU Law, IBFD.

understand how the proportionality test is performed and to draw parallels with the Swedish rules by reasoning equally as the CJEU has done in similar circumstances.

In order to fulfil the aim of the thesis the Swedish interest deduction limitation rules will be examined by a rule-oriented approach, which intends to identify the problems and difficulties in the application of the rule through its technical meaning.¹⁶ As mentioned above this thesis intends not to provide a final answer. It rather intends to further clarify the underlying process and criterions searched for by the CJEU to identifying arguments and evaluating results, thereby emphasizing both reliable statements and contradictory considerations. This is done by an inductive approach, which means that the analysis starts from the existing case law to create a understanding of the decisions made by CJEU and the empirical findings will then be the basis for the arguments.¹⁷ The analysis according to a EU legal research method based on the methodological scheme seeks to clarify how the Swedish rules should be interpreted, which is a *de lege ferenda* research method.¹⁸

1.4 Delimitation

This thesis is limited to the treatment of the Swedish interest deduction limitation rule and its application in a cross-border transaction within the European Union. The OECD BEPS project and particular actions 4, *Limit base erosion via interest deductions and other financial payments*, and to some extent action 2, *Neutralise the effects of hybrid mismatch arrangements*, could influence the future direction of treatment of intra-group debt financing structures. However this projects has not been subject for examination. This is because of the stage at where this work has reached so far. However the realised discussion drafts on action 4 has presented certain methods to limit base erosion through interest deductions limitation rules, it is in the author's opinion that such measures will not have the intended effect until all or a majority of the Member States ratifies such rules. Other sorts of limitation rules such as Thin Capitalization, Neutralization of debt and equity rules and interest deduction limitation rules with in the European Union is not analysed or compared as the thesis is intended to form a basis on how the Swedish rules may be perceived by the CJEU. Furthermore, the thesis deals only with the relevant parts of EU law in relation to direct taxation. The work does not give a complete account of EU tax law but is limited to cover only the relevant treaty provisions regarding the freedom of movement affected by the Swedish rules. Therefore the thesis does not take account of the Interest & Royalties Directive or any particular negotiated Double Tax Conventions agreements.

1.5 Outline

As the method used to analyse whether an infringement exist is the same as the one CJEU uses in its case law the logic and framework of the outline are already established. In chapter 2 the Swedish interest deduction limitation rule is to be scrutinized together with case law and doctrinal debates to create an understanding on how it may affect the fundamental freedoms. This will be followed by an analysis of the scope of the fundamental freedoms in chapter 3, where it will be examined how the Swedish rule affects the freedoms of movement and by what manner the

¹⁶ Westberg, *Avhandlingsskrivande och val av forskningsansats - en idé om rättsvetenskaplig öppenhet*, Lund, 1992, s. 421 f.f.

¹⁷ Dawn Watkins and Mandy Burton, *Research Methods in Law*, (2013), Routledge Publishing: London and New York, p. 56.

¹⁸ Makkonen, T., *Nordic Cosmopolitanism – Essays in International Law for Martti Koskenniemi*, Brill Academic Publisher, 2003, p. 256.

rules may be a violation. The empirical findings of the examination at this point gives the reader an understanding of the effects the fundamental freedoms have on national law, the link between direct taxation and the internal market. With that knowledge the thesis continues to analyse how and for what reasons a violation of the fundamental freedoms has been justified by the CJEU. To reach the aim of this thesis those findings will be applied to the effects of the Swedish interest deduction limitation rules, creating the basis for arguments in the last chapter on whether the Swedish rules treats taxpayers in a equal or unequal manner justified by the CJEU.

2 Swedish Interest Limitation - Regime

2.1 Introduction

Sweden's introduction of interest deduction limitation rule came into force as of 1 January 2009, as a reaction to the failure to limit deduction on interest expenses.¹⁹ The rule was intended to target excessive debt financing, tax base erosion and abusive arrangements through intercompany debt financing of shareholdings.²⁰ After criticism and monitoring of the 2009 rules by the Tax Administration the rules underwent amendments in 2013 and is currently in force. In order to fulfil the aim of this thesis this paper will only focus on the rule as it stands at the time of the writing of the thesis.

2.2 Scope of application – To Whom Does it Apply?

All corporate taxpayers may deduct expenses related to acquiring and maintaining income, including interest expenses according to the general rule found in Chapter 16, Swedish Income Tax Act (SITA).²¹ As the 2013 interest deduction limitation rule is derogation from the main rule, served as a specific anti-avoidance rule, the rule does not apply to all company loans. The first article provides for the scope of the interest deduction limitation rule. It states that the interest deduction limitation rule is applicable to affiliated companies²² and further explains what shall be regarded as affiliated company as intended by the rule.²³ There are two alternative definitions explained on when a company is considered affiliated. The affiliated criterion is fulfilled when one of the companies directly or indirectly, through shareholding or in another way has substantial influence over the other company or, when the companies are mainly under same management.²⁴

The paragraph has been criticised for its lack of clarity, in particular the wording substantial influence as it does not have a precise threshold stated in the law.²⁵ In the

¹⁹ Proposition 2008/09:65, p. 30; Brokelind, C. (2015) Comment on the formal investigation against Swedish interest deduction limitation rules. *Highlights & Insights in European Taxation*, no. 5 pp.13-17

²⁰ Proposition 2008/09:65, p. 31; Skatteverkets promemoria, 2008-06-23, dnr 131 348803-08/113, p. 5 and 15.

²¹ Inkomstskattelagen (1999:1229), Chapter 16:1 §.

²² The Swedish term is "intressegemenskap".

²³ Inkomstskattelagen (1999:1229), Chapter 24:10a §. para. 1.

²⁴ Inkomstskattelagen (1999:1229), Chapter 24:10a §.

²⁵ See for example Jilkén, D. and Jilkén, C., *Väsentligt inflytande och under huvudsak gemensam ledning – luddiga begrepp på drift?*, Svensk Skattetidning, 2013, nr. 6/7, p. 498 and 516 (pp. 492-517); and Jilkén, C., *Skatteverkets dialogsvar om ränteavdrag*, Svensk Skattetidning, 2014, nr. 3, p. 193 (pp. 187-213).

legislative process it is mentioned that shareholdings just below 50% may be considered and that the term substantial influence is a customary term, used in several other tax related contexts in Swedish tax law.²⁶ In the preparatory works to the SITA the legislator has mentioned thresholds of 40% ownership could be sufficient in order to achieve substantial influence status, indicating that a 40% ownership might be enough for companies to be considered as affiliated.²⁷ However the Swedish Tax Authorities have suggested that they could consider shareholdings way below 40%, where the assessment will not solely be based on the level of shareholding, but rather collectively with other contractual agreements and number of parties involved will be considered.²⁸ The lack of clarity on when companies have substantial influence in other companies creates legal uncertainty and sets the taxpayer in a problematic position to evaluate the taxable outcome of its activities. Nevertheless, companies are also regarded as affiliated if they are mainly under the same management according to the alternative definition. The paragraph does not provide for a clear definition or threshold when companies are regarded as mainly under same management but in the preparatory works of the legislation it has been clarified that it is a quantitative requirement of at least 75 %.²⁹ Such level of threshold is intended to prevent circumvention of the status by splitting up the shareholdings on a number of companies, e.g. subsidiaries, that are under common control by a parent company or where unrelated parties are commonly controlled by a third party.³⁰ The legislator points out the importance of actual influence and not formal influence, which applies to both definitions on affiliated companies. What is included in the term company in the interest deduction limitation rule is explained by the second paragraph of the article. It covers legal persons and registered partnerships.³¹ The SITA chapter 2 Article 2 states that terms used in SITA also includes its corresponding foreign phenomenon, which excludes other company forms that accordingly to Swedish law are not considered a legal person.³²

2.3 The Main Rule & Back-to-Back Loans

The core principle of the Swedish interest deduction limitation rule lies within the second article. Pursuant to the main rule, deduction of interest expenses are not allowed if the debt relates to loans between affiliated companies.³³ However, in order for the main rule to not limit interest deductions on commercially justified debt financings between affiliated companies, the main rule is backed up by derogations from the main rule and derogations from the derogation. The main rule covers all interest expenses related to debts between affiliated companies, which is a deviation from the principle of net income taxation found in SITA chapter 16 Article 1.

In the third paragraph the so-called back-to-back loans are regulated. The rules are intended to limit the deductibility of interest expenses incurred by a third party debt, to the extent where the debt is represented by a claim, that one of the companies in the affiliation has on the third-party company, or to a company belonging to the

²⁶ Proposition 2012/13:1, p. 239.

²⁷ Proposition 1999/2000:2 part 1 p. 502 ff; Borg, E. P., *Inkomstskattelagen (1999:1229) – Chapter 24:10a§ Kommentar*, Karnov database (2015-09-23).

²⁸ Skatteverkets ställningstagande 2013-02-25, *Några frågor vid tillämpningen av ränteavdragsbegränsningsreglerna gällande väsentligt inflytande, undantaget från 10 % - regeln och ventilen*, dnr. 131-117306-13/11.

²⁹ Proposition 2008/09:65 p. 68, 72 and 87; and Proposition 2012/13:1 p. 217.

³⁰ Proposition 2008/09:65 p. 46.

³¹ *Handelsbolag* is the Swedish term; *Inkomstskattelagen (1999:1229)*, Chapter 24:10a §. para. 2.

³² See also SITA, chapter 2:3-4§§ and Chapter 5:2§ for more companies covered.

³³ *Inkomstskattelagen (1999:1229)*, Chapter 24:10b §.

same affiliation as the third party and the debt concerns an acquisition of shares.³⁴ This provision was introduced to prevent circumvention of the general rule.³⁵ There are exceptions to this rule, however they apply when the conditions for deductibility of interest expenses are applicable, found in the derogations to the interest deduction limitation rule, discussed below.³⁶ The term “shares” has the same definition as defined in chapter 48 article 2 SITA, including participation certificates, equity certificates, convertibles, redeemable- and sales rights with respect to shares and share derivatives etc.³⁷ The Supreme Administrative Court has acknowledged that the term shall have a wide definition including also newly issued shares.³⁸

2.4 The 10%-rule

As mentioned above, there are two derogations where intra-group deduction of interest expenses is accepted. One of the exceptions is the ‘ten-percent’ rule.³⁹ This exception requires a minimum level of taxation, where such level is determined by a hypothetical-test in order to see whether the interest income corresponding to the interest expense would have been taxed by at least 10% in the hands of the beneficial recipient.⁴⁰ When conducting the hypothetical-test the laws of the State in which the company within the affiliation that actually is the beneficial owner of the income is resident shall be regarded.⁴¹ Other income, losses or deductible expenses from its normal activities shall not be included when assessing whether the interest income has been taxed.

How the Swedish interpretation of beneficial owner ought to be is rather unclear due to the fact of the frequent appearance of the ‘beneficial owner’ in the Swedish internal law and that it is interpreted inconsistent.⁴² In the interest deduction limitation rule the meaning of the word should be interpreted in its international meaning accordingly to the legislator, however, there is no uniform international interpretation. The purpose of the beneficial owner concepts in this context is to hinder deduction of interest expenses when the receiver of the income only acts as a conduit company or intermediary located in a jurisdiction where the interest income is taxed by at least 10% but is not the real beneficiary who can enjoy the income.⁴³

The exception rule also contains an alternative approach aimed at industries that is not taxed conventionally, such as, pension funds or assurance companies.⁴⁴ The alternative approach allows deduction on interest expenses if the beneficial owner of the interest income within the association is subjected to Swedish yield tax or a

³⁴ Inkomstskattelagen (1999:1229), Chapter 24:10c §.

³⁵ Proposition 2008/09:65 s. 54 f. and 84 f; Proposition 2012/13:1 s. 265 ff.

³⁶ Inkomstskattelagen (1999:1229), Chapter 24:10d and f §§.

³⁷ Borg, E. P., *Inkomstskattelagen (1999:1229) – Chapter 24:10c§ Kommentar*, Karnov database (2015-09-23).

³⁸ HFD 2011 ref. 90 V.

³⁹ Inkomstskattelagen (1999:1229), Chapter 24:10d §.

⁴⁰ Proposition 2008/09:65, p. 59.

⁴¹ Proposition 2008/09:65, p. 59-60, 85-86; Proposition 2012/13:1, p. 216-217.

⁴² Chapter 6a paragraph 4, SITA based on Council Directive 2003/49/EC of 3 June 2003 - *on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States*; Kupongskattelag (1970:624) 2§; Swedish tax treaties based on OECD-MC, article 10-12; and Inkomstskattelagen (1999:1229), Chapter 24:10d-f §§.

⁴³ Proposition 2008/09:65, p. 61 and Proposition 2012/13:1 p. 254; Brokelind, C. (2015) Comment on the formal investigation against Swedish interest deduction limitation rules. *Highlights & Insights in European Taxation*, no. 5 pp.13-17

⁴⁴ Proposition 2012/13:1 p. 244.

comparable tax.⁴⁵ It is also required that the interest rate accruing on the debt during the fiscal year, on an average, have not exceeded 250% of the standard state bond interest rate provided for during the calendar year preceding the fiscal year.⁴⁶

2.4.1 A Derogation From The Derogation

The legislator found it necessary, after having observed an adjustment to the 10% rule by companies, to implement a limitation on deductibility of interest expenses even if the corresponding interest income is taxed with at least 10%.⁴⁷ Deduction of interest expenses is not accepted if the main reason for the debt financing is for the association to sustain a significant tax benefit.⁴⁸ This paragraph contains two cumulative thresholds that shall not be infringed if one seeks to deduct interest expenses, which is an attempt by the Swedish legislator to hinder abusive arrangements and base erosion. The first threshold is the requirement of a 10% taxation of the recipient of the interest income and the second threshold is the so-called 'motive test', where the taxpayer has to prove that the main reason for the debt financing is not to receive a substantial tax benefit. This threshold is set at 75%, meaning that a 24% business motivated transaction will not be accepted.⁴⁹ However, when determining the motive of the debt financing, both the lenders and the borrowers perspective shall be investigated and all relevant circumstances are to be considered. Criticism was directed towards this paragraph already before it was implemented.⁵⁰ Both the 'ten-percent' rule and the 75% threshold have been criticised for being too difficult to assess and will require excessive resources to construct accounting records due to the different accounting standard used in different states when reporting the 'hypothetical-test'.⁵¹ One may ask whether such thresholds coupled with the passing on of the burden of proof are compatible with EU-Law.

There have been several cases submitted for advanced rulings by the Swedish Board of Advance Rulings where taxation exceeding 10% have been established. In all cases the Board has denied deduction, claiming that the taxpayer has not been able to show that the underlying transactions are not mainly tax driven.⁵² The rule automatically presumes that taxation lower than 10% is tax avoidance and if the taxation is over 10%, but not at a level of 22% (The Swedish Corporate Tax Rate), the Board has in all cases challenged the taxpayers claim by suggesting that the taxpayer has not been able to show that the main reason for such transaction was to receive a substantial tax benefit.⁵³ Some of the Boards Advance Rulings were appealed to the Supreme Administrative Court, which dismissed the appeal by claiming that the Swedish Interest deduction limitation rule required a comprehensive investigation, not suitable for an advanced ruling.⁵⁴ The 10% rule has been criticised by various academic authors for being unclear and causing legal

⁴⁵ Inkomstskattelagen (1999:1229), Chapter 24:10d §. para. 2, p. 1.

⁴⁶ Ibid, para. 2, p. 2.

⁴⁷ Proposition 2012/13:1, p. 247, 251.

⁴⁸ Inkomstskattelagen (1999:1229), Chapter 24:10d §. para. 3.

⁴⁹ Proposition 2012/13:1, p. 251.

⁵⁰ Proposition 2008/09:65, 28 October 2008, p. 57 ff.; Tivéus, U., *Regeringen föreslår skärpta ränteavdragsbegränsningsregler*, SkatteNytt, 2012, p. 261-262 (pp. 258-265).

⁵¹ Proposition 2008/09:65, p. 58

⁵² Skatterättsnämnden förhandsavgöranden: Board of Advance Rulings, 2014-04-29, dnr 80/13/D; and 2014-07-10, dnr 92-13/D.

⁵³ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 5.

⁵⁴ HFD Case nr. 2674-14; and HFD Case nr. 4217-14.

uncertainty.⁵⁵ The Tax Administration and the legislator have tried to clarify their view and pointed out where guidance could be acquired. The Swedish Tax Administration did so by releasing a statement⁵⁶ in 2013, containing their view of the interpretation.⁵⁷ In the preparatory work of the Swedish interest deduction limitation rule the legislator suggests that guidance on the interpretation can be obtained from how to apply the second derogation concerning mainly business motivated debt financings.⁵⁸

In addition, the European Commission has raised concerns on how the Swedish interest deduction limitation rule is treating non-resident affiliations in an unequal manner as resident affiliations. The reason behind this treatment is that Swedish groups can through the group-participation rules transfer debts or capital, without ever or in rare cases be questioned whether the transaction is mainly tax motivated or business motivated due to taxation way above 10% will occur.⁵⁹

2.5 Released Pressure – When Business Motivated

In order for the rules to not disallow deduction of interest expenses on commercial justified debt financings between affiliated companies, active in low-taxed jurisdictions, the interest deduction limitation rule contains a Business Purpose test.⁶⁰ The so-called ‘Ventilen’ in Swedish is intended to allow deductions on interest expenses where the main reason for the debt financing is business motivated. Regardless on whether the interest income corresponding to the interest expense has been taxed at a level above 10%, if the beneficial owner of the interest income is resident within the EEA or located in a state with which Sweden has a DTC with, which is not limited to certain incomes only.⁶¹ In similarity as the exception to the 10% rule mentioned above, the business purpose test also includes the threshold of 75% through the requirement that the purpose of the debt is mainly business motivated. The legislator motivates the requirement because the rule is applicable when the interest income is taxed at a low level and argues that the rule should be used restrictively because of the great tax advantage it creates for the taxpayer.⁶² This requirement, again, puts pressure on the taxpayer to convince the Tax Administrator that the threshold is achieved. Upon assessing whether the debt financing is mainly business motivated, particular attention should be given on whether contribution of equity could have been used instead by the lender or any other of the companies included in the affiliation that have significant influence in

⁵⁵ See e.g: Carneborn, C., *Nya tioprocentsregeln – En ren beräkningsregel?*, Skattenytt, 2013, p. 46- 51; Fredrik, O., *Även solen har sina fläckar EU-rättsliga frågetecken kring flera svenska skatteregler*. Skattenytt, 2013, p. 102.

⁵⁶ *Ställningstagande* in Swedish, which is not a legal source and therefore not a binding document.

⁵⁷ Swedish Tax Agency, Skatteverkets ställningstaganden – *Några frågor vid tillämpningen av ränteavdragsbegränsningsreglerna gällande väsentligt inflytande, undantaget från 10 %-regeln och ventilen*, dnr 131-117306-13/111, 25 February 2013.

⁵⁸ Proposition 2012/13: 1 p. 253

⁵⁹ The corporate tax rate is 22% in Sweden, Inkomstskattelagen (1999:1229), Chapter 65:10§; European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 4-5.

⁶⁰ Proposition 2012/13:1 p. 255 and Proposition 2008/09:65 p. 67 and 87.

⁶¹ Inkomstskattelagen (1999:1229), Chapter 24:10e §.

⁶² Proposition 2012/13:1 p. 256.

the lending company.⁶³ This requirement is a codification of the Swedish case law rendered by the Supreme Administrative Court.⁶⁴

The Swedish Government has been reluctant to describe all relevant circumstances that need to be considered when assessing the main purpose test. Stating that such evaluation is to be made on all relevant circumstances of the individual cases.⁶⁵ However, the legislator in the preparatory work has discussed circumstances that indicate that the debt financing is not mainly business motivated. The legislator explains that tax reasons are not to be considered business reason when applying the test, even if it is legitimate for businesses to rearrange activities to obtain tax optimization.⁶⁶ Additionally, when assessing the main purpose test, considerations shall be taken on whether the lender has received funding in order to be able to provide a loan to the borrower or if the corresponding claim is transferred to another company in the affiliation.⁶⁷ The legislator has in the preparatory work mentioned that business motivated cash-pooling arrangements should not be targeted, but has not recognized that such models look differently in different industries and investment choices.

Existing case law, further upholds such views by claiming that the business purpose test shall not equate organisational reasons with business reason, by not considering organisational reasons as valid motive for engaging in certain debt financing structures.⁶⁸ Such establishment causes confusion and uncertainty on how to use different type of holding structures, financing structures but also acquisition of other companies which is followed by an internal acquisition in order to incorporate the company in the affiliation. Nevertheless as mentioned above third party debt that is followed by an internal debt financing or the other way around, the so-called back-to-back loans are also covered by the 10%-rule and the business purpose test.⁶⁹

2.6 Final Remarks

More than six years after Sweden introduced the interest deduction limitation rule, which experienced amendments in 2013, concerns have been raised regarding the compatibility of the rules with EU law.⁷⁰ Both, academics and the European Commission have questioned whether the Swedish rules discriminate or creates a restriction on the freedom of establishment.⁷¹ Should the rule infringe EU law, question remains on whether they would be justified by the rule of reason doctrine. The Supreme Administrative Court established in 2012 that the rules were not discriminatory by examining whether the debt financing was business motivated and therefore there was no need for any assessment on justification grounds, or if the rules are proportional.⁷² However, the European Commission has compared the effects of the Swedish interest deduction limitation rule with existing CJEU case

⁶³ This is a codification of the developed case law: HFD 2011 ref. 90, Case nr 7649-09, *see*: Proposition 2012/13:1, p. 217-218, 263.

⁶⁴ HFD 2011 ref. 90 I-V.

⁶⁵ Prop. 2012/13:1 p. 257.

⁶⁶ Prop. 2012/13:1 p. 257.

⁶⁷ Prop. 2012/13:1 p. 258 f.

⁶⁸ HFD 2011 ref. 90 I; HFD 2012 not. 3, and HFD 2012 not. 23.

⁶⁹ Inkomstskattelagen (1999:1229), Chapter 24:10f § p.1.

⁷⁰ Samuelson, L., 'HFD Avvaktar EU-Domstolen om Rän-teavdragsbegränsnings' *Svensk Skattetidning*, no. 6/7, 2011, p. 558; Hilling, M., 'Är Det Möjligt Att Utforma EU-Förenliga Skatteflyktsregler?', *Svensk Skattetidning*, no. 10, 2012, p. 823; Proposition 2008/09:65, p. 69-70

⁷¹ *Ibid*; TFEU, Art. 49 Freedom of Establishment; European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 6.

⁷² *See* HFD 2011 ref. 90; HFD 2012 ref. 6, HFD 2012 not. 3, Case no. 6062-11 & 6063-11.

law, together with the cases referred to the Boards for advance rulings as bases for its arguments.⁷³ Obviously, the Swedish Tax Authorities have in all twenty advance rulings, up to date, regarding interest deductions where there is a foreign receiver denied the claim of deduction when the taxation was less than 22%. All of those twenty claims where the taxation has exceeded the 10% threshold the authority has claimed that the main reason for debt was for the group to obtain a substantial tax benefit.⁷⁴ On the remaining claims, where the conditions have been such that taxation of the recipient of the interest income has been below 10%, the Tax Authorities have claimed that the applicant has not been able to show that the debt was mainly business motivated.⁷⁵ Questions have been raised whether such shifting of the burden of proof on the taxpayer is proportionate when the taxation is below 10%.⁷⁶

The European Commission has brought the Swedish rules under scrutiny, by claiming the rule infringing the freedom of establishment on reasons explained above. The European Commission does not deny that justified reasons for rejecting interest deduction are applicable, they rather argue that the Swedish rules, by demanding a 75% threshold which automatically denies debt financings that may not be wholly artificial goes beyond what is necessary to achieve its objectives.⁷⁷ The Swedish government has defended its rules and informed the European Commission that they are not going to change their rules on these accusations. This leaves the European Commission with no more option than proceeding with a reasoned opinion where Sweden within a certain time-frame must apply or risk a referral to the CJEU. In the meantime the Swedish Supreme Administrative Court has rejected any requests on advance rulings regarding the interest deduction limitation rules.⁷⁸

3 The Fundamental Freedoms

3.1 Introduction

The Swedish interest deduction limitation rule is an attempt to counter base erosion and abusive tax practices targeting cross-border debt financings between affiliated companies. Even if the rule does not explicitly mention that it is primarily targeting cross-border debts, the legislators clearly stated such intentions in the preparatory work.⁷⁹ Coupled with the effects of the rule, it has somewhat become obvious that so is the case.⁸⁰ According to the TFEU, when rules target cross-border activities it is important that the rule treat EU nationals in the same situation equally.⁸¹ In order to protect and sustain an effective internal market, direct or indirect discrimination on individuals or entities based on nationality is forbidden unless the treaty states

⁷³ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 5.

⁷⁴ Ibid p. 5.

⁷⁵ Ibid, p. 5.

⁷⁶ Ibid, p. 8.

⁷⁷ Ibid, p. 7 f.f.

⁷⁸ See Case no. 2674-14.

⁷⁹ Prop. 2012/13:1 p. 272.

⁸⁰ *This assumption is made by the Commission, backed with statistics on the outcome of the Swedish Board of Advance Rulings regarding the interest deduction limitation rule. For further detail see: European Commission, letter of formal notice – violation number 2013/4206, Annex: C (2014) 8699 final, p. 5.*

⁸¹ The Treaty of the Functioning of the European Union (TFEU), Article 18-25.

otherwise.⁸² However, the scope of the Treaty's prohibition of discrimination based on nationality only applies when comparing a national from one Member State with one from another Member State in a cross-border activity and not to one purely internal to Member States.⁸³ The European internal market is protected by the fundamental freedoms, covering four freedoms. These are, the free movement of goods, the free movement of persons, the free movement of services and the free movement of capital. Within the free movement of persons there are more freedoms i.e. the freedom of establishment, the free movement of workers and the free movement of citizenship.⁸⁴ When Member States introduce tax rules they must be compatible with these freedoms by not performing in discriminatory or restrictive way.

However, the CJEU has through its decisions created justification grounds for infringement of the fundamental freedoms based on the need to protect the general grounds of public interest, the so-called Rule of Reason doctrine.⁸⁵ The impact of the fundamental freedoms on the national rule varies depending on which freedom it concerns.⁸⁶ When evaluating whether the Swedish interest deduction limitation rule are discriminatory or restrictive, which falls within the area of direct taxation, one must first decide which freedom or freedoms are applicable.

3.2 Effected Freedoms

The free movement of goods does not play a significant role for direct tax purposes compared to its effect on indirect taxation.⁸⁷ Moreover, this freedom is not affected by the Swedish interest deduction limitation rule, since the rules only apply to interest expenses between affiliated companies. By the same token, the free movement of workers and the free movement of citizenship are not affected. To start with, the freedom to provide service in article 56 TFEU provides for the right of nationals of one Member State to provide services in another Member State, without the need to establish a domicile there. The freedom in question precludes Member States from establishing national rules that hampers the possibilities of providing services between Member States in contrast to providing it purely within one Member State.⁸⁸ As a result the freedom also covers the persons whom the service are intended to benefit from it and without the need for the service provider to be established in that stat. This includes situations where only the service itself crosses

⁸² The TFEU provides for certain grounds that allows for discriminatory national rules. These grounds are Public Policy, Public Security and Public health, which in the area of direct taxation never served as justification. *See*: TFEU Article 45.

⁸³ Helminen, M., *EU Tax Law – Direct Taxation*, (2013), Published by IBFD, e-book, Chapter 2, p. 1.

⁸⁴ Helminen, M., *EU Tax Law – Direct Taxation*, (2013), Published by IBFD, e-book, Chapter 2, p 6. *See also*: TFEU Articles 21, 34, 45, 49, 56 and 63.

⁸⁵ It originated from Case: *Cassis Dijon* 120/78, *Reewe-Zentral*, [1979] ECR 649, para. 8, and has developed through the years. *See also*: Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 71.

⁸⁶ Helminen, M., *EU Tax Law – Direct Taxation*, (2013), Published by IBFD, e-book, Chapter 2, p 6. *See also*: Smit, D. D., *The relationship between the free movement of capital and the other EC Treaty freedoms in third country relationships in the field of direct taxation: a question of exclusivity, parallelism or causality?*, EC Tax Review, 2007, Issue 6, p. 257.

⁸⁷ Terra, B. & Wattel, P. J., *European Tax Law*, 5th Edition, Kluwer Law, 2008, p. 52.

⁸⁸ C-281/06, *Hans-Dieter and Hedwig Jundt v Finanzamt Offenburg*, [2007] ECR I-0000, para. 52; C-136/00, *Rolf Dieter Danner*, [2002] ECR I-8147, para. 29; C-118/96, *Jessica Safir v Skattemyndigheten*, [1998] ECR I-1897, para. 23; and C-290/04, *FKP Scorpio Konzertproduktionen GmbH v Finanzamt Bergisch*, [2006] ECR I-09461, para. 31.

the border.⁸⁹ The CJEU has in its case law mentioned that the providing of loans could include in the application of providing services within the framework of Article 56 TFEU.⁹⁰

The Swedish interest deduction limitation rule therefore could fall within the freedom to provide services for the above-mentioned reasons. However, article 57 TFEU explicitly mentions that the free movement to provide service is to apply when none of the Freedoms of goods, persons and capital is applicable. Consequently, one must judge the character of the service to establish which freedom is affected. Services are normally characterised by a temporary activity. If the service requests great infrastructure in other Member State it could be a sign that other freedom is also affected.⁹¹ This view has been upheld by CJEU in cases where the court has chosen to only examine either the free movement of capital or establishment when the free movement of services also been applicable.⁹² In the *Sodemare SA* case the CJEU made the distinction between the freedom of establishment and free movement of service based on the duration of the activity.⁹³ The questions that remain are whether the Swedish interest deduction limitation rule also falls within the scope the freedom of establishment and the freedom of capital and if so, do any of them prevail over the other?

The freedom of establishment ensures EU nationals the right to conduct businesses in other Member States by setting up of agencies, subsidiaries or branches. It also includes the right to take up and pursue undertakings as self-employed and to set up and manage activities, within the laws and conditions applying to the Member States own nationals, where the establishment is located.⁹⁴ An establishment within this freedom is characterized by CJEU as “actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period”.⁹⁵ The CJEU has in further case law clarified that the pursuit of economic activity requires a profit making activity on a stable and continuous basis and that “indefinite period” is determined by factors such as regularity, duration, continuity or periodicity.⁹⁶ Accordingly to the above mentioned the Swedish interest deduction limitation rule, which targets debts between affiliated companies in a cross-border situation, falls within the scope of the freedom of establishment.

The CJEU has in various cases tested, with regards to national interest deduction limitation rules, whether a restriction appears on the freedom of establishment.⁹⁷ Where the rational lies in whether “national provisions which apply to holdings by

⁸⁹ C-76/05, *Herbert Schwarz und Marga Gootjes-Schwarz v Finanzamt Bergisch*, [2007] ECR I-06849, para. 36; C-290/04, *Scorpio*, para. 32; C-294/97, *Eurowings*, [1999] ECR I-07447, para. 34; and C-55/98, *Skatteministeriet v Bent Vestergard*, [1998] ECR I-07641, para. 19-20.

⁹⁰ Art. 56-57 TFEU; C-484/93, *Svensson and Gustavsson*, [1995] ECR I-03955, para. 11; C-222/95, *Parodi*, [1997] ECR I-03899, para.17; and C-452/04, *Fidium Finanz*, [2006] ECR I-09521, para. 40.

⁹¹ Terra, B. & Wattel, P. J., *European Tax Law*, 5th Edition, Kluwer Law, 2008, p. 53.

⁹² C-386/04, *Centro di Musicologia Walter Stauffer* [2006] ECR I-08203. *See also*: AG Stix-Hackl opinion in C-386/04, para. 32.

⁹³ *See*: C-70/95, *Sodemare and Others v Regione Lombardia*, [1997] ECR I-03395 para. 24.

⁹⁴ TFEU, Article 49.

⁹⁵ C-221/89, *The Queen v Secretary of State for Transport, ex parte Factortame*, [1991] ECR I-03905, para. 20.

⁹⁶ C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, [1995] ECR I-04165, para. 25, 27; C-70/95, *Sodemare and Regione Lombardia*, [1997] ECR I-3395, para. 24.

⁹⁷ *See e.g.* C-324/00, *Lankhorst-Hohorst*, para. 32; C-350/11, *Argenta Spaarbank*, para. 20, 34; C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007], ECR I-02107, para. 27; Case C-436/00, *X and Y*, [2002] ECR I-10829, para. 37.

nationals of Member State concerned in the capital of a company established in another Member State, giving them definite influence on the company's decisions and allowing them to determine its activities, come within the substantive scope of the provisions of the EC Treaty on freedom of establishment⁹⁸. Such national rules could ultimately affect companies to establish in the Member State.

Article 63 of the TFEU provides that the Free Movement of Capital prohibits all restrictions on the movement of capital between Member States and third countries. In contrast to the other fundamental freedoms, this freedom affects transactions beyond the borders of the Internal Market.⁹⁹ The TFEU provision on the free movement of capital does not define the expression movement of capital. Through the CJEU case law, the nomenclature found in Annex I to the Directive 88/361¹⁰⁰ has been recognized as an indicative source for the determination of the expression, which however it is not an exhaustive source.¹⁰¹ Normally, the term capital movement is to be understood as a transfer of capital that is not restricted by a transaction falling under free movement of goods or services, a cross-border stream of value in form of monetary capital or other material or immaterial assets from one Member State to another.¹⁰²

In order to determine whether the Swedish interest deduction limitation rule could affect the free movement of capital one must bear in mind that the rules target debt financing between affiliated companies. The Swedish interest deduction limitation rule requires certain form of control in the decision-making of the companies involved. Nevertheless, whether the term movement of capital could impact on such control in other companies, the nomenclatures points I and III coupled with the explanatory notes set out in Annex I in the directive implies that direct investment in the participation of an undertaking by means of a shareholding or acquisition of securities on the capital market establishes capital movement within the meaning of Article 56 EC (Now Article 63 TFEU).¹⁰³ It is further pointed out in the directives explanatory notes that direct investments is characterised, particularly, by the possibility of participating effectively in the management of a company or in its control. Consequently, the Swedish Interest deduction limitation rule could fall within the scope of the free movement of capital.

The second question to answer is whether one fundamental freedom prevails over the other or whether they should be tested simultaneously? The TFEU does not establish any order of priority between the freedoms. However, it is mentioned that the freedom to provide services is supplementing the free movement of goods, persons and capital in article 57 TFEU. The first time the CJEU examined the question of prevailing freedom, in the context of direct taxation, was in *Cadbury Schweppes*.¹⁰⁴ In that case the taxpayer raised that three freedoms were affected, the freedom- to provide services, capital and establishment. The CJEU held, according to settled case law that national provisions applying to holdings by

⁹⁸ C-524/04 *Test Claimants in the Thin Cap Group Litigation*, [2007], ECR I-02107, para. 27.

⁹⁹ C-98/01, *Commission v United Kingdom*, [2003] ECR I-4641, para. 38; C-282/12, *Itelcar*, para. 23, 25.

¹⁰⁰ Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

¹⁰¹ C-67/08, *Block*, [2009] ECR I-00883, para. 19. With further case-law reference; C-222/97, Manfred Trummer and Peter Mayer, [1999] ECR I-1661, para. 20 and 21; C-98/01, *Commission v United Kingdom*, [2003] ECR I-4641, para. 39.

¹⁰² Joined Cases C-286/82 and C-26/83, *Luisi and Carbone v Ministero dello Tesoro*, [1984] ECR I-00377, para. 21-22.

¹⁰³ C-98/01, *Commission v United Kingdom*, [2003] ECR I-4641, para. 40; and Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

¹⁰⁴ C-196/04, *Cadbury Schweppes*, [2006] ECR I-07995.

residents of one Member State of the company's capital established in another Member State, which gives them definite influence over the company's decision comes within the substantive scope of the freedom of establishment.¹⁰⁵

However, the court did not reject that the other freedoms were applicable, it rather stated that if the examined provisions had "restrictive effects on the free movement of services and the free movement of capital, such effects are an unavoidable consequence of any restriction on freedom of establishment and do not justify, in any event, an independent examination of that legislation in the light of Articles 49 EC and 56 EC" (Now Article 56 and 63 TFEU).¹⁰⁶ The CJEU has in numerous cases argued in the same manner as in *Cadbury Schweppes*, when searching for the prevailing freedom.¹⁰⁷ However, an independent or parallel examination of the freedom of capital, when applicable, would have a significant impact on any third country situation, since it would mean that national from third countries would indirectly have access to EU internal movement rights. This has however not been the case. The CJEU has in third country circumstances still searched for the prevailing freedom and stated that any restriction on other freedoms are an unavoidable consequence of the restriction on the predominant freedom.¹⁰⁸

At first glance at the CJEU case law one might think that the prevailing freedom with regards to the Swedish interest deduction limitation rules would be the freedom of establishment, because of the criterion of substantial influence that is required by the interest deduction limitation rule in order to establish an affiliation.¹⁰⁹ However, as showed in chapter two in this paper, the Swedish government and specially the Tax Administration require a very low threshold of shareholding in order to consider a company to have substantial influence.¹¹⁰ In both, *Itelcar* and *Test Claimants in the FII Group Litigation*, the CJEU chose the free movement of capital as the prevailing freedom.¹¹¹ The court concluded in both these cases that when national provision does not necessitate a definite influence, the free movement of capital should prevail.¹¹² When does the court consider that definite influence exists? A straight answer does not exist, it has not been established an exact threshold by the CJEU where they consider that the criterion is fulfilled.

However, the Court has elaborated in numerous cases a spectrum of different types of control. Where a 25% shareholding has been considered as sufficient to allow influence on the company's management and control and enforces conditions, which ensures that the shareholding is not solely a financial investment.¹¹³ This was the case in the *Scheunemann* case, which regarded shareholdings by a German national in a third country company. The CJEU stated that the freedom of establishment was applicable and therefore the German national could not rely on the scope of the freedom, because it is not applicable with regards to third country.¹¹⁴ The German

¹⁰⁵ Ibid, para. 31.

¹⁰⁶ Ibid, para. 33.

¹⁰⁷ C-464/05, *Geurts and Vogten*, [2007] ECR I-9325, para. 16; C-31/11, *Scheunemann*, para. 30 and C-102/05, *A and B*, [2007] ECR I-0000, para. 26 and 27

¹⁰⁸ C-452/04 *Fidium Finanz*, [2006] ECR I-09521, para. 45-46 and 49; C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 34.

¹⁰⁹ Inkomstskattelagen (1999:1229), Chapter 24:10a §.

¹¹⁰ Samuelsson, *Regeringens slutliga förslag om effektivare ränteavdragsbegränsningar*, Skattenytt, 2012, s. 820 f.f; Inkomstskattelagen (1999:1229), djupkommentar till 24 kap. 10a §.

¹¹¹ C-282/12, *Itelcar*, para. 25 and C-35/11, *Test Claimants in the FII Group Litigation*, para. 102.

¹¹² C-282/12, *Itelcar*, para. 20, 22 and 23; C-35/11, *Test Claimants in the FII Group Litigation*, para. 98, 99, 102.

¹¹³ C-31/11, *Scheunemann*, para. 25 and 29. C-168/11, *Beker*, para. 25-26.

¹¹⁴ C-31/11, *Scheunemann*, para. 30 and 33

internal provision concerning inheritance taxation required a 25% shareholding in order to obtain a tax benefit. It is important to recognize that the court did not consider the 25% as sufficient and crucial in its assessment when determining the applicable freedom. The German national owned 100% of the shares in the third country company, which influenced the court in its judgement to choose the freedom of establishment as the prevailing freedom and the free movement of capital as an unavoidable consequence of the freedom of establishment.¹¹⁵ It is questionable, whether the court had chosen the freedom of establishment if the shareholding by the German national would have only been 25%. In its assessment the court does not mention that the 25% shareholding creates definite influence, it rather defined a type of control, which is similar to the one found in the nomenclature of Annex I to the Directive 88/361, outlining the free movement of capital.¹¹⁶ Moreover, the CJEU has in its settled-case law determined that inheritance taxation in principle falls within the scope of Article 63 TFEU.¹¹⁷ The CJEU made an important statement in *Test Claimants Litigation*¹¹⁸ case that effects which freedom is applicable with regards to the Swedish rules. The Court mentions that when national rules at issue is to apply, both, to shareholdings which could create definite influence on decision making and on the basis of a shareholding not conferring such influence the court can with respects to the facts of the case at issue determine which freedom is applicable.¹¹⁹

Consequently, as the Swedish interest deduction limitation rule is to apply both when definite influence is at hand and where lower levels of control exists, it could imply that both the freedom of establishment and free movement of capital could be applicable as predominant freedom when establishing whether the Swedish national rules violate the principles protecting the Internal Market. Moreover, the CJEU has made it clear in its case law that in order to establish whether a national rule falls within the scope of one or other of the freedoms of movement, the aim of the legislation in question must be taken into consideration.¹²⁰ Nevertheless, the Swedish Supreme Administrative Court and the legislator in its preparatory work of the interest deduction limitation rule are of the opinion that the freedom of establishment is the applicable freedom.¹²¹ This is also the view of the European Commission in its letter of formal notice to the Swedish Government, where they also based the compatibility analyses on that specific freedom.¹²² It is in the author's view not clear why the Commission has restricted its claim of restrictive measures to only the freedom of establishment and not also to the free movement of capital.

3.3 What is the Violation?

Direct taxation falls within the competence of the Member States. The sovereignty of states gives them the right to establish their desired tax base.¹²³ There are only a few

¹¹⁵ C-31/11, *Scheunemann*, para. 25, 30 and 31.

¹¹⁶ Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

¹¹⁷ C-31/11 *Scheunemann*, para. 22; C-11/07, *Eckelkamp and Others*, [2008] ECR I-6845, para. 39; C-35/08, *Busley and Cibrian Fernandez*, [2009] ECR I-9807, para. 18 and C-25/10, *Missionswerk Werner Heukelbach*, [2011] ECR I-497, para. 16.

¹¹⁸ C-35/11, *Test Claimants in the FII Group Litigation*.

¹¹⁹ C-35/11, *Test Claimants in the FII Group Litigation*, para. 93-94.

¹²⁰ Joined Cases C 436/08 and C 437/08, *Haribo Lakritzen Hans Riegel and Österreichische Salinen*, [2011] ECR I 305, para. 33; C 132/10, *Halley*, [2011] ECR I 8353, para. 17 and C-31/11, *Scheunemann*, para. 20.

¹²¹ HFD 2011 ref. 90 II-V; Prop. 2012/13:1 p. 269

¹²² European Commission, letter of formal notice – violation number 2013/4206, Annex: C (2014) 8699 final, p. 6.

¹²³ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 45.

areas within the jurisdiction of direct taxation, applying to Member States, which is harmonized through EU directives.¹²⁴ However Member States are still obliged to make sure that national legislation does not violate EU regulations, in particular the TFEU fundamental freedoms creating the internal market with regards to direct taxation. The general Article 18 of the TFEU prohibits any discrimination based on the grounds of nationality. This articles scope is rather limited with regards to direct taxation in comparison to the fundamental freedoms.¹²⁵ Any discrimination, direct or indirect, based on nationality is also prohibited with respect to the fundamental freedom, as provided in the general rule found in Article 18 TFEU.¹²⁶ An indirect discrimination will occur when a national provision treats a resident and a non-residents in comparable situation differently on bases of other criterions then nationality, a covert discrimination, which finally amounts to discrimination based on nationality.¹²⁷

The TFEU also forbids any kind of restrictions on the fundamental freedoms. The CJEU has established in its case law that all measures that prohibit, impedes or render less attractive the exercise of the basic freedoms are considered as restrictions.¹²⁸ A restriction has a greater scope than the application of the general article of discrimination based on nationality. A restriction could both occur from tax treatments, which render less attractive circumstances, but also from procedural or administrative requirements.¹²⁹ It is not only the host state that is prohibited from applying legislation that is restrictive or discriminatory, this also applies to the home state.¹³⁰ The equal treatment of activities and persons rises from the general principle of equality in EU Law and thereby it is also relevant for the fundamental freedoms.¹³¹ Moreover, the general principle of equal treatment commands that comparable situations must not be treated differently and different situation must not be treated by the same manner, except for where such treatment is objectively justified. The CJEU has developed this method when examining whether a discrimination or restriction exists, through the so-called comparison test.¹³² Such exam has been done through comparing the factual cross-border situation with a hypothetical national situation or by comparing the factual cross-border activity with a hypothetical cross-border activity. This analysis is the so-called vertical and

¹²⁴ See: Parent-Subsidiary Directive 2011/96/EU, Interest-Royalty Directive 2003/49/EC, Merger Directive 2005/19/EC, Savings Directive 2003/48/EC, Mutual Assistance Directive 2011/16/EU and Recovery Directive 2014/59/EU.

¹²⁵ Helminen, M., *EU Tax Law – Direct Taxation*, (2013), Published by IBFD, e-book, Chapter 2, p. 6.

¹²⁶ C-270/83, *Commission v France (Avior Fiscal)*, [1986] ECR I-00273, para. 13; See also: Helminen, M., *EU Tax Law – Direct Taxation*, (2013), Published by IBFD, e-book, Chapter 2, p. 6.

¹²⁷ C-224/01, *Köbler*, [2003] ECR I-10239, para. 58; C-15/96, *Schöning-Kougebetopoulou mot Freie und Hansestadt Hamburg*, [1998] ECR I-00047, para. 11-12.

¹²⁸ See e.g. C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt*, [2008] ECR I-08061, para. 30; Case C-55/94, *Gebhard*, [1995] ECR I-4165, para. 37; C-442/02, *CaixaBank France*, [2004] ECR I-8961, para. 11.

¹²⁹ C-279/93, *Finanzamt Köln-Altstadt mot Schumacker*, [1995] ECR I-00225, para. 49; C-55/98, *Vestergaard*, [1999] ECR I-07641, para. 21-22.

¹³⁰ See e.g. C-9/02, *de Lasteyrie du Saillant*, [2004] ECR I-2409, para. 42; C-251/98, *Baars*, [2000] ECR I-2787, para. 28; C-371/10, *National Grid Indus*, [2011] ECR I-12273, para. 35.

¹³¹ Zalasinski, A., *The Limits of the EC Concept of ‘Direct Tax Restriction on Free Movement Rights’, the Principles of Equality and Ability to Pay, and the Interstate Fiscal Equity*, (2009), Volume 37, Issue 5, p. 293(pp. 282-297); Terra, B. and Kajus, J., *Introduction to European VAT (Recast)*, (2014), IBFD Publishing, e-Book, IBFD Database, p. 29.

¹³² See e.g. C-513/04, *Kerckhaert-Morres*, [2006] ECR I-10967, para. 19; C-279/93, *Schumacker*, [1995] ECR I-225, para. 30, and C-311/97, *Royal Bank of Scotland*, [1999] ECR I-2651, para. 26.

horizontal comparison.¹³³ The CJEU has then looked at whether different sets of rules would apply to comparable situations or the same rules would apply to non-comparable situation.¹³⁴ However, it has been stated by the CJEU that resident and non-resident taxpayers are, as a rule, not in a comparable situation. Consequently, to determine whether resident and non-resident taxpayer could be comparable the court has examined the aim and purpose of the national tax provision in order to determine whether there is any objective differences between resident and non-residents.¹³⁵

3.3.1 The Swedish Rules a Discrimination or Restriction

The Swedish interest deduction limitation rules might be discriminatory or restrictive when applied in cross-border transaction where the recipient is taxed by at least 10 % coupled with the requirement that the main reason for such transaction has not been to receive a substantial tax benefit. This also includes the requirements in the business motive test found in chapter 24:10e §, which necessitates that the main reason for the debt financing is business motivated when taxation is below 10%. The rules do not directly discriminate on the bases of nationality.¹³⁶ It is rather based on the difference in the level of taxation between countries. However, it is argued by the European Commission that the rules indirectly discriminate foreign group companies in comparison with Swedish groups, due to the fact that the Swedish group contribution rules only apply to Swedish groups located in Sweden. With the effect that the interest deduction limitation rules only apply to foreign groups. This difference in treatment of resident groups and group companies which are located in more than one Member State would also restrict companies choice of establishment.¹³⁷ The Commissions argument is valid in the sense that the interest deductions limitation rules does not apply to Swedish group because the taxation will never be below 22%.¹³⁸ However, the Swedish interest deduction limitation rule does, as explained in chapter 2, not only apply to group companies, but also to affiliated companies. In order to be recognized as a group company according to SITA, it is required a shareholding of over 90%.¹³⁹ This type of definite influence goes beyond what is necessary in turn to be recognized as affiliated company accordingly to the Swedish interest deduction limitation rules. This means that the European Commission has narrowed its claim of discrimination or restriction to a stricter type of control covered by the freedom establishment.

According to the author of this paper this might have been unnecessary. One may question whether the Commission paid attention to the aim and purpose of the rule when establishing their claim. However, the Swedish government claims that a Swedish group with right to give group contribution is not in a comparable situation with a group of companies being located in more than one Member State, which can

¹³³ José, C., Andreas, B. *The Columbus Container Services ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle*, Intertax, Vol. 37 issue 4, 2009, p. 213, (pp. 212-222).

¹³⁴ C-9/02, *de Lasteyrie du Saillant*, [2004] ECR I-2409, para. 46; C-470/04, *N*, [2006] ECR I-7409, para. 35; C-371/10, *National Grid Indus*, [2011] ECR I-12273, para. 37.

¹³⁵ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 57-58.

¹³⁶ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 6-7; HFD 2011 ref. 90 II-V; Board of Advance Rulings 2014-04-16, dnr. 71-13/D and 2014-04-29, dnr. 80-13/D; Proposition 2012/13:1 s. 268-270; and Swedens answer to the European Commission (dnr Fi2014/4205).

¹³⁷ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 5-7.

¹³⁸ This was also confirmed by the Swedish government in the preparatory work, see Proposition 2012/13:1, p. 272-273.

¹³⁹ Inkomstskattelagen (1999:1229), Chapter 35-35a.

not give group contributions with regards to the aim and purpose of the Swedish interest deduction limitation rules. They also claim that the CJEU has made it clear that it is justified to treat internal groups different than to external groups when such rules make it possible for MNE to choose in which jurisdiction they will be taxed.¹⁴⁰ In order to determine whether discrimination exists, one must decide, bearing in mind the aim and purpose of the rule, whether an internal loan between a Swedish group is comparable with a cross-border loan from one group member to another and whether two independent cross-border loans are comparable. The CJEU did this comparison in the *Oy AA* case and came to the conclusion that a cross-border group is comparable with a pure internal group and the difference in treatment causes both a restriction and is an indirect discrimination.¹⁴¹ However, the court did not compare the transaction with another cross-border transaction in the *Oy AA* case. This is not a surprise, when glancing at the established case law.¹⁴² If the rules were to be scrutinized through the perception that its purpose is intended to limit the deductibility of interest expenses within group companies, the Swedish interest deduction limitation rules would by a strict vertical comparison be regarded as a restriction on the freedom of establishment according to existing case law.¹⁴³

By applying the horizontal comparison test to also two independent cross-border debt financings within group companies with regards to the aim and purpose of the rules would not change the fact that debt financing within group companies are comparable.¹⁴⁴ This would mean that the Swedish interest deduction limitation rules would have a restrictive effect on companies who wish to establish in other Member States if such states do not have the same tax rate as Sweden or above.¹⁴⁵ This is due to the fact that the deductibility of the Swedish rules are conditional upon the taxation level of the state where the beneficial recipient is located.¹⁴⁶ It has been established that the Swedish interest deduction limitation rules could have an indirect discriminatory and restrictive effect on comparable transactions, which is not in line with the principle of equal treatment entrenched to the fundamental freedoms. The analysis will go on to examine whether the restriction and indirect discrimination caused by the Swedish rules could be justified.

3.4 The Rule of Reason

It is provided for certain justification grounds in the TFEU for when a national rule might be discriminatory. These justifications are public health, public security and public policy.¹⁴⁷ Such justification grounds have been put forwarded to the CJEU to justify discriminatory national laws but has never been accepted as justification by the Court in the area of direct taxation.¹⁴⁸ It was in 1979 that the CJEU decided in *Cassis de Dijon* that a restriction could be justified by the overriding reason of public

¹⁴⁰ The answer to the European Commissions letter of formal notice from 20 mars 2015 (dnr Fi2014/4205), where they refer to C-231/05, *Oy AA*, [2007] ECR I-06373, para. 53-56.

¹⁴¹ C-231/05, *Oy AA*, [2007] ECR I-06373, para. 38-39.

¹⁴² C-298/05, *Columbus Container Services*, [2007] ECR I-10451, para. 40.

¹⁴³ C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 59-62.

¹⁴⁴ According to the reasoning of AG's opinion in C-298/05, *Columbus Container Services*, para. 64, 117.

¹⁴⁵ According to the reasoning of AG's opinion in C-298/05, *Columbus Container Services*, para. 128-129.

¹⁴⁶ *Inkomstskattelagen* (1999:1229), Chapter 24:10d-e§§.

¹⁴⁷ See: TFEU Article 36, 45, 52, 65 and 202.

¹⁴⁸ Michael, L., Pistone, P., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 71.

interest.¹⁴⁹ The rule of reason has gradually grown out of the CJEU case law as Member States put forward claims justifying national measures that restrict the freedom of movement in the name of the imperative requirement of overriding public interest.¹⁵⁰ Through the courts case law it has emerged areas that might be accepted as justification in the name of public interest, which are *safeguarding the balance allocation of taxing rights, the principle of fiscal territoriality, cohesion of the tax system, prevent abusive practices and fraud, neutralization in the other state and effectiveness of fiscal supervision*.¹⁵¹ Many authors have discussed these topics and even suggested that they could be categorized as closely linked or in related groups of justification.¹⁵² However, the following analysis will examine which of them might serve as justification for the Swedish interest deduction limitation rules and which could not according to the rule of reason doctrine created by the CJEU.

3.4.1 Justification Grounds not Applicable on the Swedish Rules

If one of the arguments, presented above, that might justify a discrimination or restriction is not accepted it might still be justified if the other state involved is willing to provide for a tax credit that neutralizes the negative effects causing the discrimination or restriction.¹⁵³ However, Sweden does not have such provisions in its DTC that gives the taxpayer the possibility to utilize the denied interest costs in Sweden by the other contracting state.¹⁵⁴ Moreover, the denial of deduction is not a tax that could be neutralized by the other state using the credit method.¹⁵⁵ Further argument put forward to the CJEU justifying restrictive or discriminatory national provisions on the freedoms of movement in the name of public interest by Member States is the need to safeguard the effectiveness of fiscal supervision.¹⁵⁶ The CJEU has accepted that Member States apply measures that can ascertain the taxpayer's claim clearly and precisely.¹⁵⁷ However, the court has stressed that such measures must not be disproportionate burdensome and is appropriate when other less strict

¹⁴⁹ C-120/78, *Rewe v Bundesmonopolverwaltung für Branntwein ('Cassis de Dijon')*, [1979] ECR I-00649, para. 13-14.

¹⁵⁰ See e.g. C-250/95, *Futura*, [1997] ECR I-2471, para. 26; C-204/90, *Bachmann*, [1992] ECR I-00249; C-493/09, *Commission vs Portugal*, [2011] ECR I-09247; Marcel, G. H. Schaper, *The Need to Prevent Abusive Practices and Fraud as a Composite Justification*, EC Tax Review, Kluwer Law International, 2014, Issue 4, p. 220. (pp. 220-229).

¹⁵¹ The recognized justification grounds in the field of direct taxes is well described in prior research, see e.g. Van Thiel, S., *Justifications in Community law for income tax restrictions on free movement: Acte clair rules that can be readily applied by national courts – Parts 1 & 2*, European Taxation, 2008, (Volume 7-8), pp. 279-290 & pp. 339-350; Cordewener, A., Kofler, G., Van Thiel, S., *The Clash between European Freedoms and National Direct Tax Law: Public Interest Defences Available to the Member States*, Common Market Law Review, 2009, (Volume 46), pp. 1951-2000. See also Schaper, M.G.H., *A Computational Legal Analysis of Acte Clair Rules of EU Law in the Field of Direct Taxes*, 2014, (Volume 6), No 1, World Tax Journal, pp. 77-108.

¹⁵² See e.g. Poulsen, M., *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, Intertax, 2012, Volume 40, Issue 3, Kluwer Law International BV, pp. 200-211; Terra, B., and Wattel, P., *European Tax Law*, (2012), 6th edition, Kluwer Law International, Chapter 18.

¹⁵³ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 77.

¹⁵⁴ See e.g. The Nordic Double Tax Convention (1996:1512), Article 25.

¹⁵⁵ C-487/08, *Commission vs. Spain*, [2010] ECR I-4843, para. 59-61 and 63; C-540/07, *Commission v Italy*, [2009] ECR I-0000, para. 38.

¹⁵⁶ C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995, para. 47 and 59; C-250/95, *Futura Participations*, [1997] ECR I-02471, para. 31.

¹⁵⁷ C-39/04, *Laboratoires Fournier*, [2005] ECR I-02057, para. 24; C-318/10, *SIAT*, para. 44.

measures are not available.¹⁵⁸ As previously mentioned the Swedish interest deduction limitation rules objective is to prevent tax base erosion as a specific anti-abuse provision and not to safeguard an effective fiscal supervision. Consequently, it is not a claimable justification.

3.4.2 Territoriality Principle

The principle of territoriality is of great importance, as it creates the boundaries for Member States on its power to allocate taxing rights and is also the principle, which generates constraints on the principle of equality protecting the fundamental freedoms from discrimination or restrictions.¹⁵⁹ Countries usually tax persons resident on its territory on its worldwide income and non-resident on its income derived from activities allocated to its territory. For such reasons it is argued that resident taxpayers and non-resident taxpayers, in general, are not in a comparable situation and therefore a difference in treatment could be justified.¹⁶⁰ However, the comparability test must be assessed in the light of legislation at hand, as explained under section 3.3.1 and whether objective differences exist between the situation of residents and non-residents.¹⁶¹ Moreover, academics have argued that this approach is not feasible, because the non-comparability is rather a mere consequence of the reduced territorial boundaries of tax jurisdiction and whether such limitation could justify effects on other items, such as deductions, credits or tax rates.¹⁶² As a result Member States must, by preserving the concept of tax neutrality, show an actual relationship between the territorial boundaries in its taxing rights and the subsequent disadvantage for the taxpayer. The justification of different treatment in the light of the territorial principle has only been tested by the CJEU in relation to the possibility deny deductions of not utilized foreign losses of persons subjected to limited liability in cases where the foreign profits is not taxed in the state where the deduction is claimed or in accordance with the *Schumacker* doctrine, which is of no relevance for the Swedish rules examined in this paper.¹⁶³

The question whether the Swedish interest deduction limitation rules could be justified by the government through the territoriality principle as a restrictive or discriminatory measure in the name of the public interest is unlikely. Since Sweden does not tax outbound interest payments nor does it tax the profits of affiliated companies located in other Member States through DTC.¹⁶⁴ However, this does not

¹⁵⁸ C-204/90, *Bachmann*, [1992] ECR I-00249, para. 18 and 20; C-39/04, *Laboratoires Fournier*, [2005] ECR I-02057, para. 25; C-493/09, *Commission v Portugal*, [2011] ECR I-09247, para. 42-48. See: C-132/10, *Halley*, [2011] ECR I-08353, para. 36, with regards to States possibility to use the Mutual Assistance Directive, 77/799/EEC, as less restrictive measure.

¹⁵⁹ Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 280 (pp. 271-293).

¹⁶⁰ C-279/93, *Schumacker*, [1995] ECR I-00225, para. 31-34; C-234/01, *Gerritse*, [2003] ECR I-05933, para. 43-44; C-562/07, *Commission v Spain*, [2009] ECR I-09553, para. 46; C-250/95, *Futura Participations*, [1997] ECR I-02471, para. 22.

¹⁶¹ C-319/02, *Manninen*, [2004] ECR I-07477, para. 38-39; AG opinion in *Manninen*, para. 42 and 44; C-562/07, *Commission v Spain*, [2009] ECR I-09553, para. 47.

¹⁶² Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 284 (pp. 271-293).

¹⁶³ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 74; It has been established by the Schumacker doctrine that personal and family circumstances of a taxpayer must be taken into account in at least one Member State.

¹⁶⁴ See: Swedish Double Tax Conventions, Article 8 and 12.

mean that the principle is of no importance in the pursuit to determine whether the Swedish rules could be justified. This is due to the fact that the principle of territoriality is entrenched with the two justification grounds, *balance allocation of taxing powers* and *the coherence of the tax system*, included in the scope of the public interest which will be presented below.¹⁶⁵ The author of this paper agrees with the bold statement made by Wolfgang Schön that, “Territoriality is not in itself a “public interest” that justifies unequal treatment in specific cross-border situations. It is merely a constraint to the taxing powers of a Member State”.¹⁶⁶

3.4.3 Balance Allocation of Taxing Rights

As mentioned earlier in this paper the intended purpose of the Swedish interest deduction limitation rules is to combat base erosion and tax avoidance. However, it is settled case law that the CJEU refuses to accept unequal treatment by Member States based on the argument that restrictions are necessary to combat tax base erosion.¹⁶⁷ Although the court has accepted certain measures as justifications in the public interest that protects Member States territorial taxing rights, which has budgetary effects. One is the need to safeguard the balance allocation of taxing powers (balance allocation) and the other one is the need to safeguard the cohesion of the tax system, which is discussed in section 3.4.5.¹⁶⁸ The justification of an unequal treatment based on the balance allocation concept has its core element in the idea that the involved states have the right to allocate the tax base on territorial basis (i.e. unilaterally), or through negotiated DTC. Meaning that the framework for how taxes are balanced, as a result from the taxpayer activities, is already created by the Member States and therefore the taxpayer shall not be able to transfer the tax base at will between jurisdictions. Thereby limiting the taxpayer’s options of shifting profits to be taxed in low-tax jurisdictions and utilizing expenditures or losses in high-tax jurisdictions without being backed up by motivated economic transactions.¹⁶⁹

The CJEU case law on the applicability of this justification is rather unclear. Particularly, since the balance allocation concept as justification has been put forwarded to the court in a series of cases but seldom has it been accepted on a stand-alone basis.¹⁷⁰ The CJEU applied this justification for the first time in the *Marks & Spencer* case coupled with the justifications tax avoidance and territoriality.¹⁷¹ In *X Holding* the court justified a restriction exclusively on the balance allocation concept with the same reasoning as in its previous case law except for the including of other justifications.¹⁷² What is evident from the courts jurisprudence with regards to the balance allocation concept as justification is that it will not accept such restrictions solely on the notion that resident and non residents

¹⁶⁵ Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 285 (pp. 271-293).

¹⁶⁶ Ibid, p. 285.

¹⁶⁷ C-264/96, *Imperial Chemical Industries plc*, [1998] ECR I-4695, para. 28; C-35/98, *Verkooijen*, [2000] ECR I-4071, para. 59; C-446/03, *Marks & Spencer*, ECR I-10837, para. 44 and C-319/02, *Manninen*, [2004] ECR I-7498, para. 49.

¹⁶⁸ Neyt, R. and Peeters, S., *Balanced Allocation and Coherence: Some Thoughts in Light of Argenta and K*, EC Tax Review, 2014 issue 2, Kluwer Law International, p. 67 (pp. 64-75).

¹⁶⁹ Poulsen, M., *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, Intertax, Volume 40, Issue 3, 2012 Kluwer Law International, p. 204 (pp. 200-211).

¹⁷⁰ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 78; Poulsen, M., *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, Intertax, Volume 40, Issue 3, 2012 Kluwer Law International, p. 203 (pp. 200-211).

¹⁷¹ C-446/03, *Marks & Spencer*, [2005] ECR I-10837, para. 43, 46, 36, 39-40 and 49.

¹⁷² C-337/08, *X Holding*, [2010] ECR I-01215, para. 28-33.

are not in a comparable situation without examining whether the legislation in hand is necessitated in order to protect the Member States exercise of taxing powers in relation to activities carried on in their territory and thereby preventing the taxpayer from choosing the outcome of the taxation within the involved states.¹⁷³ Otherwise it would be free for States to treat residents and non-residents differently in all circumstances in the name of the balance allocation concept and thereby destabilizing the principles of the internal market. However, the CJEU has not been precise under what circumstances the balance allocation concept isolated from other justification could be applicable or accepted, since the court used the same reasoning in *X Holding* as in its previous case law where it was accepted in conjunction with others. Various authors have suggested and questioned whether the CJEU's case law on the balance allocation of taxing powers is relevant on its own or whether it must be applied with other justifications in order to achieve its purpose of creating a symmetric taxation where the Member States territorial taxing rights are limited.¹⁷⁴ However, in *Michael Lang* investigation of the concept he makes a distinction on when the concept is relevant on its own and how it is to apply in conjunction with other justification grounds.¹⁷⁵ He describes the possibility to apply the justification autonomous in relation to transfer of profits causing tax-deductible expenses at the will of the taxpayer and thereby undermining the balance allocation concept.¹⁷⁶ A distinction made by *Lang*, which is important with regards to the Swedish rule, is that such rules at issue shall not be formed as anti-abuse legislation as that would automatically require the combination of justification grounds.¹⁷⁷

Both the European Commission and the Swedish government seem to agree that the Swedish interest deduction limitation rules could be justified with reference to the balance allocation of taxing powers in combination with the need to prevent tax avoidance.¹⁷⁸ This will be examined in section 3.4.4, where the justification anti-abuse is analysed. However, to determine whether the balance allocation concept alone could justify the Swedish rules is rather unclear. If one considers the overall assessment made by the CJEU in its case law one may say no, but then again, if the basis for the assessment is made upon the *X Holding* case the answer could be yes. After all, the Swedish interest deduction limitation rules does hinder affiliated companies to use debt as an instrument to shift profits to where ever they see fit and in what State the expenses shall be utilized, which is the objective of the balance allocation rule. However, to stop the examination here would not be correct. As both the AG Mengozzi and the court elaborated in the *Argenta Spaarbank* case one must seek to determine whether such granting of deduction would deprive the involved

¹⁷³ C-446/03, *Marks & Spencer*, [2005] ECR I-10837, para. 45; C-470/04, *N*, [2006] ECR I-7409, para 42; C-231/05, *Oy AA*, [2007] ECR I-6373, para. 51, 53-54; C- 414/06, *Lidl Belgium*, [2008] ECR I-3601, para. 31; C-350/11, *Argenta Spaarbank*, para. 53. See also: van Thiel, S., *Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules that Can Be Readily Applied by National Courts – Part 2*, European Taxation, 2008 issue 7 p. 342-345 (pp. 339–350).

¹⁷⁴ See e.g. Poulsen, M., *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, Intertax, 2012, Volume 40, Issue 3, Kluwer Law International BV, p. 207 (pp. 200-211). Terra, B. and Wattel, P., *European Tax Law*, (2008), 5th Edition: Kluwer Law International BV Netherlands, p. 764-766; Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 280 (pp. 271-293).

¹⁷⁵ Lang, M., *Non-Discrimination in European and Tax Treaty Law – Open Issues and Recent Challenges*, (2015), Volume 94, Linde Verlag: Wien, p. 137-145.

¹⁷⁶ Ibid, p. 142.

¹⁷⁷ Ibid, p. 142-143.

¹⁷⁸ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 7, and The answer to the European Commissions letter of formal notice from 20 mars 2015 (dnr Fi2014/4205), p. 11.

states their territorial taxing rights.¹⁷⁹ As Sweden has chosen to not levy any withholding tax on outbound interest payments in their negotiated DTC, they were never able to tax the outbound interest payment nor the income of a subsidiary located in another Member State. Neither does the granting of deduction by Sweden jeopardize the other countries possibilities to tax the subsidiaries located in its territory. This allocation of taxing power is the choice of the states involved and is not for the CJEU to intervene with.¹⁸⁰ In addition, as *Lang* described the autonomous use of the balance allocation concept, the rules at issue shall not as in Sweden's case target abusive practices. Therefore, in order for the balance allocation concept to be relied on by the Swedish government to protect its tax base it seems to be needed to be forwarded in combination with other justification.

3.4.4 Anti-abuse

As mentioned in previous section, tax restrictions made by Member States with the objective of combating abusive practices may serve as justification by imperative requirement of overriding public interest if it is proportionate.¹⁸¹ The anti-abuse principle created by the CJEU has a narrow field of application, as it only targets wholly artificial arrangements intended to circumvent national legislation, but also where such abusive or fraudulent conducts by the taxpayer results in exploitation of the provisions of the TFEU.¹⁸² Moreover, the CJEU has in its case law developed certain criteria in search for whether such arrangements exist.¹⁸³ To begin with such structures are characterised by a tax advantage created by a cross-border activity, which the taxpayer would not have benefited from in a purely domestic setting.¹⁸⁴ Moreover, restrictive national legislation could only be justified in circumstances where the aim of the rule is to systematically through objective and verifiable elements identify abusive or artificial arrangements not reflecting economic reality, thereby providing consideration of its objective.¹⁸⁵ This means that national rules shall not categorically and generally disallow benefits in cross-border situation by assuming that all transaction is abusive. The rules shall allow the verifying of genuine commercial justification on a case-by-case basis, without excessive administrative constraints put on the taxpayer.¹⁸⁶

However the argumentation by CJEU on the anti-abuse concept as justification for restrictive measures by Member States has been slightly different when it is considered together with the balance allocation concept. One difference that has been pointed out by several researchers is the level of artificiality required when it is considered combined with the balance allocation concept.¹⁸⁷ It seems that the narrow

¹⁷⁹ C-350/11, *Argenta Spaarbank*, para. 55 and AG Mengozzis opinion in *Argenta Spaarbank*, para. 62-63.

¹⁸⁰ AG Kokott opinion in C-48/13, *Nordea Bank*, para. 37.

¹⁸¹ C-212/97, *Centros*, [1999] ECR I-1459, para. 24; C-436/00, *X and Y*, [2002] ECR I-10829, para. 41; C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995, para. 47.

¹⁸² C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995, para. 55.

¹⁸³ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 75

¹⁸⁴ Schaper, M.G.H., *The Need to Prevent Abusive Practices and Fraud as a Composite Justification*, EC Tax Review, Kluwer Law International, 2014, Issue 4, p. 225. (pp. 220-229).

¹⁸⁵ C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 92; C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995, para. 70.

¹⁸⁶ C-212/97, *Centros*, [1999] ECR I-1459, para. 25; C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 92; C-324/00, *Lankhorst-Hohorst*, para. 38; and C-436/00, *X & Y*, [2002] ECR I-10829, para. 43.

¹⁸⁷ Neyt, R. and Peeters, S., *Balanced Allocation and Coherence: Some Thoughts in Light of Argenta and K*, EC Tax Review, 2014 issue 2, Kluwer Law International, p. 73 (pp. 64-75);

concept of wholly artificial arrangement has been broadened by the CJEU to include tax avoidance when it has been justified in conjunction with the balance allocation concept.¹⁸⁸ *Raffaele Russo* has reviewed the concept of tax avoidance, both from an international and EU aspect.¹⁸⁹ Where the author discusses the tax avoidance concept as a spectrum containing legitimate and justified tax planning in one corner and wholly artificial arrangements at the other end, distant from each other by a grey area.¹⁹⁰ This makes the courts reasoning as when to apply both the anti-abuse concept and balance allocation concept combined as justifications for restrictive national provision rather unclear. However, it seems that the CJEU accept these concepts in conjunction as justification where there might be a danger for the tax advantage to jeopardise the involved states to exercise the power to tax in relation to activities carried out in their territory, which would by manipulative and improper conducts risk the shifting of profits at will by the taxpayer within the involved states.¹⁹¹

Whether the anti-abuse concept created by the CJEU could justify the Swedish interest deduction limitation rule on a stand-alone basis is questionable. Especially since the legislator has developed the rules as a SAAR intended to protect the Swedish tax base. As explained above, this means that the rule must exclusively target wholly artificial arrangements. However, the Swedish rules are formed in a manner that it categorically and generally disallows the benefit of deduction where the taxation of the interest income is taxed below 10%. Thereby, it systematically assumes that such transactions are wholly artificial. Even if the Swedish rule gives the taxpayer the opportunity to demonstrate that the engaged debt financing is not to receive a substantial tax benefit or whether it is mainly business motivated, when taxation is below 10%, the required thresholds are not inline with EU law. These thresholds are set so high that sound tax planning, possible through tax differentials, encouraged by the CJEU would risk triggering the non-deductibility of interest expenses.¹⁹² The European Commission in its letter exchange with the Swedish Government has stressed this issue and whether the rules are proportionate. The proportionality test is an important factor when determining whether such rules could be justified and will be discussed under section 3.5.

Poulsen, M., *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, Intertax, 2012, Volume 40, Issue 3, Kluwer Law International BV, p. 207 (pp. 200-211); Baker, P., *Transfer Pricing and Community Law: The SGI Case*, Intertax, 2010, Volume 38, Issue 4, Kluwer Law International BV, p. 194-196; and Schaper, M.G.H., *The Need to Prevent Abusive Practices and Fraud as a Composite Justification*, EC Tax Review, Kluwer Law International, 2014, Issue 4, p. 226-227 (pp. 220-229).

¹⁸⁸ C-231/05, *Oy AA*, [2007] ECR I-6373, para. 63; and C-446/03, *Marks & Spencer*, [2005] ECR I-10837, para. 49.

¹⁸⁹ Russo, R., (ed.) et al: *Fundamentals of International Tax Planning*, (2007), IBFD Publications BV, Netherlands, p. 51-57.

¹⁹⁰ *Ibid*, p. 58-59.

¹⁹¹ C-196/04, *Cadbury Schweppes*, [2006], ECR I-7995, para. 55; C-231/05, *Oy AA*, [2007] ECR I-6373, para. 62-63. *See also*: De Broe, L., *The ECJ's Judgment in Argenta: Narrow Interpretation of "the Preservation of the Balanced Allocation of Taxing Rights between Member States": A Headache for Designers of Tax Incentives in the Union*, EC Tax Review, Kluwer Law International, 2013, Issue 5, p. 210-212; and Schaper, M.G.H., *The Need to Prevent Abusive Practices and Fraud as a Composite Justification*, EC Tax Review, Kluwer Law International, 2014, Issue 4, p. 225 (pp. 220-229).

¹⁹² C-212/97, *Centros*, [1999] ECR I-01459, para. 27; C-167/01, *Inspire Art*, [2003] ECR I-10155, para. 96; C-364/01, *Barbier*, [2003] ECR I-15013, para. 67; Jurisdiction Shopping a valid concept by the CJEU and Commission, *in this regard see also*: Robert, E. and Tof, D., *The Substance Requirement and the Future of Domestic Anti-Abuse Rules within the Internal Market*, European Taxation, IBFD Online Publishing, 2011, (Volume 51), No. 11, Heading 2.

However, the Swedish government is of the opinion that the Swedish rules could be justified by the need to safeguard the balance allocation of taxing powers combined with the anti-avoidance concept, arguing that the rules would not need to exclusively target wholly artificial arrangements under such circumstances.¹⁹³ As explained above, this could be a valid argument when analysing the CJEU case law, however, it is far from certain if the court would agree that a symmetric taxation is achieved by the Swedish rules as it is rather unclear how the court applies this concepts combined.

3.4.5 Cohesion of tax system

The cohesion of the tax system as justification for a restrictive national measure affecting the equal treatment of nationals of the Member States was for the first time invoked by the CJEU in 1992.¹⁹⁴ The concept of coherence is built on the assumption that there is a connection between the benefit that arises from a national provision and the offsetting of that advantage by a particular tax levy.¹⁹⁵ This connection is recognised by the CJEU, as a “direct link” creating symmetry in the system of taxation which otherwise would be limited due to the Member States territorial limitation of taxing rights (micro coherence).¹⁹⁶ The nature of that direct link must be tested in the light of the objective pursued by the tax rules.¹⁹⁷ A Member State may not rely on the coherence concept as justification to deny an advantage, where the national rules allowed taxation in that state but where it through negotiated DTC allocated the taxing right to the other Member State.¹⁹⁸ In such cases the CJEU has mentioned that Member States has to sort out the cohesion of the tax system through the means of bilateral tax conventions (macro coherence).¹⁹⁹ Be that as it may, the establishment of the direct link seems to have slightly changed by the CJEU in its settled case law from its start in 1992 and as it stands today. In the courts early assessment on the coherence concept such direct link required a correlation of the tax advantage and the corresponding tax levy by relating to the same tax and applied to one and the same taxpayer.²⁰⁰ This requirement seemed to have been achieved if a close internal relation was found to exist between the advantage and the corresponding disadvantage.²⁰¹

To demonstrate an example on such internal relation, would be where an advantage is given in the form of loss relief in Member State A by losses incurred by a permanent establishment located in Member State B and where the offsetting of that advantage would appear by Member State A requiring the recapture of tax base when the permanent establishment makes profits in the following years. In contrast,

¹⁹³ The answer to the European Commissions letter of formal notice from 20 mars 2015 (dnr Fi2014/4205), p. 14.

¹⁹⁴ C-204/90, *Bachmann*, [1992] ECR I-00249; and C-300/90, *Commission v Belgium*, [1992] ECR I-00305

¹⁹⁵ Weber, D., *An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, EC Tax Review, Kluwer Law International, 2015, Issue 1, p. 54 (pp. 43-54).

¹⁹⁶ Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 279-280 (pp. 271-293).

¹⁹⁷ AG Opinion Kokott in C-48/13, *Nordea Bank*, para. 47 and C-66/14, *Finanzamt Linz*, para. 47.

¹⁹⁸ C-80/94, *Wielockx*, [1995] ECR I-02493, para. 24.

¹⁹⁹ C-136/00, *Danner*, [2002] ECR I-08147, para. 41.

²⁰⁰ See e.g. C-35/98, *Verkooijen*, [2000] ECR I-04071, para. 58; C-251/98, *Baars*, [2000], ECR I-02787, para. 40; and C-168/01, *Bosal*, [2003] ECR I-09409, para. 29 and 30.

²⁰¹ Robert, N. and Steven, P., *Balanced Allocation and Coherence: Some Thoughts in Light of Argenta and K*, EC Tax Review, 2014 issue 2, Kluwer Law International, p. 69 (pp. 64-75).

a domestic permanent establishment would not be required to recapture the utilized losses.²⁰² The alteration seen in the assessment of whether a direct link exist in the CJEU later case law is that the close internal relation of the advantage and disadvantage seem to be satisfied where the link is not as close or direct as emphasised in earlier case law. In the *K* case a direct link was established between the deductibility of capital losses incurred in the sale of property in France and on previous or subsequent capital gains incurred by the sale of securities in Finland.²⁰³ There is no connection in the loss making of the real estate and gains made through the securities. The court argues that in the Finnish and French DTC the allocation of the taxing rights had been given to France and therefore the losses incurred by the Finnish resident could not be utilized in France or Finland.²⁰⁴ In addition the court also recognized the possibility of tax base erosion if such losses were to be accountable in Finland. Making it possible for the taxpayer to shift profits at will. The possibility of relying on the coherence concept in such situation is questionable. Since the Finnish government has limited its taxing rights by exempting such incomes from France, the unilateral coherence of the Finnish system is broken. The court seems to emphasize the symmetric taxation and to be more willing to accept such link even when there is no close relation of the tax advantage and the tax levy when it considers the coherence concept combined with the balance allocation concept as justification.²⁰⁵

Moreover, the required condition that the tax advantage and the disadvantage in form of tax levy have to relate to the same taxpayer has also been expanded by the CJEU depending on the aim of the rules involved. This was the case in *Papillon*, which regarded the French consolidation rules, where the court accepted that there was a link between the advantage and the offsetting of it when the rules concerned parent companies and its subsidiaries.²⁰⁶ Several researchers has recognised this broadening of the coherence scope made by CJEU in its case law. Wolfgang Schön explains the court actions as, "... hereby replacing in this one-sided approach the "direct link" between expenditure and income of an individual taxpayer with a "link" between certain types of expenditure and certain types of income arising from taxpayers cross-border activities in general"²⁰⁷. AG Kokott has also upheld this line of reasoning in her opinion in *Manninen*²⁰⁸ and *Finanzamt Linz*²⁰⁹. However, this does not mean that States could create a link between different items of expenditure and items creating profits at will or between different tax subjects. This is clear from the courts recent case law in *Argenta Spaarbank*, *Nordea Bank* and *Finanzamt Linz* where the CJEU found that such direct link does not exist when examining the objectives of the rules.²¹⁰

²⁰² This was the case in C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt*, [2008], ECR I-08061.

²⁰³ C-322/11, *K*, para. 69.

²⁰⁴ *Ibid*, para. 42-45.

²⁰⁵ *Ibid*, para. 54-55 and 71.

²⁰⁶ C-418/07, *Papillon*, [2008] ECR I-08947, para. 47-50.

²⁰⁷ Schön, W., *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?* Bulletin for International Taxation, 2015 (Volume 69) No. 4/5, IBFD, p. 279 (pp. 271-293). *Other authors have made this conclusion, see also: Weber, D., An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, EC Tax Review, Kluwer Law International, 2015, Issue 1, p. 58 and 51 (pp. 43-54); Neyt, R. and Peeters, S., *Balanced Allocation and Coherence: Some Thoughts in Light of Argenta and K*, EC Tax Review, 2014 issue 2, Kluwer Law International, p. 70 (pp. 64-75).

²⁰⁸ AG Kokott opinion in C-319/02, *Manninen*, [2004] ECR I-07477, para. 55-56.

²⁰⁹ AG Kokott opinion in C-66/14, *Finanzamt Linz*, para. 58.

²¹⁰ C-350/11, *Argenta Spaarbank*; C-48/13, *Nordea Bank*; and C-66/14, *Finanzamt Linz*.

Safeguarding the coherence of the Swedish tax system has not been brought up as a justification ground by the Swedish government. Whether this justification ground could have been relied on is unclear. In order to make this examination the criteria establishing a direct link explained above has to be analysed bearing in mind the aim and purpose of the Swedish rule. The required taxation of at least 10% of the interest income in the hands of the beneficial owner is established, as mentioned in section 2.4, by a hypothetical test. It is tested whether the received interest income would be taxed by at least 10% according to the legislation of the Member State of the receiver and as if the receiver did not have any other income. By limiting the taxation to only the received interest income one could argue that the Swedish rule has established a direct causal nexus between the tax advantage at issue (deduction of interest expenses) and the resulting taxation of interest income. As the purpose of this justification ground is to avoid double taxation or to ensure that income is taxed once.²¹¹ By requiring such level of taxation the incentive to shift the profits to a low tax jurisdiction reduces. In *Keller Holding* however, no link was established between the deductibility of financial costs and the taxation of profits.²¹² As opposed to the Swedish rules the required taxation was not narrowed down to financial income.

Moreover, in *Argenta Spaarbank* no direct link was established between the deductibility of risk capital and the required taxation of profits in Belgium.²¹³ The CJEU states that there is no direct link “between the advantage calculated by taking account of the assets and the taxation of the return generated by them”²¹⁴. In addition the court highlights that the Belgic rules requirement of taxation is directed towards all kinds of income incurred by the permanent establishment and thereby not income or profits created through the expenses of risk capital.²¹⁵ In the author’s opinion, the rules at issue in *Argenta Spaarbank* is not comparable to the Swedish rules. As the Swedish rule separates the deductible costs so precise that these costs are earmarked and the same income or profit that is required to be taxed at the hands of the recipient. Therefore it could be argued that the Swedish rule create a direct link between the tax advantage and the offsetting of that advantage.

However it is obvious that the benefit given (i.e. deduction of interest expenses) to the Swedish taxpayer and the required taxation are not in the hands of the same taxpayer. Be that as it may, as the purpose of the rule is to protect the Swedish tax base and the aim is to hinder affiliated companies to take advantage of abusive internal debt financing. Consequently, by aiming towards affiliated companies, the question that remains is whether there is a need for the rule to be directed towards the same taxpayer, as described above with regards to the *Papillon* case where the court accepted that it did not need to be the same taxpayer in order for the direct link to exist. On the other hand, in *Bosal* and *Keller Holding* the court did not accept that there was a direct link when the deduction and taxation did not concern the same taxpayer.²¹⁶ However the three cases differ with regards to how the assessment of the direct link is established when considering the aim and purpose of the rules. In both *Bosal* and *Keller Holding* it seems like the court did not include the objective of the rules in its assessments of whether a direct link existed and only focused on the fact that the advantage and the offsetting of the advantage did not concerned the same taxpayer. In *Bosal* a direct link could be established between the advantage and the

²¹¹ Lang, M., et al, *Introduction to European Tax Law on Direct Taxation*, (2013) Third Edition, Linde Verlag: Wien, p. 72.

²¹² C-471/04, *Keller Holding*, [2006] ECR I-02107, para. 43.

²¹³ C-350/11, *Argenta Spaarbank*, para. 49.

²¹⁴ *Ibid*, para. 46.

²¹⁵ *Ibid*, para. 47.

²¹⁶ C-168/01, *Bosal*, [2003] ECR I-09409, para. 35; and C-471/04, *Keller Holding*, [2006] ECR I-02107, para. 42-43.

disadvantage, the only thing that did not uphold that link was the fact that the court focused on whether they also were directed towards the same taxpayer.²¹⁷

Finally, the allocation of taxing power has not been shifted from Sweden to other Member States through bilateral treaties, as the profits from affiliated companies located in other Member States was never Sweden's to tax in the first place. It could be argued that the Swedish rules might justify unequal treatment valid under the coherence concept combined with the need to safeguard the balance allocation of taxing power in order to sustain a symmetric application of the fiscal territorial principle.

3.5 The Proportionality Principle

Even if the Swedish rules were to be justified by overriding reasons of public interest described above. Such rules must comply with the principle of proportionality.²¹⁸ In the case law of the CJEU it has been established four cumulative conditions that needs to be fulfilled in order to justify national measures which may hinder or make less attractive the exercise of the fundamental freedoms guaranteed by the Treaty, the so-called *Gebhard-test*.²¹⁹ The two first conditions are the examination of whether the rules applies in a non-discriminatory manner and if it could be justified by the imperative requirements in the general interest. The last two conditions are of importance for the assessment whether national measures could be considered proportionate. National measures must be suitable for securing the attainment of the pursued objective and they must not go beyond what is necessary in order to achieve the objective.²²⁰ This means that the court applies two tests to examine (i) whether the disputed legislation satisfies the intended objective and (ii) whether there are less restrictive measures available to achieve the same result.²²¹ The result of these two tests must lead to the determination of whether the rules are proportionate or not, there is no room for quasi-proportionate rules.²²²

The European Commission has accused the Swedish rules for not being proportionate by the fact that they do not only target wholly artificial arrangements but also for putting heavy administrative constraints on the taxpayer.²²³ The latter emerges as the rules shifts the burden of proof exclusively on the taxpayer. The Commission also claims that the required thresholds inserted in the rules are vague and therefore difficult to demonstrate, adding additional constraints on the taxpayer

²¹⁷ Weber, D., *An Analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, EC Tax Review, Kluwer Law International, 2015, Issue 1, p. 51 (pp. 43-54).

²¹⁸ Hilling, M., *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, Intertax, 2013, Volume 41, Issue 5, Kluwer Law International, p. 302.

²¹⁹ C-55/94, *Gebhard*, [1995] ECR I-04165; See also: Inwinkl, P. and Nilsson, T., *The Swedish Taxation on Loans from Foreign Companies*, EC Tax Review, 2011, Issue 2, Kluwer Law International, p. 90.

²²⁰ C-19/92, *Kraus v Land Baden-Württemberg*, [1993] ECR I-01663, para. 32; and C-55/94, *Gebhard*, [1995] ECR I-04165, para. 37. C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 64.

²²¹ D. Weber (2005), *Tax Avoidance and the EC Treaty Freedoms: A study of the Limitations under European Law to the Prevention of Tax Avoidance*, The Hague: Kluwer Law International, p. 209.

²²² Hilling, M., *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, Intertax, 2013, Volume 41, Issue 5, Kluwer Law International, p. 302.

²²³ European Commission, letter of formal notice – Violation Number 2013/4206, Annex: C (2014) 8699 final, p. 7-8.

in assessing the taxable outcome of its activities. Consequently creating legal uncertainty for the taxpayer.²²⁴ It is clear that the rule do not solely target wholly artificial arrangements as the rule automatically assumes tax avoidance when the received interest income is taxed less the 10%. In such circumstances the Swedish rule requires the taxpayer to demonstrate that the debt financing is mainly business motivated, without the tax authority being required to provide even prima facie evidence of tax evasion or avoidance. In fact, as the investigation pursued by the Commission showed, all cases rendered to the Swedish Board of Advance Rulings where taxation was less then 22% such shift was made by the burden of proof to the taxpayer. In *SIAT* the CJEU states that it may be justified to request the taxpayer to provide information that clarifies that the transactions engaged is not abusive or artificial as it is inline with the objective of such SAAR.²²⁵ However, the court mentions that the Belgian rule is not proportionate because it demands the taxpayer to assess whether the receiving company in another country is taxed appreciably more advantageous then a Belgian company. To assess such threshold as appreciably more advantageous jeopardize the possibility for the taxpayer to determined the scope of the rules with sufficient precision and therefore placing the taxpayer in situation of legal uncertainty.²²⁶

This was also the case in *Itelcar*²²⁷, where the CJEU did not approve rules placing the taxpayer in a situation where it cannot assess its taxable outcome. The court made it clear that, “rules which do not meet the requirements of the principle of legal certainty cannot be considered to be proportionate to the objective pursued”²²⁸. Similarly, the Swedish rule, by requiring the taxpayer to provide for a 75% commercially justified threshold seems excessive and problematic to measure due to the great deal of subjective assessment it would require. In addition such calculation made by a taxpayer when deciding the investment alternatives may not be perceived by the same way when assessed by the Tax Authorities, consequently creating legal uncertainty. Moreover the Swedish rule denies all interest expenses and not only that exceeding what would have been agreed at arm length’s, as demanded by the CJEU of rules intended to combat tax avoidance.²²⁹ Be that as it may, the objective of the emphasised rules in *SIAT* and *Itelcar* was to combat tax-avoidance (anti-avoidance concept). If the Swedish rules were to be tested under the justification of anti-avoidance alone, the first step in the proportionality test would be achieved. As its objective to hinder abusive tax avoidance through debt financing is attained. Nevertheless, it would fail the second test. Since it goes beyond what is necessary to achieve its objectives. The rule could have been narrowed down to only target wholly artificial arrangements and not to be dependent on the level of taxation.

However, the Swedish government has stressed that the rules are intended to safeguard the balance allocation of taxing powers combined with the anti-avoidance concept, therefore the examination of whether the rules achieve its objective must be done through this aim. As was demonstrated in section 3.4.4 the anti-abuse concept seems to be to some extent disregarded by the CJEU in its assessment of the justification ground when combined.²³⁰ Under these circumstances the rule achieves

²²⁴ Ibid, p. 8-9.

²²⁵ C-318/10, *SIAT*, para. 53.

²²⁶ C-318/10, *SIAT*, para. 57.

²²⁷ C-282/12 *Itelcar*.

²²⁸ C-282/12, *Itelcar*, para. 44; and C-318/10, *SIAT*, para. 59.

²²⁹ C-524/04, *Test Claimants in the Thin Cap Group Litigation*, [2007] ECR I-02107, para. 83; C-318/10, *SIAT*, para. 52; and C-282/12, *Itelcar*, para. 38.

²³⁰ Hilling, M., *Justifications and Proportionality: An Analysis of the ECJ’s Assessment of National Rules for the Prevention of Tax Avoidance*, Intertax, 2013, Volume 41, Issue 5, Kluwer Law International, p. 300 (pp. 294-307); AG Kokotts opinion in *Oy AA*, [2007] ECR

its objective of hindering the taxpayer to shift the taxation of income at will by abusive debt financing. However, the question remains on whether the rule goes beyond what is necessary to obtain its objective. When both justification grounds are assessed combined it is not certain that the CJEU would perceive the rules as causing burdensome administrative constraints by demanding the taxpayer to clarify taxation levels and motives for such transaction even if they are not artificial. None the less, the rules may still be regarded as creating legal uncertainty. The Swedish government has also pointed out in its defence that the taxpayer is in a better position to demonstrate the authenticity of its actions and that the CJEU have accepted the requirement of certain level of taxation in the hands of the receiver.²³¹ Be that as it may, the rules contain several criteria that need to be fulfilled and all of them are difficult to assess with precision. This is also the reason why the Swedish Supreme Administrative Court has renounced the possibility for the taxpayer to apply for an advance ruling, arguing that the Swedish rules are not suitable because they require such extensive investigation and evidence from different parties.²³² Whether the CJEU would consider the Swedish interest deduction limitation rules not proportionate and accept that the rule might not be sufficiently precise is however not clear.

Even if the CJEU would accept that the Swedish rules might justify unequal treatment valid under the coherence concept combined with the need to safeguard the balance allocation of taxing power in order to sustain a symmetric taxation it still must be ascertained whether the legislation goes beyond what is necessary in order to attain those objectives.²³³ As Sweden is not in a position to tax the profits or the interest income of the affiliated companies resident in other Member States the rules logic is to create certain conditions for when the interest expenses could be deductible without jeopardizing the Swedish tax base. By requiring certain level of taxation in the hands of the beneficial receiver the incentives to locate profits and debts at will between the involved states and not accordingly to where the activities are performed decreases.²³⁴ By this logic it could be said that the rules are justified as it attains its objective. However, as the Swedish rules do not explicitly mention that it is intended to limit deductions only where there is a foreign affiliated company not taxable in Sweden but rather gives attention to combat tax avoidance through debt financing. The Swedish government needs to combine these two justification grounds for restrictive national measures with the justification ground of anti-abuse in order for the rules to achieve its objectives. How national rules target its means may affect which justification ground is applicable as has been demonstrated above. Whether the court would recognize the Swedish rule to be proportionate by not going beyond what is necessary to achieve its objective and whether less restrictive measures could exist is still unclear as the rules may be perceived as not sufficiently precise.

I-6373, para. 62-63; C-337/08, *X Holding*, [2010] ECR I-01215, para. 71; and C-18/11, *Philips Electronics UK*, para. 41-42.

²³¹ In Sweden's answer to the European Commission (dnr Fi2014/4205) they refer to C-231/05, *Oy AA*, para. 62-64.

²³² HFD case no. 2674-14; and HFD case no. 4217-14.

²³³ C-322/11, *K*, para. 72; and C-371/10, *National Grid Indus*, [2011] ECR I-12273, para. 81.

²³⁴ Hey, J., *Base Erosion and Profit Shifting and Interest Expenditure*, Bulletin for International Taxation, 2014, Issue 6/7, IBFD, p. 333 (pp. 332-345).

4 Conclusions

In order to fulfil the aim of the thesis three questions were asked. The first question was whether the Swedish interest deduction limitation rule is discriminatory or restrictive. The analysis has showed that the Swedish rule treats resident and non-residents in comparable situations unequal. The unequal treatment appears both as an indirect discrimination and a restriction, ultimately violating the freedom of establishment and under certain circumstances also the free movement of capital.

The second question was whether such violation could be justified by the imperative reasons of overriding public interest. As the aim and purpose of the Swedish Interest deduction limitation rule is to prevent base erosion and tax avoidance through debt financing structures, the analyses has showed that the systematic logic of the Swedish rule cannot be justified by any of the overriding reasons in isolation. However, as the interest deduction limitation rules intend to reduce the incentives for deduction of interest expenses where Sweden's territorial taxing rights over the corresponding interest income are limited when such transactions could be perceived as abusive. The Swedish governments options of justifying such rule exist in a combination of justification grounds. On the one hand, Sweden must defend the inner logic of its rule by arguing that the rule forms a symmetric logic of taxation, as protection of tax base as justification is not accepted and on the other hand the Swedish government must defend its rule as a SAAR. To justify discriminatory or restrictive national measures by reasons such as the necessity for a symmetric taxation can only be done by either one of the balance allocation concept and the coherence concept, or combined. However, the Swedish interest deduction limitation rule does not only target wholly artificial arrangements, which is a requirement for SAAR set by the CJEU in order for the rules to be considered proportionate. When SAAR is combined with one or both justification grounds, which necessitate a symmetric taxation the CJEU has demonstrated that the rules could be considered proportionate even if it does not only target wholly artificial arrangements, which is the answer to the third question of this thesis.

The results presented here are not conclusive on whether the Swedish interest deduction limitation rule could justify unequal treatment in the light of the justification grounds. As it also could be argued that the Swedish governments claim of a symmetric taxation is not fulfilled. One might suggest that the Swedish rules go beyond the Swedish territorial taxing rights. As it demands a certain level of taxation in the hands of the receiver, which the Member State where the receiver is located is not demanding, nor has Sweden in its web of bilateral tax treaties tried to curb such transactions. The thesis has also showed that regardless of chosen justification grounds certain level of legal uncertainty is unavoidable. However, whether the CJEU would reject the Swedish rules only on aspects of legal uncertainty is not clear, although the fact that the Swedish Supreme Administrative Court has rejected the possibilities to appeal the outcome from the Advance rulings indicates that the rules creates legal uncertainty. In the authors opinion the Swedish governments arguments could be accepted if the taxpayer could predict the outcome of its taxation through less burdensome ways. The coherence concept could also be added as justification ground if the court would accept a broader assessment of how to establish a direct link between the tax advantage given through the deduction and the offsetting of the advantage by a tax levy in line with the arguments forwarded by Juliane Kokott as mentioned above. Both the Swedish government and the European Commission have overlooked this justification ground as possible. The thesis has showed that the Commission could have also claimed that the Swedish rule infringes the free movement of capital and not only the freedom of establishment.

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