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Targeted interest deduction limitation rules post-Lexel

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Summary

The need for targeted interest deduction rules is far from over. Most recently targeted interest deduction limitation rules have been presented in the proposal for a Directive implementing OECD Pillar Two in the EU, as well as in the proposal for a Directive on debt-equity bias reduction allowance.

In *Lexel*, the Court of Justice of the European Union struck down the Swedish targeted interest deduction legislation of 2013 regarding loans between associated companies. The Court considered the legislation to constitute an unjustifiable restriction of the freedom of establishment. In essence, the Court stated that only wholly artificial arrangements could be the object of the targeted interest deduction rules. After *Lexel*, the question that arises is whether targeted interest deduction rules, with the aim to combat tax base erosion, have any future, or must Member States only rely on the application of anti-abuse rules?

The outcome in the *Lexel* case seems to differ from previous case law. Although the Court found the German legislation in *Lankhorst-Hohorst* not to be justified, the legislation in *Thin Cap*, *SIAT,* and *Masco Denmark* was considered justified, if not proportionate. As this thesis explains, the reason for the Court's judgment in *Lexel* may lie in the sudden change in the legal facts and arguments presented by the Swedish tax authorities during the proceedings. Therefore, the thesis argues that the *SIAT* judgment remains intact, meaning that Member States may impose targeted interest deduction rules, which even require taxpayers to prove the right to deduction, as long as the applied rules meet the principle of legality, and are thus proportional in the eye of the Court.

Preface

I wish to express sincere gratitude to Professor Cécile Brokelind for always challenging me, making me read more, think more, write more, and thus learn more.

Merci pour tout

I would also like to thank Professor Mats Tjernberg for his valuable input and comments on this thesis.

Tack

Abbreviation list

ALP	Arm's length principle
ATAD	Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, as amended ("the Anti-Tax Avoidance Directive")
ATAD 3	Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final of 22 December 2021
BEPS	Base Erosion and Profit Shifting
CIT	Corporate Income Tax
CJEU	Court of Justice of the European Union
DEBRA	Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes, COM(2022) 216 final of 11 May 2022
EBITDA	Earnings Before Interest Tax Depreciation and Amortization
EBIT	Earnings Before Interest and Tax
EFTA	European Free Trade Agreement
ETR	Effective Tax Rate
EU	European Union
G20	Group of Twenty Finance Ministers and Central Bank Governors
HFD	Swedish Supreme Administrative Court (Högsta förvaltningsdomstolen)
IRD	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, as amended ("the Interest and Royalty Directive")
MD	Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between

	Member States (codified version), as amended, ("the Merger Directive")
MNE	Multi-National Entity
OECD	Organization for Economic Cooperation and Development
P2D	Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021 ("the Pillar Two Directive")
PSD	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), as amended ("the Parent-Subsidiary Directive")
QDTT	Qualified Domestic Top-up Tax
TFEU	Treaty on the Functioning of the European Union
UK	United Kingdom of Great Britain and Northern Ireland
UTPR	Under-Taxed Payment Rules

1 Introduction

1.1 Background

Sweden, and reasonably, the other Member States of the European Union (EU) are faced with the following trilemma: how to keep interest rates low, and thus provide low-cost capital to companies, at the same time preventing tax base erosion, and complying with the fundamental freedoms provided by the Treaty on the Functioning of the European Union (TFEU).

One plausible way to achieve the goal of reducing the costs for capital is by not charging any withholding tax on cross-border interest payments, even beyond what is required by the Interest and Royalty Directive[1] (IRD). However, not applying withholding tax in general, or only as required by the IRD, opens the possibility for aggressive tax planning, tax avoidance, or tax evasion[2], by shifting income from a high-tax jurisdiction to a low-tax jurisdiction through interest payments.

Even before the adoption of the Anti-Tax Avoidance Directive[3] (ATAD), which requires the Member States to implement a general interest deduction limitation rule, many Member States had already implemented various interest deduction limitations rules. Ratio-based rules based on OECD's best practices, safe harbor debt-to-equity rules or targeted interest deduction limitations rules in special situations, such as on loans between associated companies, as was the case with Sweden, already existed.[4] Noteworthy is that in 2018 only three Member States, namely Cyprus, Estonia, and Malta, did not apply any interest deduction limitation rules at all.[5]

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[1] OJ L 157, 26.6.2003, p. 49–54, Article 1.

[2] For lexical definitions, see Iaia, R. *Article 6 ATAD and the 'Non-genuineness' of Arrangements*, EC Tax Review, 2021-5&6, pp. 242-253.

[3] Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

[4] Petutschnig, M., Rechbauer, M. and Rünger, S. *Assessment of the Interest Barrier Rule of Article 4 of the EU Anti-Tax Avoidance Directive for a Sample of European Firms*. World Tax Journal, August 2019, pp. 347-377.

[5] IBFD Tax Knowledge Centre ed., *European Tax Handbook 2018*, Books IBFD.

In a nutshell, targeted interest deduction rules may serve to prevent avoidance of the general rules, such as the general interest limitation rule provided for by Article 4 ATAD, or to address other base erosion and profits shifting risks.[6] The purpose of targeted interest deduction rules is according to the Court of Justice of the European Union (CJEU) "to prevent practices the sole purpose of which is to avoid the tax that would normally be payable on profits generated by activities undertaken in the national territory".[7] In the scope of many targeted interest deduction rules are multinational entities (MNEs). The reason is that MNEs are in a better position to take advantage of disparities between different jurisdictions which allows MNEs to circumvent general rules or engage in profit shifting arrangements to low-tax jurisdictions. This has been acknowledged by the ATAD[8], and more recently in the proposal for a Directive implementing OECD Pillar Two[9] in the EU and the proposal for a Directive on a debt-equity bias reduction allowance[10].

In *Lexel*[11], the CJEU struck down the Swedish targeted interest deduction legislation of 2013 regarding loans between associated companies, considering the legislation to constitute an unjustifiable restriction of the freedom of establishment. Previously, the CJEU had come to the same conclusion regarding the German legislation in *Lankhorst-Hohorst*[12]. In *Thin Cap*[13], *SIAT*[14], and *Masco Denmark*[15], although finding the interest deduction rules to be justifiable, the CJEU considered the rules disproportionate. In essence, the CJEU stated that only wholly artificial arrangements could be the

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[6] OECD. *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion, and Profit Shifting Project*. OECD Publishing, Paris, 2015, para. 168-174.

[7] C-524/04 Thin Cap, EU:C:2007:161, para. 77.

[8] Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1, Recital 6.

[9] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021, Recitals 2 and 11. See also ibid, Article 15(8).

[10] Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes, COM(2022) 216 final of 11 May 2022, Recital 6. See also ibid, Article 5.

[11] C-484/19 Lexel, EU:C:2021:34.

[12] C-324/00 Lankhorst-Hohorst, EU:C:2002:749.

[13] C-524/04 Thin Cap, EU:C:2007:161.

[14] C-318/10 SIAT, EU:C:2012:415.

[15] C-593/14 Masco Denmark, EU:C:2016:984.

object of the targeted interest deduction rules, i.e., only loans and interest payments that amount to abuse of law.

Now, after *Lexel*, the question that arises is whether targeted interest deduction rules, with the aim to combat tax base erosion, have any future, or must Member States only rely on the application of anti-abuse rules?

1.2 Aim

This thesis aims to examine whether Member States of the EU, after the *Lexel* case, can rely on specific legislation limiting interest deductions between associated companies, other than legislation or principles preventing abuse of law.

Thus, the research question of this thesis is whether national legislation, limiting interest deductions between associated companies, can be introduced to prevent tax base erosion.

1.3 Method and material

Several sources of law, such as national legislation, secondary and primary EU legislation, including draft legislation, as well as the case law of the CJEU were analyzed in order to derive an answer to the posed research question. In addition, both legal doctrine and soft law, such as OECD's BEPS Action Plans[16], were used to interpret the primary sources of law.

Interpreting national law which transposes secondary EU law poses certain risks that either stem from linguistic differences of terms applied or by different methods of interpretations applied by national courts. In light of the constitutional requirement of legal certainty, Swedish tax legislation is interpreted in a three-step model, first taking a stance from the literal meaning of the legislative text. If necessary, this is followed by the systematic approach, which requires that the legislative text be interpreted in the context of its application. It is only when a clause cannot be interpreted by its literal

[16] See OECD, *Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project*, OECD, 2015.

meaning and the context of its application that a teleological interpretation may be applied, where according to Swedish legal tradition, preparatory legislative works may play a considerable role in defining the aim and purpose of the legislation.[17]

The CJEU on the other hand tends to rely more on a purposive interpretation of sources of law, even when the literal meaning is “tolerably clear”.[18] This discrepancy has been taken into consideration in the analysis of the legal sources and any issues arising from possible interpretative differences have been highlighted.

To avoid linguistic discrepancies as far as possible, Swedish legal sources have been studied in the original language when necessary and available. However, other sources of law, and soft law, have been studied in English. When necessary for interpretative reasons, or to highlight differences, Swedish editions of secondary EU legislation, or case law of the CJEU, have been compared to the English editions.

1.4 Delimitation

This study is focused on the aftermath of the *Lexel* case and its effects on targeted interest deduction rules resembling the contested Swedish legislation. Where applicable, the effects of the Lexel case on other targeted rules, such as thin-cap rules, will be discussed separately. Secondly, this thesis does not delve into the problem of defining interest, interest-like payments, or the use of hybrid instruments, and discusses only briefly the issue of the arm's length principle (ALP) regarding cross-border interest payments. Finally, this thesis does not consider any interaction and effects between national and EU primary and secondary legislation on one side, and

[17] See Tjernberg, M. *Skatterättslig tolkning*, Iustus Förlag, Uppsala, 2018, pp. 83-99; Fritz, M. *Förbudet mot rättsmissbruk i EU-rätten: En förändrad avvägning mellan rättssäkerhet och rättvisa i den svenska skatterätten (diss.)*. Lund, Lund University, 2020, pp. 128-131.

[18] See Beck, *G. The Legal Reasoning of the Court of Justice of the EU* (Modern Studies in European Law), Bloomsbury 2012. Fritz, M. *Förbudet mot rättsmissbruk i EU-rätten: En förändrad avvägning mellan rättssäkerhet och rättvisa i den svenska skatterätten (diss.)*. Lund, Lund University, 2020, pp. 165-166.

tax treaties on the other side, in the analysis of targeted interest deduction legislation.

1.5 Outline

Chapter Two offers an overview of targeted interest deduction limitation rules as tools for the prevention of tax base erosion. The chapter begins with a brief discussion of the role of the BEPS Project and the current proposals for the introduction of new targeted interest deduction limitation rules stemming from the OECD Pillar Two project and the European Commission's proposal for a debt-equity bias reduction allowance. This is followed by a brief overview of the Anti-Tax Avoidance Directive, and the Interest and Royalty Directive. The chapter ends with a discussion on how the Abuse of rights approach can be applied instead of targeted rules.

Chapter Three contains a detailed introduction to the Swedish legislation leading to the *Lexel* case, including a short overview of the contribution rules. This is followed by a presentation of the facts of the case, the judgment, and the effects on the 2019 amendments to the targeted interest deduction legislation in Sweden. The chapter continues with a case law analysis of previous judgments and an in-depth analysis of the inconsistencies in the *Lexel* judgment.

Chapter Four contains the concluding remarks, where the answer to the posed research question is presented and briefly discussed.

2 Interest, and the need for targeted rules

2.1 Targeted interest deduction rules

2.1.1 The BEPS Project

The OECD/G20 Base Erosion and Profit Shift (BEPS) Project began drafting a report on the limitation of base erosion involving interest deductions and other financial payments in July 2013, and the final report was delivered in October 2015.[19] The final report calls upon states to introduce fixed (group) ratio rules to battle tax base erosion[20], but allows targeted rules in addition to the general rule regarding entities in multinational groups.[21] The final report identifies five risk areas where targeted rules may be of importance to battle tax base erosion[22]:

- arrangements where interest is paid to another associated company in another state to reduce the level of interest, subject to tax in the first state,
- back-to-back structured arrangements,
- artificial loans where no new funding is raised,
- excessive interest payments to associated companies financing tax-exempt income, and
- interest payments to associated companies which are subject to low or no taxation in the corresponding interest income.

According to the final report, the targeted rules should be applicable to all entities irrespective of whether they are also subject to the fixed (group) ratio

[19] OECD. *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion, and Profit Shifting Project.* OECD Publishing, Paris, 2015.

[20] Ibid, Chapters 6 and 7.

[21] Ibid, Chapter 9.

[22] Ibid, Chapter 9, para. 173.

rule[23]. As will be seen, the Swedish legislation in the *Lexel* case seems to have addressed some of the aforementioned risk areas, denying deductibility of interest payments, even before the final report was published.

2.1.2 OECD Pillar Two

In the proposal for a Directive implementing OECD Pillar Two in the EU[24] (P2D), the European Commission is proposing 'reverse' targeted interest deduction rules for the protection of national (high-tax) tax bases, with the possibility of low-tax jurisdictions benefitting indirectly from the rules as well.

Article 15(8) P2D, implementing rule 3.2.7 of OECD Pillar Two[25], provides that interest related to loans concluded between associated companies in a cross-border situation, shall not be taken into consideration in the computation of the qualifying income or loss of the creditor if the following three cumulative conditions are met:

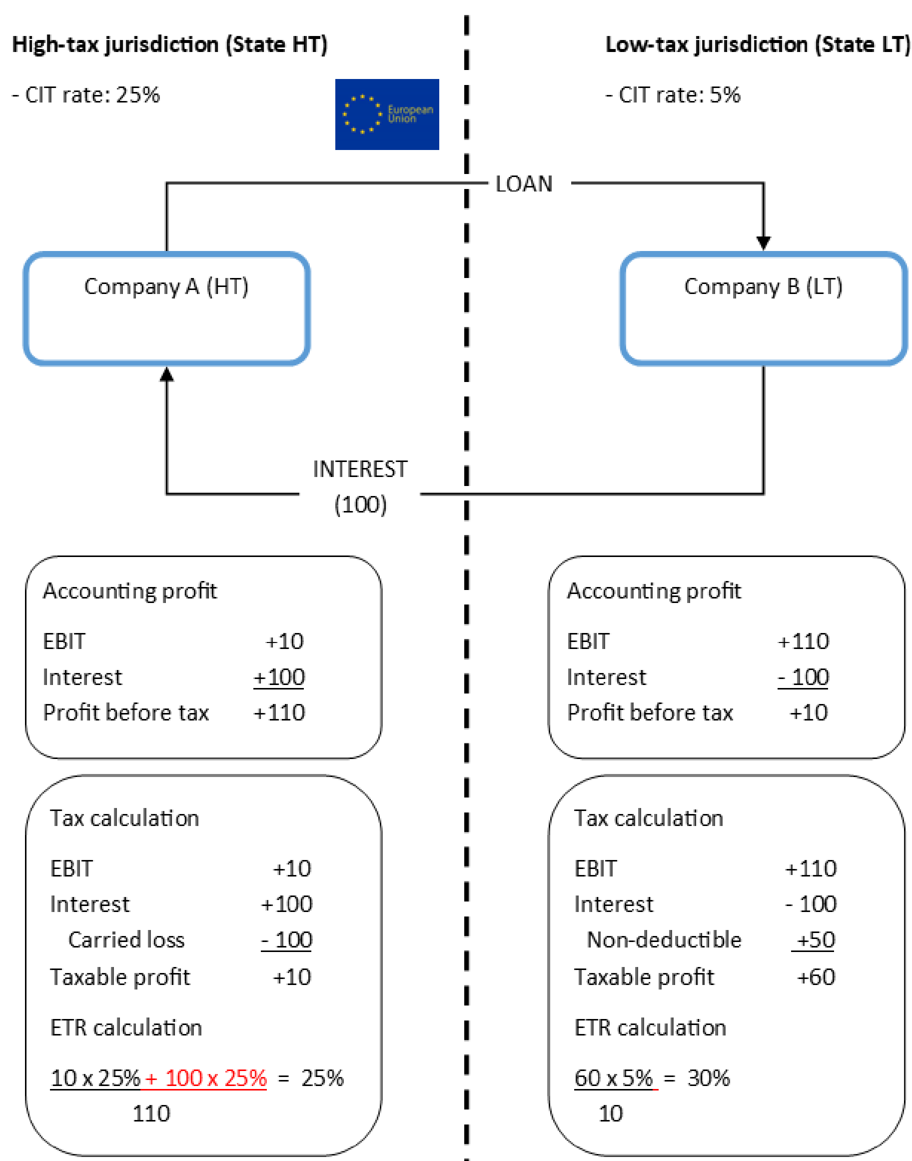
- The debtor entity is located in a low-tax jurisdiction, or in a jurisdiction that would have been low-taxed if the expense had not been accrued,
- It can reasonably be anticipated that over the duration of the loan, the expenses of the debtor are increased without a corresponding increase in the taxable income of the creditor, and
- The creditor is located in a high-tax jurisdiction, or in a jurisdiction that would have been high-taxed if the income related to the expense had not been accrued by the debtor.

The purpose of the rule is to prevent tax base erosion of the high tax jurisdiction as the following example will show.

[23] Ibid, Chapter 9, para. 174.

[24] Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021.

[25] Article 3.2.7, OECD. *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, 2021.



Picture 1: Example of a situation where Article 15(8) P2D would be applicable.

State LT is a low tax jurisdiction where the corporate income tax (CIT) rate is 5%, while State HT is an EU Member State with a CIT rate of 25%. The definition of a low-tax jurisdiction is a jurisdiction with an effective tax rate (ETR) of less than the established global minimum tax rate of 15%.[26] Additionally, the provisions of the P2D have been transposed into national legislation in State HT.

[26] Article 3(29) Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021; See also Article 10.1.1, OECD. *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris, 2021.

In State LT, only half of the interest payments are deductible. Company B, the debtor, has earnings before interest and tax (EBIT) of 110 units and has paid 100 units of interest on a loan from Company A, the creditor, which is an associated company in State HT. The accounting profit of Company B is 110 – 100 = 10 units. The company has no previous tax balance to offset, but since interest deduction is limited to 50%, the taxable profit of the company is 110 – 50 = 60 units. The income tax due is 3 units, leading to an effective tax rate of 3 / 10 = 30%.

In State HT, Company A is part of a group of companies, and as such, has the right to offset negative interest balances from other associated companies. Company A has an EBIT of 10 units and has received interest payments from Company B in the amount of 100 units. The accounting profit is 10 + 100 = 110 units, and assuming that Company A could offset the total interest payment received, the taxable profit is only 10 units. The tax on the profit is 2,5 units, but the effective tax rate is 25%, since the 'tax credit' on the transferred negative interest balances increases the covered tax by 100 x 25% = 25 units according to the general rules of the P2D.[27] This arrangement means that the group pays only 5,5 units of tax, and there is no need for a top-up tax in either state.

However, since there is an offset in State HT, Article 15(8) P2D would recalculate the effective tax rate to only 2,5 / 110 = 2,3%, requiring a top-up tax to be paid (or most likely, the non-application of the interest offset), thus preventing tax base erosion. State HT would also recalculate the ETR of Company B to 5 / 60 units = 5% and would potentially impose the undertaxed profit rule (UTPR), unless State LT would implement OECD Pillar Two, either in full or by applying a qualified top-up tax (QDTT). [28]

Importantly, the application of Article 15(8) P2D requires only an objective assessment of the facts and circumstances in the specific case, and no

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[27] Article 20(2) Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021.

[28] See Articles 2.2 – 2.4 and 5.2 OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris, 2021; See also Articles 10 - 13 Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021.

reference is made to whether the loans are at arm's length. However, given the comments to the OECD Pillar Two[29], it might be considered that the subjective element of tax avoidance or evasion is presumed if the arrangement leads to an immediate erosion of high-tax jurisdiction's tax base. This assumption seems to contradict what the CJEU has established in its case law[30], awarding the taxpayer the right to rebut the claim of abuse. The difference in this situation is whether an assessment with the fundamental freedoms is possible. In essence, Article 15(8) P2D does not involve any optionality and is equally applicable in cross-border situations as in domestic situations, thus achieving harmonization.[31] However, only multinational entities (MNEs) with a turnover of over 750 million EUR are within the scope of the P2D, so only a small field of interest deduction limitations is potentially harmonized.[32]

Notably, the opposite, and arguably more common arrangement of eroding the tax base of the high-tax jurisdiction through interest payments to low-tax jurisdictions is left without targeted rules in the current proposal. Even with a global minimum tax of 15%, there are incentives for loan arrangements, which involve shifting income to a lower tax jurisdiction, if the split between the high-tax jurisdiction and the lower tax jurisdiction is substantial enough.

2.1.3 Debt-equity bias reduction allowance

On 11 May 2022 the European Commission presented a proposal for a Directive on a debt-equity bias reduction allowance[33] (DEBRA). The aim of the Directive is to partly neutralize the bias against equity financing. The bias

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[29] Article 3.2.7 OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris, 2022.

[30] See Ravelli, F. and Franconi, F. *Numerous EU Member States are in Breach of EU Law by Requiring Taxpayers to Demonstrate Absence of Abuse*, European Taxation, October 2021, pp. 440-449; Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, pp. 343-346. See also C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others, EU:C:2019:134, para. 141; C-116/16 and C-117/16 T Danmark and Y Denmark, EU:C:2019:135, para. 116.

[31] Article 2(1) Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021.

[32] Ibid.

[33] Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes, COM(2022) 216 final of 11 May 2022.

arises from the fact that interest payments are generally deductible while costs related to equity financing are non-deductible in most Member States, which in turn favors debt in investment situations.[34]

The proposed Directive would require Member States to allow for a tax deduction, calculated as a notional interest on the increase of a taxpayer's equity from one tax period to the next, for the duration of ten consecutive tax periods.[35] The allowance will however be subject to the general interest deduction rules of Article 4 ATAD, with a possibility to carry forward or back excess notional interest. This means that the deduction of notional interest cannot in any case exceed 30% of the company's earnings before interest, taxes, depreciation, and amortization (EBITDA).[36]

In order to avoid misuses, and the circumvention of the conditions for receiving an allowance, Member States will be obliged to introduce a new set of targeted interest deduction rules.[37] Once again, mainly transactions between associated companies are the object of the targeted rules. If the Directive is adopted, associated companies will not be granted an allowance if the increase in capital is the result of a loan between associated companies, a transfer of business activity as a going concern, or if the investor is established in a third country, lacking fiscal supervision. Importantly, and similar to the Swedish legislation in *Lexel*, the aforementioned rules will not apply if the taxpayer can prove that the transactions have been carried for valid commercial reasons. In addition to these rules, the Directive also provides for valuation rules if equity is increased by contributions in kind as well as special rules and conditions when the increase of equity is the result of a restructuring.

This shows that despite the general anti-abuse clause of the ATAD, and the principle of prohibition of abuse of law, there is still a need for targeted interest deduction rules. One of the reasons for this may be the lack of full harmonization in direct taxation in the EU, and as long as differences exist

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[34] Ibid, Recital 2.

[35] Ibid, Recital 4. See also Ibid., Article 4.

[36] Ibid, Article 6.

[37] Ibid, Article 5.

between Member States, so will the need for targeted rules. Furthermore, targeted rules seem to prevent tax base erosion without requiring an arrangement to amount to abuse of law. Thus, prevention of tax base erosion is not purely a matter of preventing abusive practices.

2.2 The Anti-Tax Avoidance Directive

The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, including the interest limitation rules, was implemented in the EU by the Anti-Tax Avoidance Directive, which was adopted on 12 July 2016. The OECD fixed ratio rule, with an option for Member States to adopt group ratio rules, has been implemented through Article 4 ATAD. The ATAD obliges Member States to introduce a minimum level of protection, and according to the recital of the ATAD[38]:

> "…Member States could in addition to the interest limitation rule provided by this Directive also use targeted rules against intra-group debt financing, in particular thin capitalization rules…"

Clearly, applying targeted rules is in line with the aim and purpose of the ATAD, especially since the ATAD only requires Member States to implement minimum standards of protection. Since the targeted rules are not required by the ATAD, they can be assessed in the light of the fundamental freedoms.

Govind and Zolles[39] argue further that the optionality provided in Article 4 of the ATAD, read in conjunction with Recital 7 of the ATAD, does not provide such exhaustive harmonization that assessment of national legislation with fundamental freedoms would be precluded. Even if the interest limitation under Article 4 of the ATAD might be considered non-discriminatory from a TFEU fundamental freedoms point of view, it may still produce *de facto*

[38] Recital 6 to the Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

[39] Govind, S. & Zolles, S. in: Lang, M. et al. (editors). *Introduction to European Tax Law on Direct Taxation* (2020), mom. 647-650.

disadvantages in cross-border situations.[40] A general conclusion is therefore that all interest limitation rules, at least until the adoption of the proposed Directives, may be assessed in the light of the fundamental freedoms provided for the TFEU.

2.3 Interest and Royalty Directive

On 3 June 2003, the Council adopted the Interest and Royalty Directive[41] (IRD). The aim was that transactions between associated companies of different Member States should not be subject to less favorable tax conditions than those applicable to the same transactions carried out between associated companies of the same Member State.[42] The method of achieving this is through the abolition of taxation at the source if several formal conditions are met[43].

The IRD, as well as the other corporate directives[44], contains an anti-fraud and abuse clause.[45] The clause provides that Member States are not precluded from applying domestic or treaty-based provisions and that Member states may refuse to apply the IRD if the principal motive or one of the principal motives is tax evasion, tax avoidance, or tax abuse.

Importantly, the CJEU in the *Scheuten Solar Technology*[46] judgment concluded that Article 1(1) of the IRD does not preclude national legislation according to which interest paid to another associated company is included in the tax assessment of the paying company. The CJEU concluded that by denying deductibility for the interest paid, the legislation at issue did not lead to a reduction of the creditor's income, that the beneficiary of the interest is

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[40] Smit, D. in: Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law - Volume 1: General concepts and direct taxation*, 7th ed. (2018), p. 504.

[41] OJ L 157, 26.6.2003, p. 49–54.

[42] Interest and Royalties Directive, OJ L 157, 26.6.2003, p. 49–54, Recital 1.

[43] Article 1(1) Interest and Royalties Directive, OJ L 157, 26.6.2003, p. 49–54.

[44] See Article 15 Merger Directive, OJ L 310, 25.11.2009, p. 34; Article 1(2) - (4) Parent-Subsidiary Directive, OJ L 345, 29.12.2011, p. 8.

[45] Article 5 Interest and Royalties Directive, OJ L 157, 26.6.2003, p. 49–54.

[46] C-397/09 Scheuten Solar Technology, EU:C:2011:499.

not subject to tax, and that the payment of interest does not constitute a chargeable event for tax.

In *Scheuten Solar Technology*, the national legislation was assessed only in the light of the IRD. According to the CJEU, when the EU legislature adopts a tax measure, judicial review of compliance with primary law is limited to review as to manifest error.[47] However, this holds only if there is no optionality involved, i.e., in fully harmonized areas of law. Article 9 of the IRD clearly implies that the IRD is a minimum harmonized directive, and thus that the Member States must take into consideration the non-discrimination principles and fundamental freedoms of the EU. Any assessment of national legislation would therefore be allowed, not only with the IRD, but also with the fundamental freedoms.[48]

2.4 Justification of targeted rules

The ATAD obliges Member States to introduce general interest deduction limitations. The tendency is now towards introducing targeted interest deduction rules. If the P2D and the DEBRA are adopted by the Council, it would mean a first step towards harmonized targeted interest deduction rules in the EU. Instead of seeking justification for those rules, Member States will be obliged to introduce such rules. That will inevitably lead to the question whether those targeted interest deduction rules may be assessed only in the light of the Directives, or also with the fundamental freedoms. However, the proposed targeted interest deduction rules do not cover all risks which were identified in Action 4 - 2015 Final Report of the OECD.[49] Thus, Member States must still rely on national legislation to combat certain undersirable practices.

This raises the main question of whether national rules, especially when transactions between associated companies are involved, can be justified.

[47] C-390/15 RPO, EU:C:2017:174, para. 54.

[48] C-168/01 Bosal, EU:C:2003:479, para. 25-26.

[49] OECD. *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report, OECD/G20 Base Erosion, and Profit Shifting Project.* OECD Publishing, Paris, 2015., Chapter 9, para. 173. See Section 2.1.1.

Before *Lexel*, the CJEU found that the targeted rules in *Thin Cap*, *SIAT* and *Masco Denmark* could be justified by the need to combat tax avoidance and evasion,[50] the need to ensure the effectiveness of fiscal supervision[51], or the need to preserve the balanced allocation between Member States of the power to impose taxes[52]. Although justified, the targeted rules in *Thin Cap*, *SIAT* and *Masco Denmark* failed the proportionality test of the CJEU.

Furthermore, in *SIAT* the CJEU stated that the grounds for justification were closely linked.[53] This suggests that the said grounds have a common objective which Wattel refers to as 'tax base integrity'. [54] Tax base integrity is a summary term encompassing both the substantive justifications that the CJEU has applied in case law, such as the need for a balanced allocation of taxing power between the Member States, fiscal cohesion, fiscal territoriality, and the general prohibition of abuse of rights, as well as for the single procedural justification, i.e., the need for fiscal supervision.[55] From a tax base integrity perspective, a restriction of the freedom of establishment would thus be possible to "avoid situations 'capable of jeopardizing the right of the Member State of origin to exercise its powers of taxation in relation to activities carried on within its territory'".[56]

After the *Danish cases*[57], the legal situation has become clearer regarding abusive practices, but the issue of burden of proof and the use of indicators of abuse still raises discussion. The challenge for tax base integrity justification

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[50] C-524/04 Thin Cap, EU:C:2007:161, para. 77; C-318/10 SIAT, EU:C:2012:415, para. 48.

[51] C-318/10 SIAT, EU:C:2012:415, para. 48.

[52] C-318/10 SIAT, EU:C:2012:415, para. 48; C-593/14 Masco Denmark, EU:C:2016:984, para. 38.

[53] C-318/10 SIAT, EU:C:2012:415, para. 48.

[54] Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, p. 352. See also Lenaerts, K. *The Concept of 'Abuse of Law' in the Case Law of the European Court of Justice on Direct Taxation'*, Maastricht Journal of European and Comparative Law, 2015/3, pp. 329-351; Schaper, M. *The Need to Prevent Abusive Practices and Fraud as a Composite Justification*, 23 EC Tax Review 2014/4, pp. 220-229; Wattel, P.J. *Fiscal Cohesion, Fiscal Territoriality and Preservation of the (Balanced) Allocation of Taxing Power; What is the Difference?* in: Dennis Weber (ed.): 'The Influence of European Law on Direct Taxation', Kluwer Law International, 2007, p. 139-156.

[55] Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, p. 352.

[56] Ibid.

[57] C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others, EU:C:2019:134; C-116/16 and C-117/16 T Danmark and Y Denmark, EU:C:2019:135.

on the other hand is establishing under which legal conditions national legislation preventing tax base erosion can be justified, proportionate, and abiding with the principle of legal certainty.

The relationship between tax base integrity and the prevention of abuse is straightforward. Tax base integrity protection encompasses the need to prevent abuse, which covers only intentional and purely artificial arrangements (the manifestation of the subjective and the objective elements of abuse). Prevention of abusive practices has thus a narrower scope than tax base integrity justification. In a nutshell, there is no need for reliance on abuse defense if tax base integrity justification can be successfully invoked.

2.5 Abuse of rights approach

Instead of targeted interest deduction rules, Member States can choose to rely only on the general principle to prevent the abuse of rights, and no specific legislation is therefore necessary. As the CJEU has stated, irrelevant of whether the Member State relies on national legislation, legislation transposing Directives[58], or relying directly on primary law, the meaning of the principle is the same.[59] Initially, the CJEU held that only wholly artificial arrangements, without any commercial justification, could amount to abuse.[60] However, the reasoning of the CJEU has evolved since then and according to case law abuse exists if, in addition to the artificiality clause, the main purpose or one of the main purposes of the arrangement in question is to obtain a tax advantage.[61] This implies that taxpayers can take tax-efficient routes and

[58] Article 5 Interest and Royalties Directive, OJ L 157, 26.6.2003, p. 49; Article 15 Merger Directive, OJ L 310, 25.11.2009, p. 34; Article 1(2) - (4) Parent-Subsidiary Directive, OJ L 345, 29.12.2011, p. 8; Cf. Article 6 Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

[59] C-6/16 Eqiom, EU:C:2017:641, para. 64; C-14/16 Euro Park Service, EU:C:2017:177, para. 69; C-504/16 and C-613/16 Deister - Juhler, EU:C:2017:1009, para. 97; C-251/16 Cussens and Others, EU:C:2017:881, para. 30-31. C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others, EU:C:2019:134, para. 101; C-116/16 and C-117/16 T Danmark and Y Denmark, EU:C:2019:135, para. 75.

[60] See C-264/96 Imperial Chemical Industries v Colmer, EU:C:1998:370; C- 294/97 Eurowings Luftverkehr, EU:C:1999:524; C-110/99 Emsland-Stärke, EU:C:2000:695; C-255/02 Halifax and Others, EU:C:2006:121; C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas, EU:C:2006:544.

[61] See C-425/06 Part Service, EU:C:2008:108. Cf. C-251/16 Cussens, C-251/16, EU:C:2017:881; Article 6 Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

fiscally motivated decisions as long as they are not predominant.[62] The question that arises, is whether the assessment of alleged abuse should be done *in casu* or whether indicators of abuse may initially be applied to identify potential abusive arrangements, followed by a right of the taxpayer to rebut such a claim, and who bears the burden of proof.

2.5.1 Burden of proof

Since *Emsland Stärke*[63], the CJEU has generally held that abuse is identified through a dual test. Abuse exists if both the objective and the subjective requirements are met. The objective element is met when the object and purpose of the legislation are defeated, which is a question of law, while the subjective element is met when abusive intent can be established, which is a matter of fact.[64]

While *Cadbury Schweppes*[65] and *Thin Cap*[66] suggested that the burden of proof regarding the absence or existence of abuse was placed on the taxpayer, a substantial number of cases since 2008 consistently put a *prima facie* burden of proof on the tax authority, which the taxpayer may rebut, thus leading to the division of the onus of proof.[67] After the *Danish cases*, there is now an ongoing debate whether there is a substantial difference between providing *prima facie* evidence by the tax authorities and the overall burden of proof, given the strict policy of the CJEU in the *Danish cases*.[68]

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[62] See C-126/10 Foggia, EU:C:2011:718; C-103/09 Weald Leasing, EU:C:2010:633; WebMindLicences, C-419/14, EU:C:2015:834 para. 46; C-653/11 Newey, EU:C:2013:409, para. 46.

[63] C-110/99 Emsland Stärke, EU:C:200:695.

[64] Ibid, para. 52-53; C-255/02 Halifax and Others, EU:C:2006:121, para. 74-75. C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas, EU:C:2006:544, para. 64.

[65] C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas, EU:C:2006:544, para. 70.

[66] C-524/04 Thin Cap, EU:C:2007:161, para. 82.

[67] See Ravelli, F. and Franconi, F. *Numerous EU Member States are in Breach of EU Law by Requiring Taxpayers to Demonstrate Absence of Abuse*, European Taxation, October 2021, pp. 440-449; Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, pp. 343-346. See also C-126/10 Foggia, EU:C:2011:718, para. 37; C-14/16 Euro Park Service, EU:C:2017:177, para. 55; C-6/16 Eqiom, EU:C:2017:641, para. 32; C-504/16 and C-613/16 Deister Holding and Juhler Holding, EU:C:2017:1009, para. 71-74; C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others, EU:C:2019:134, para. 140-142.

[68] Ravelli, F. and Franconi, F. *Numerous EU Member States are in Breach of EU Law by Requiring Taxpayers to Demonstrate Absence of Abuse*, European Taxation, October 2021, pp. 440-449, p. 444.

A conclusion is that only interest payments on loans between associated companies, which are void of any commercial justification and that have been entered into for the main purpose, or one of the main purposes, of obtaining a tax benefit would amount to abuse. It is then upon the tax authorities to show that the dual test of abuse is met, allowing the taxpayer to rebut that claim. However, the question remains whether the tax authorities may use predefined indicators of abuse or is *in casu* assessment mandatory?

2.5.2 Indication and assumption of abuse

In *Leur-Bloem*[69], the CJEU held that "competent national authorities cannot confine themselves to applying predetermined general criteria but must subject each particular case to a general examination". [70] However, the reasoning of the CJEU has changed since *Leur-Bloem*, and in the *Danish cases*, the CJEU accepted the use of indicators of abuse, such as the use of conduit entities, timeline of company restructuring, and lack of economic substance.[71] The CJEU has also accepted that the arm's length principle (ALP) as an indicator of genuineness,[72] but low taxation by itself cannot serve as a sole indicator of abuse[73].

Regarding lack of substance, it is noteworthy to highlight that the European Commission has presented a proposal[74] for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU is adopted ("ATAD 3"). The proposal requires certain companies to declare, in their tax returns, whether they meet the minimum requirements of substance as defined by the Directive. The information would then be shared with the other Member States. If the taxpayer is found to lack

[69] C-28/95 Leur-Bloem, EU:C:1997:369.

[70] Ibid, para 41.

[71] C-115/16, C-118/16, C-119/16 and C-299/16 N Luxembourg 1 and others, EU:C:2019:134, para. 131-133.

[72] See C-524/04 Thin Cap, EU:C:2007:161; C-282/12 Itelcar, EU:C:2013:629; C-657/13 Verder LabTec, EU:C:2015:331. See also Opinion of Advocate General Geelhoed in C-524/04 Test Claimants in the Thin Cap Group Litigation, EU:C:2006:436, para. 66.

[73] C- 294/97 Eurowings Luftverkehr, EU:C:1999:524, para. 44; C-422/01 Skandia and Ramstedt, EU:C:2003:380, para. 52.

[74] Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final of 22 December 2021.

substance, or does not provide evidence in its tax returns, the taxpayer would still have the right to rebut the position in a later assessment, thus abiding with the abuse doctrine of the CJEU.[75] Importantly, lacking substance is only an indication of abuse, which would still require that the subjective element is proven.

Essentially, these indicators might serve as *prima facie* evidence of abusive practices, which the taxpayer has the right to rebut, as the ATAD 3 proposal suggests. An imperative is then that the indicators are defined objectively and relevantly. For interest deduction, clearly, the lack of substance of the creditor might serve as a good indicator of abuse, and if adopted, the tax authorities would have a robust tool at their disposal in the shape of ATAD 3. However, tax authorities will still need to prove intent, which requires an *in casu* assessment, which is the main difference compared to targeted interest deduction legislation justified by reason of tax base integrity.

The question that now remains, is whether a set of targeted interest deduction rules can be justified on the need to ensure the tax base integrity of a Member State after the *Lexel* judgment, or must Member States rely only on targeting purely artificial loan arrangements?

[75] Cf. Articles 6, 7, 8, and 9 Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU, COM(2021) 565 final of 22 December 2021.

3 *Lexel*, and beyond

3.1 The *Lexel* case

3.1.1 The national interest deduction rules

A couple of years into the new millennium the Swedish tax authorities noticed great outflows of interest to countries with low or no taxation of interest, and multinational companies were using loans to finance the takeover, or reorganization, of subsidiaries in Sweden.[76] According to the tax authorities, this meant losses of revenue of more than 700 million Euros per year[77].

In order to combat this phenomenon, new legislation was introduced in 2009, making interest payments non-deductible if the loan, directly or indirectly, was used to purchase shares in a group company. However, if the interest was paid to a country where the interest would have been subject to at least 10% corporate income tax, or if the loan was concluded on predominantly commercial reasons, it would have been deductible.[78] Based partly on the reasoning in *Scheuten Solar Technology*, the Swedish Supreme Administrative Court established that the legislation of 2009 did not amount to a restriction on the freedom of establishment, without referring the question at issue to the CJEU.[79]

The legislation of 2009 was not considered effective, which led to the introduction of a new set of rules in 2013. The scope was broadened to include all intra-group loans. Interest payments were non-deductible unless the interest would have been taxed with at least 10% income tax in the receiving state ("the ten percent rule") unless the tax authorities could show that the loan was taken for the group as a whole to receive a substantial tax benefit ("the exception rule"). Even if the ten percent rule was not met, the interest

[76] Prop. 2008/09:65 Sänkt bolagsskatt och vissa andra skatteåtgärder för företag, pp. 30-36.

[77] Ibid, pp. 43-44.

[78] Ibid, (legislative comments on Chapter 24, Article 10 d), pp. 85-88.

[79] HFD 2011 ref. 90 I-V.

payments could still be deductible if the interest was paid to a Member State of the EU or a state with which Sweden had signed a tax treaty[80].

According to the legislative preparatory works[81], which is essential in Swedish legal interpretation, "the exception rule" does not apply if the parties to the loan arrangement are entitled to give and receive deductible intra-group contributions.

Even before *Lexel* was brought before the CJEU, the European Commission had started an infringement procedure giving Sweden a formal notice.[82] The Commission claimed that the interest deduction legislation of 2013, by treating groups of companies which cannot apply the contribution rules differently, infringed the freedom of establishment and went beyond what was necessary to achieve the aim of the legislation. The Swedish government argued to the contrary.[83]

In connection with the implementation of the Anti-Tax Avoidance Directive[84] (ATAD), and the general interest deduction limitation rule, Sweden introduced new special interest deduction rules in 2019. The new legislation reduced the scope of the exception rule, requiring that the ten percent may be set aside only if the loan was taken for the group to 'exclusively, or almost exclusively', receive a substantial tax benefit. Even though the scope was narrowed, the European Commission issued an updated infringement notice, claiming that the 2019 amendments still constituted a restriction on the freedom of establishment.[85]

3.1.2 The Nordic contribution model

The essence of the group contribution model applied in Sweden, Finland, and Norway is that members of a group of companies, meeting the legal

[80] See C-484/19 Lexel, EU:C:2021:34, para. 3-8.

[81] See C-484/19 Lexel, EU:C:2021:34, para. 9-13; Prop. 2012/13:1 Budgetpropositionen för 2013 (legislative comments on Chapter 24, Article 10 d), pp. 332-334.

[82] Formal notice according to Article 258 TFEU, SG-Greffe (2014) D/17633, (file 2013/4206), of 26 November 2014.

[83] Regeringskansliet, Svar på formell underrättelse angående avdragsrätt för ränta för koncerninterna lån, Fi2014/4205, 20.02.2015, p. 1.

[84] Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

[85] Additional formal notice according to Article 258 TFEU, SG-Greffe (2014) D/17633, (file 2013/4206) of 9 June 2021.

requirements of association and being subject to tax, can pay contributions to other group members[86]. The contribution is deductible for the paying company and included as taxable income in the receiving company. One basic difference between the Swedish on one side and the Finnish and Norwegian model on the other side is the amount of the contribution allowed. In Sweden, this is not regulated, save for general solvency limitations provided by company law, leaving the possibility for one group company to contribute funds to another group company exceeding the first company's annual profit, which is not allowed either in Finland or Norway.[87]

In *Oy AA*[88], the CJEU held that the contribution model applied in Finland, and by analogy, the Nordic contribution model, constitutes a restriction on the freedom of establishment. However, the CJEU found a proportionate justification in the need for a balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance[89].

3.1.3 The facts of the case

The facts in the *Lexel* case are straightforward.[90] Lexel is a Swedish company part of a French multinational group of companies. A Belgian group company, 'BE-1', was prior to the transaction of the main proceedings owned 85% by a French group company, 'FR-1' and 15% by 'ES-1', a group company established in Spain. In December of 2011, Lexel acquired 15% of the shares from 'ES-1' after having previously taken out a loan in advance from the Group's internal bank, 'FR-2', established in France. All the companies are directly or indirectly associated.

Lexel made interest payments on the loan to 'FR-2' in 2013 and 2014. During this period 'FR-2', which was part of consolidated tax group, had no profits and used the interest received to offset deficits. During the two years at hand,

[86] For an overview of the Swedish legislation, see C-484/19 Lexel, EU:C:2021:34, para. 10-13; Finnish legislation see C-231/05 Oy AA, EU:C:2007:439, para. 6-10; Norwegian legislation, see Report for the Hearing in Case E-3/21, EFTA Court E-3/21-17, para. 8-10.

[87] For Finland, see section 6 of the Law on Intra-group Financial Transfers (21.11.1986/825); For Norway, see section 10-2 of the Income Tax Act (LOV-1993-03-14) in Report for the hearing in Case E-3/21, EFTA Court E-3/21-17, para. 8.

[88] C-231/05 Oy AA, EU:C:2007:439.

[89] Ibid, para. 60.

[90] See also C-484/19 Lexel, EU:C:2021:34, para. 14-30.

the corporate tax rate in France was 33,43% while the corresponding rate was only 22% in Sweden.

Lexel stated that it had bought the shares from 'ES-1' because the Spanish subsidiary required capital to finance the acquisition of a company outside the group, essentially using the proceeds to pay off the loans it had taken out in that context.

The Swedish tax agency, after confirming that the 10% rule was applicable, nevertheless applied the exception rule, claiming that the arrangement had been undertaken with the aim of gaining a substantial tax benefit. Lexel replied that the acquisition of the shares from 'ES-1' was not intended to confer a tax benefit on the Group and that no benefit arose from the fact that 'FR-2' was able to use the interest income to offset deficits linked to the activities in the consolidated French tax group. Lexel claimed simply that the corresponding income would eventually be taxed with a higher tax rate than applicable in Sweden.

3.1.4 The judgment

The question posed by the Swedish Supreme Administrative Court to the CJEU in the *Lexel* case is whether the freedom of establishment precludes national legislation[91]:

> "[…] which provides that a company established in one Member State is not allowed to deduct interest payments made to a company belonging to the same group, established in another Member State, on the ground that the principal reason for the debt having arisen appears to be the obtaining of a substantial tax benefit, whereas such a tax benefit would not have been deemed to exist if both companies had been established in the first Member State, as in that situation they would have been covered by the provisions on intra-group financial transfers."

[91] C-484/19 Lexel, EU:C:2021:34, para. 31; Cf. C-484/19 Lexel, Request for a preliminary ruling from the Swedish Supreme Administrative Court of 5 June 2019, para. 66.

In short, the CJEU concluded that there is a difference in treatment and that a domestic and cross-border situation are comparable[92]. Consequently, the CJEU found that the legislation constituted a restriction on the freedom of establishment before applying its rule of reason examination.

Previously in *X BV & X NV*[93], the CJEU faced a similar but not identical issue. The Dutch legislation disallowed the deduction of interest paid if the loan was taken for the purpose of acquiring a subsidiary that was not subject to tax in the Netherlands. In this case, the acquired company was resident in Italy. The CJEU concluded that this amounted to a restriction of Article 49 TFEU since it would have been possible to deduct the interest paid in a purely domestic situation if the loan-taking company and the acquired company would have formed a consolidated group for tax purposes.

The CJEU first assessed whether the difference in treatment could be justified by the need to fight against tax evasion and tax avoidance. With reference to *Cadbury Schweppes*[94], *X BV & X NV*[95], and *Thin Cap*[96], the CJEU held that[97] (i) the objective of the legislation must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, (ii) that the taxpayer must be given an opportunity, without undue administrative burden, to provide evidence of any commercial justification of the arrangement, and (iii) if the arrangement has been proven to be a purely artificial arrangement, the deduction should be limited to the proportion of interest that would have been agreed had the relationship between the parties been at arm's length.

The CJEU concluded the "exception rule" did not target purely artificial arrangements and that the application of that exception is not limited to such arrangements, and targets even arrangements that are carried out at arm's

[92] Ibid, para. 35-45.

[93] C-398/16 and C-399/16 X BV and X NV, EU:C:2018:110.

[94] C-196/04 Cadbury Schweppes, EU:C:2006:544, para. 55.

[95] C-398/16 and C-399/16, X BV & X NV, EU:C:2018:100, para. 46.

[96] C-524/04 Thin Cap, EU:C:2007:161, para. 82-83.

[97] C-484/19 Lexel, EU:C:2021:34, para. 46-51.

length.[98] Therefore justification for the fight against tax evasion could not be accepted[99].

The CJEU went on to examine whether the difference in treatment could be justified by the need to safeguard the allocation of the power to impose taxes between the Member States. With reference to *Marks & Spencer*[100], *Hornbach-Baumarkt*[101], *Lidl Belgium*[102], *SGI*[103], *Oy AA*[104], and *X Holding*[105], the CJEU held that this justification can be accepted (i) where the system in question is designed to prevent conduct that is liable to jeopardize the right of a Member State to tax activities carried out on its territory, which requires that the Member State applying the tax rules in respect of both losses and profits, and (ii) to prevent the free choice of deciding in which Member State a profit is taxed or a loss is taken into account, justifying advantages reserved only to resident consolidated companies.[106]

The CJEU claims, however, in line with *Groupe Steria*[107], as regards other tax advantages, that the transfer of profits and losses requires a separate assessment. That is according to the CJEU the reason why the balanced allocation of power to impose taxes could not justify the legislation at hand in *X BV & X NV*[108], since the latter case involved an advantage without any specific link to the tax scheme applicable to such entities.[109]

In *X BV & X NV*, the conditions for deduction differed according to whether the acquired company was part of the same consolidated tax entity as the acquiring company, which the CJEU understands as a question of general offsetting of costs and gains related to the consolidated tax entity. In *Lexel*, the application of the "exception rule" depends inter alia on the tax residency

[98] Ibid, para. 52-54.

[99] Ibid, para. 57.

[100] C-446/03 Marks & Spencer, EU:C:2005:763, para. 46.

[101] C-382/16 Hornbach-Baumarkt, EU:C:2018:366, para. 43.

[102] C-414/06 Lidl Belgium, EU:C:2008:278, para. 31.

[103] C-311/08 SGI, EU:C 2010:26, para. 61-62.

[104] C-231/05 Oy AA, EU:C:2004:439, para 56.

[105] C-337/08 X Holding, EU:C:2010:89, para 29-33.

[106] C-484/19 Lexel, EU:C:2021:34, para. 58-62

[107] C-386/14 Groupe Steria, EU:C:2015:524, para. 14.

[108] C-398/16 and C-399/16 X BV & X NV, EU:C:2018:110, para. 40-41.

[109] C-484/19 Lexel, EU:C:2021:34, para 63-64.

of the creditor, "FR-2". By being disqualified based on the residency of applying the general assumption that a substantial benefit cannot arise between Swedish companies eligible to receive and give deductible contributions, the CJEU found a difference in treatment.[110]

However, the CJEU concludes that the differences in treatment in *Lexel* do not have any bearing on the justification assessment. According to the legislative preparatory works of the 2013 legislation, the purpose of the legislation is to prevent the erosion of the Swedish tax base, which cannot be confused with the need to preserve the balanced allocation of the power to impose taxes between Member States, and, in line with *Marks and Spencer*[111], cannot be regarded as an overriding reason in the public interest that may be relied upon to justify a measure.[112]

The CJEU concludes that the loan would have been deductible if 'FR-2' were not an associated company, and notes that[113]:

> "[…] where the conditions of a cross-border intra-group transaction and an external cross-border transaction correspond to those on an arms-length basis, there is no difference between those transactions in terms of the balanced allocation of the power to impose taxes between the Member States."

Thus, the need to preserve a balanced allocation of the power to impose taxes between the Member States could not be accepted. The CJEU also considered whether the restriction could be justified by taking into account both the fight against tax evasion and tax avoidance *and* the preservation of a balanced allocation of the power to impose taxes between the Member States together.

[110] Ibid, para. 65.

[111] C-446/03 Marks & Spencer, EU:C:2005:763, para. 44.

[112] C-484/19 Lexel, EU:C:2021:34, para. 66-68.

[113] Ibid, para. 69.

The CJEU noted, that both in *Oy AA*[114] and *SGI*[115], the national legislation could be upheld, despite the fact that the measures at issue do not specifically target purely artificial arrangements, devoid of economic reality and created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory.[116] However, since the CJEU concluded that the balanced allocation of the power to impose taxes between the Member States cannot be applied in *Lexel*, the legislation at hand cannot be justified on the two grounds considered together, and that the interest limitation legislation of 2013 thus constitutes an unjustifiable restriction on the freedom of establishment.[117]

3.2 Post-*Lexel* effects: the legislation of 2019

On 13 December 2021, the Swedish Supreme Administrative Court (HFD) delivered its judgment on the interest deduction limitation legislation of 2019, concluding that even the legislation of 2019 constitutes a restriction on the freedom of establishment.[118]

Unlike *Lexel*, this case involved an appeal on an advance tax ruling issued by the Board for advance tax rulings, "Skatterättsnämnden". The facts in the advance ruling were the following: Husqvarna is a company part of a multinational entity and has a debt to an associated company established in Ireland, "IE-1" in the amount of 11 billion SEK (≈1.1 billion EUR). Husqvarna petitioned the Board to ascertain whether the interest payments to "IE-1" are deductible. In the petition, Husqvarna stated that the interest is at arm's length and that the debtor is subject to a 12.5% corporate income tax. In essence, Husqvarna wished to know whether the interest payments would be denied, in full or in part, with the application of "the exception rule" as amended by the 2019 legislation. If deduction were denied, Husqvarna claimed that this would constitute a restriction on the freedom of

[114] C-231/05 Oy AA, EU:C:2004:439, para. 63.

[115] C-311/08 SGI, EU:C 2010:26, para. 66.

[116] C-484/19 Lexel, EU:C:2021:34, para.75.

[117] Ibid, para. 76-77.

[118] HFD 2021 ref. 68.

establishment. The Board found however that the exception rule was not applicable, thus avoiding ruling on whether the 2019 legislation constituted a restriction.[119]

The Swedish tax authority appealed to the Supreme Administrative Court, claiming that the interest at hand should not be deductible based on the exception rule, and that the rule does not constitute a restriction on the freedom of establishment. Husqvarna's claim remained the same as before.[120]

After a lengthy discussion on whether the court should first rule on if "the exception rule" is applicable or if the legislation constitutes a restriction on the freedom of established, the court concluded that it is in the public interest to first deliver a judgment on the latter issue.[121]

The court acknowledged that "the exception rule" had been amended by the 2019 legislation, and that the "ten percent rule" may be set aside only if the loan was taken for the group to *exclusively, or almost exclusively*, receive a substantial tax benefit.[122] In a nutshell, the court concluded that the situation is essentially identical to that in *Lexel* and that the legislation of 2019 constitutes a restriction on the freedom of establishment which cannot be justified by the need to preserve a balanced allocation of the power to impose taxes between Member States nor the need to fight against avoidance, nor considered together.

Finally, the court merely concluded that having found the legislation in breach of Union law, there is no need to try the main question in the proceedings, effectively avoiding scrutinizing in detail the 2019 legislation.

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[119] Ibid, para. 1-6.

[120] Ibid, para. 7-8.

[121] Ibid, para. 16-23.

[122] Ibid, para. 27.

3.3 Previous case law

The claim by Wattel[123] that *Lexel* is a recycling of *Thin Cap* cannot be upheld. Lexel is not about the arm's length principle and the right to deduct the excess interest. It is a matter of protecting the integrity of the national tax base. In Thin Cap, the UK legislation of 1988 required the recategorization of the exceeding interest payments into distribution of profits in domestic situations if the interest payment was not at arm's length. In cross-border situations, the whole amount of interest paid was considered a distribution of profits if the debtor and creditor were associated companies by ownership of more than 75% of the capital, unless a double taxation convention was in place which prevented the application of the said rules.[124] The UK legislation was amended in 1995, treating interest payments as distribution only to the extent it exceeds the amount that could have been paid at arm's length, but did not apply if the creditor and debtor were liable to corporate tax in the United Kingdom.[125] The CJEU held that legislation at hand constituted a restriction on the freedom of establishment, which could however be justified by the need to combat abusive practices and the need for balanced allocation between Member States of the power to impose taxes.[126] However the legislation was not proportional in two aspects: (i) the taxpayer was not given an opportunity to rebut the *prima facie* evidence – the interest not being at arm's length, and (ii) even if the interest arrangement would be artificial, only the excess interest could be excluded from the deduction according to the CJEU.[127] Interestingly the United Kingdom argued that there was no real restriction since the reclassification would require an adjustment in the creditor company state according to double taxation conventions, leaving the group in a tax-neutral position. Even if this is mathematically correct, it still

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[123] Wattel, P.J. Lexel. *Freedom of establishment. Sweden cannot refuse deduction of interest. Substantial tax benefit. No artificial arrangement. No balanced allocation of the power to tax. Court of Justice. (Comments).* Highlights and Insights on European Taxation, 6/2021, Wolters Kluwer, pp. 42-45.

[124] C-524/04 Thin Cap, EU:C:2007:161, para. 4-6.

[125] Ibid, para. 10-11.

[126] Ibid, para. 71-77.

[127] Ibid, para.7 8-87. See also Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, pp. 378-379.

implies that the United Kingdom would always be able to impose taxes, to the detriment of the other contracting state. This would however go beyond what might be considered a balanced allocation of the power to tax between Member States, and thus could not, and did not, pass the proportionality test of the CJEU.

The difference in the previous case *Lankhorst-Hohorst*[128] from *Thin Cap* was that the question of arm's length was unimportant according to the CJEU. The CJEU found that the different treatment of the cross-border situation, compared to a domestic one, could not be justified, although in the actual case, the interest could not have been deducted in a purely domestic situation, since the parent company had issued a guarantee for the creditors of the subsidiary.[129] However, the judgment had the effect that targeted interest deduction rules were introduced in purely domestic situations across Member States, although, from a tax base erosion perspective, there was no explicit reason. According to Vermeulen, the *Lankhorst-Hohorst* judgment was probably based on mutual recognition reasoning, as the CJEU did not accept that the denial of deduction was justified to curb tax avoidance since the interest would anyway be taxed in the state of the creditor. [130]

In *SGI*, the CJEU took a different stance and accepted that even though the Belgian requirement of arm's length profits adjustments was only applied in cross-border situations and thus amounted to discrimination, such requirements could be justified on the need to combat tax avoidance and the need to preserve the balanced allocation of the power to tax between Member States.[131] Furthermore, the CJEU accepted a division of the burden of proof as being proportionate to the set of objectives pursued by it, whereby the tax authorities need to present *prima facie* evidence as to the existence of the advantages within the meaning of the legislation, giving the taxpayer an

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[128] C-324/00 Lankhorst-Hohorst, EU:C:2002:749.

[129] Ibid, para. 30. See also Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, p. 377.

[130] Wattel, P.J., Marres, O., Vermeulen, H. (editors). *Terra/Wattel European Tax Law (Student edition) - Volume 1: General concepts and direct taxation*, 7th ed., Kluwer Law International, 2018, p. 378. See also Opinion of Advocate General Geelhoed in C-524/04 Test Claimants in the Thin Cap Group Litigation, EU:C:2006:436, para. 68.

[131] C-311/08 SGI, EU:C 2010:26, para. 69.

opportunity to rebut the tax authorities' premise.[132] The CJEU however, left the second part of the proportionality analysis to the national court to examine.

In *SIAT*, the CJEU found the legislation to be justified, but nonetheless disproportionate. In *SIAT*, the Belgian income tax code denied the deduction of "Interest, fees for granting use of patents[133]…" if the recipient was not taxed at all or taxed more advantageously than in Belgium. Although the CJEU had previously held in *Eurowings Luftverkehr*[134] and *Skandia & Ramstedt*[135], that low taxation by itself cannot be used by another Member State as justification for less favorable treatment, the CJEU now held that Belgian legislation could be justified by the need to combat tax avoidance and evasion, the need to preserve the balanced allocation between Member States of the power to impose taxes, *and* by the need to ensure the effectiveness of fiscal supervision.[136] However, since the legislation did not meet the requirements of the principle of legal certainty, it could not be considered proportionate to the objectives pursued.[137] The phrase "regime which is appreciably more advantageous than the applicable in Belgium" in the Belgian legislation was considered too vague.

3.4 Inconsistencies in the *Lexel* judgment

As the following will show, the *Lexel* judgment was correct in finding that the legislation constituted a restriction on the freedom of establishment but based on the wrong legal facts and circumstances which were presented before the CJEU.

[132] Ibid, para. 73-75.

[133] C-318/10 SIAT, EU:C:2012:415, para. 6.

[134] C- 294/97 Eurowings Luftverkehr, EU:C:1999:524, para. 44.

[135] C-422/01 Skandia and Ramstedt, EU:C:2003:380, para. 52.

[136] C-318/10 SIAT, EU:C:2012:415, para. 48.

[137] Ibid, para. 58-59.

3.4.1 What did the CJEU address?

One possible reason why the CJEU ended up in *Lankhorst-Hohorst* was the Swedish tax authority's sudden shift of opinion as noted by Deij[138]. The same line of argument is also supported by Wattel[139], with his comments that the effective tax rate had become the issue. The question posed to the CJEU was a simple one: can the advantage that domestic associated companies have in the application of "the exception rule" be justified by the need for a balanced allocation of the power to tax between Member States? In the Request for a preliminary ruling sent to CJEU, the Swedish Supreme Administrative Court reports that the opinion of the Swedish tax authority is that the purpose of the legislation is to prevent the erosion of the Swedish tax base, in both domestic and cross-border situations, by preventing the shifting of untaxed profits from Sweden to another States.[140] However, in its filing with the CJEU, the tax authority makes a policy shift: the tax benefit which arises in *Lexel* stems instead from the fact that the interest payments were not effectively taxed in France due to the incurred losses in those fiscal years.[141] Thus, the case became no longer an issue of shifting untaxed profits from Sweden to other Member States, but a question of effective taxation of the interest received, which the CJEU indirectly confirms[142]. In this sense, the connection between the interest limitation rules and the contribution rules becomes irrelevant, since a similar benefit might arise in a purely domestic situation as well. If this is how "the exception rule" rule was perceived by the CJEU, the rule cannot be justified by the need to preserve a balanced allocation of the power to impose taxes between Member States nor the need to fight against avoidance, nor considered together. In this case, it seems as if the CJEU made the right decision under the legal facts and arguments presented before them,

[138] Deij, C. Är undantaget från tioprocentsregeln förenligt medEU-rätten? Svensk Skattetidning, 2021:2, pp. 75-94.

[139] Wattel, P.J. Lexel. *Freedom of establishment. Sweden cannot refuse the deduction of interest. Substantial tax benefit. No artificial arrangement. No balanced allocation of the power to tax. Court of Justice. (Comments)*. Highlights and Insights on European Taxation, 6/2021, Wolters Kluwer, pp. 42-45.

[140] C-484/19 Lexel, Request for a preliminary ruling from the Swedish Supreme Administrative Court of 5 June 2019, para. 46.

[141] Swedish Tax Authority, Written Opinion in case C-484/19 Lexel, 30.10.2019, para. 20-22.

[142] C-484/19 Lexel, EU:C:2021:34, para. 53.

which differed from the request for the preliminary ruling and the arguments set forth by the Supreme Administrative Court.

However, this does not explain why the CJEU did not make any reference to the *SIAT* case. In the said case, the Belgian income tax code denied the deduction of "interest, fees for granting use of patents…"[143] if the recipient was not taxed at all or taxed more advantageously than in Belgium. The phrase "regime which is appreciably more advantageous than the applicable in Belgium" in the Belgian legislation was considered too vague, and therefore in defiance of the principle of legality. The Swedish legislation at issue might also be considered vague, with reference to how 'mainly for tax reasons' should be interpreted. Unfortunately, this was never addressed by the CJEU, seemingly eager to strike down the case purely on the merit of the statement of the Swedish tax authority alone. A more reasonable outcome would have been to find the Swedish legislation justified and yet disproportionate as in *SIAT*. Instead, the CJEU flips the assessment, and first assesses the proportionality issue, concluding that the legislation cannot be justified.[144]

3.4.2 The artificiality of what?

Wattel[145] also raises the issue of artificiality. In his opinion, the CJEU only focused on the fact that the conditions of the loan were at arm's length to rule out artificiality[146], but not on the incurrence of an intercompany loan in the first place. It was by taking a loan that allowed the incurred losses in France to be set off against the interest income. However, as Lexel claims[147], the corporate income tax rate was higher in France than in Sweden, and any benefit would have been merely a temporal benefit. It is however doubtful whether this temporal benefit, given the facts of the case, could be considered a substantial tax benefit. From a tax base integrity perspective though, it is

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[143] C-318/10 SIAT, EU:C:2012:415, para. 6.

[144] C-484/19 Lexel, EU:C:2021:34, para. 53.

[145] Wattel, P.J. Lexel. *Freedom of establishment. Sweden cannot refuse deduction of interest. Substantial tax benefit. No artificial arrangement. No balanced allocation of the power to tax. Court of Justice. (Comments)*. Highlights and Insights on European Taxation, 6/2021, Wolters Kluwer, pp. 42-45.

[146] Cf. C-484/19 Lexel, EU:C:2021:34, para. 69.

[147] C-484/19 Lexel, EU:C:2021:34, para. 20.

unimportant whether the interest paid is at arm's length if the purpose of the transaction is to shift profits. However, in this case, it is unlikely given the higher corporate tax rate in France, but the question remains still unaddressed by the CJEU.

3.4.3 The interaction with the contribution rules

First, what does the assumption mean that no substantial benefit can arise from a loan between two associated companies if the associated companies are eligible to apply the contributions rules? In essence, this requires that both companies are subject to Swedish corporate tax, not necessarily meaning that both companies are established in Sweden. Thus, there is no pure cross-border situation, but rather a cross-tax base situation, since the Swedish legislation is neutral on the Member State of establishment, which is another fact not addressed by the CJEU.

Regarding the 2009 and 2013 legislation, it holds that the same effect that interest payments achieve between associated parties, i.e., a shift of income from the debtor to the creditor, could be achieved with a deductible contribution from the debtor to the creditor instead. Thus, it seems reasonable to assume that the legislator intended this assumption to resemble a relief of the burden of proof rather than a matter of substance.

Even assuming that the exception rule is not a relief of burden but a substantial element, the same conclusion can be derived. Dahlberg states that, while the CJEU acknowledges the difference between the interest deduction limitation rules and the contribution rules, the Court still relies on the joint application of the rules in its judgment.[148] The question which Dahlberg poses is whether one should view the contribution system and the interest limitation legislation as separate legal constructs that have different aims and objectives, or jointly. Essentially the same question is posed in the currently pending case *PRA*[149] before the EFTA Court. In the pending case, a Norwegian taxpayer is claiming that the parallel application of the Norwegian contribution system

[148] Dahlberg, M. *Sveriges ränteavdragsbegränsningar och EU-domstolens avgörande i mål C-484/19 Lexel AB mot Skatteverket*, Skattenytt 2021, pp. 279-292.

[149] E-3/21 PRA, Request for an Advisory Opinion of 1 July 2021.

with the general interest limitation legislation in Norway constitutes a restriction on the freedom of establishment. Namely, the Norwegian legislation allows domestic associated companies to increase the EBITDA of interest-paying companies, while this is not possible in cross-border situations. In a nutshell, one of the questions facing the EFTA Court is how to reconcile the potentially conflicting aims and objectives of the sets of rules: the interest deduction limitations and the contribution rules. One reasonable solution is to identify the aim and purpose of the two sets of rules in as applied in combination, which could potentially yield a different aim and purpose than viewed in isolation. Therefore, the CJEU judgment is rational in acknowledging that the two sets of rules in *Lexel* have separate aims, but it is still their effect in combination that is essential. In any case, the combined aim and purpose of the 2013 legislation remains the same: prevention of tax base erosion.

The issue became more complex with the introduction of the general interest deduction limitations in 2019. Although profits could be shifted between associated companies in domestic situations by using contributions, using interest payment would lead to a positive interest balance for the receiving company. This could potentially be exploited and lead to deductions exceeding the 30% of EBITDA limit[150] had there been no loan, which might be considered a substantial tax benefit. Thus, the assumption that loans that are taken between associated companies, eligible to apply the contribution rules, never amount to a substantial tax benefit fails. Unfortunately, the Supreme Administrative Court did not take position on this question in its ruling on 13 December 2021.[151]

[150] See Article 4 Anti-Tax Avoidance Directive, OJ L 193, 19.7.2016, p. 1.

[151] HFD 2021 ref. 68.

4 Concluding remarks

The *Lexel* case does not provide clarity on the justification of targeted interested deduction legislation based on tax base integrity, but rather quite the opposite. Without in-depth knowledge of the case, the CJEU seems to have reverted to *Lankhorst-Hohorst* and the application of the arm's length principle as an indicator of abuse. As this thesis explains, the reason for the Court's judgment may lie in the sudden change in the facts and arguments presented by the Swedish tax authority.

From *Eurowings Luftverkehr*[152] and *Skandia & Ramstedt*[153]*,* it was already known that low taxation could not by itself be used as a ground for denial of benefits. The "ten percent rule" of the Swedish legislation contested in the *Lexel* case could be considered as indirectly discriminatory since it targeted only cross-border situations and states which have lower corporate income tax rates than Sweden.[154] However, this question was never brought up before the CJEU, and will most likely lose importance, if, and when, the P2D proposal is adopted by the Council. With a global minimum tax rate of 15%, with mechanisms such as the under-taxed payment rule (UTPR), and the built-in incentive of the OECD Pillar Two for low-tax jurisdictions to introduce qualified domestic top-up taxes (QDTT), the application of the minimum global tax-rate as a reference point is given.[155] What is more interesting is if Member States could still argue, that shifting profits from a high-tax jurisdiction, which applies a significantly higher tax rate than the global minimum tax rate, to a *lower* tax rate jurisdiction, could amount to either abuse or be denied under targeted interest deduction legislation justified by reason of tax base integrity.

[152] C- 294/97 Eurowings Luftverkehr, EU:C:1999:524, para. 44.

[153] C-422/01 Skandia and Ramstedt, EU:C:2003:380, para. 52.

[154] See Dahlberg, M. *Sveriges ränteavdragsbegränsningar och EU-domstolens avgörande i mål C-484/19 Lexel AB mot Skatteverket*, Skattenytt 2021, pp. 279-292.

[155] See Articles 2.2 – 2.4 and 5.2 OECD, Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), OECD, Paris, 2021; Articles 10 - 13 Proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, COM(2021) 823 final of 22 December 2021.

The need for targeted interest deduction rules is far from over. Even if the OECD Pillar Two, if adopted, would make the shifting of profits less attractive, the proposed rules do not eliminate all incentives. Considered together with the current, narrow scope of the P2D, the need for targeted interest rules has not changed since the final report of BEPS was delivered. The proposed rule in Article 15(8) of the proposal also shows the opposite, that by introducing the P2D, new targeted rules are needed.

The research question of this thesis was whether national legislation, limiting interest deductions between associated companies, can be introduced to prevent tax base erosion. The analysis has shown that the *Lexel* judgment should be understood as a side-step by the CJEU rather than a step towards clarification on the issue of tax base erosion and profit shifting through interest payments. Therefore, the *SIAT* judgment remains intact, meaning that Member States may impose targeted interest deduction rules, which even require taxpayers to prove the right to deduction, as long as the applied rules meet the principle of legality, and are thus proportional in the eye of the CJEU. However, the principle of legality would be best observed by avoiding reliance on intertwined domestic legislation, either as an assumption, proof or substance, as was in the *Lexel* case with the "the exception rule" – the reliance on the contribution rules.

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