Article

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The freedom of cross-border funding in multinational groups and European Union law

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Abstract: Member states often try to restrict cross-border debt financing in multinational groups. The pending Swedish case, *Lexel AB*, C-484/19, is a prime example. The Swedish tax law operates with a vague legal concept of tax abuse that is completely inappropriate to identify tax-abusive financing and disadvantages only foreign groups. This paper analyzes the Swedish rules on interest limitation in affiliated groups (C-484/19), which refers to substantial tax benefits, against the background of the European Union law and the finance theory. In this regard, a breach of European Union law can be found. This also applies to the current Swedish tax law. Moreover, the interest limitation rules are analyzed from the background of the principles of finance theory, particularly the interest coverage ratio (ICR). In this context, a comparative analysis is carried out between the Swedish rules and the Anti-Tax Avoidance Directive (ATAD) provision (Art. 4). Adequate regulations on the limitation of interest should cope with the problem of profit shifting, also preserve the freedom of financing, particularly in multinational groups, and should not contain any difference in treatment between domestic and foreign groups.

Keywords: European Union law, Freedom of establishment, International tax law, Intra-group financing, Freedom of funding, Tax avoidance, Interest deduction limitation rules, Group taxation

1 Introduction

The free choice of the financing instrument is a key factor economically and in business life. In principle, companies are free to finance their operations with equity, debt, or mezzanine capital. Besides business aspects and flexibility considerations, financing instruments can also be used

for tax planning, especially in multinational groups. For instance, against the background to the financing theory as an instrument of internal financing, namely by saving tax payments (tax-induced debt financing). Accordingly, multinational companies (MNCs) have the possibility to utilize intra-group financing. By way of example, using an internal financing company. By using internal debt financing strategies, MNCs are able to lower their group tax rate significantly (Cooper and Quyen, 2020). The principle of tax optimization via intra-group financing is internationally recognized and, in principle, not abusive. This can be demonstrated by the introduction of uniform regulations at the European Union (EU) secondary law level (ATAD)¹, which presupposes the recognition of intra-group financing companies for purposes of taxation. Pursuant to the Court of Justice of the European Union (CJEU), the use of finance companies is principally not abusive, irrespective of using a low-tax location within the EU. However, from the fiscal point of view of the states, the problem of profit shifting and the decline of tax revenues arises. Thus, the states have always tried to limit profit shifting by national tax law aiming to restrict intra-group financing (e.g., interest deduction limitation rules, thin-cap rules, worldwide debt cap). Concerning the EU / European Economic Area (EEA) area, the use of such regulations is restricted by the freedom of establishment and the free movement of capital. In that respect, regulations on generalized and suspected tax abuse are not permitted according to the case law of the CJEU (e.g., *Leur-Bloem*, C-28/95; *Egiom/ Enka*, C-6/16). In that respect and from the member states' perspective, the field of action in restricting international tax planning is limited. In addition, the member states cannot levy any withholding tax on intra-group interest payments between affiliated companies within the EU according to the EU interest and royalty directive.

The present Swedish/French CJEU case of *Lexel AB*, C-484/19 deals with such a suspected anti-abuse law that denies a Swedish stock corporation (*Lexel AB*) the tax-

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¹ Especially, the interest limitation rule (Art. 4 ATAD) and the CFC taxation rule (Art. 7, 8 ATAD). Council Directive (EU) 2016/1164 of July 12, 2016, L 193/1 [ATAD/Anti-Tax-Avoidance-Directive].

effective interest deduction for internal interest payments to a French group financing company (BF SNC). This restricts the freedom of the multinational group of companies at hand to finance and prevents the reduction of the group tax rate. On the other hand, if the same intra-group interest payment had been made between two Swedish group companies that form a Swedish „tax group“ (so-called intra-group transfers), the interest deduction limitation rules would not apply. From a European law perspective, the question arises whether the Swedish law, restricting the tax deduction of interest payments made to foreign group members, infringes the freedom of establishment and thus ultimately cannot be applied due to the primacy of EU law. The Swedish Supreme Administrative Court (Högsta förvaltningsdomstolen) submitted this question to the CJEU in a preliminary ruling after the Swedish Tax Administration (Skatteverket) and the Swedish Administrative Court of Appeal (Kammarrätten i Stockholm) rejected Lexel AB's allegation that the Swedish interest deduction restriction on intra-group debt financing was unlawful under Union law. Now, the question arises whether Sweden was allowed to refuse the tax-effective deduction of the interest payment at the level of Lexel AB, taking EU law into account? Are Paragraphs 10a to 10f of the Swedish Law on income tax in line with the freedom of establishment (Art. 49 TFEU)? These regulations are applied in the present case C-484/19 and up to December 31, 2018. Exceeding the Lexel AB case, the higher-level question is: how national interest deduction limitation rules must be legally shaped in relation to intra-group financing in order to be in line with EU law? Moreover, the influence of EU law, in particular the freedom of establishment, on the restriction of group interest payment is analyzed.

This article critically examines the Swedish interest deduction limitation rules on intra-group debt financing² in light of EU law. The investigation is based on the pending Swedish CJEU case Lexel AB, C-484/19. Are the Swedish rules in line with the freedom of establishment (Art. 49 TFEU)? Do they infringe EU law? What are the consequences? Giving potential answers to these unsolved questions, the method of legal-theoretical analysis is applied. Furthermore, the case law of the CJEU and also the core principles of EU law will be analyzed. From a broader dogmatic point of view, it is analyzed how restrictions on interest deduction must be designed in a legislative manner to be compatible with EU law. Finally, a short comparison between the old Swedish interest deduction limitation rules

and the interest barrier according to the Anti-Tax Avoidance Directive (ATAD) will be drawn. Moreover, fundamental questions of EU law will be discussed in connection with national group taxation systems (Dourado, 2018). This article is assigned to EU law, international tax law, and tax science.

2 Methodology and current status of research

This article is on EU law. The Swedish law on interest limitation in affiliated groups in the pending case *Lexel AB* (C-484/19) is analyzed against the background of the freedom of establishment (Article 49 TFEU). First, the objective content of the legal sources must be examined (analysis of primary sources). Therefore, an interpretation in light of EU primary law will be carried out. In that respect, the methods of judicial interpretation will be used. From a methodological perspective, the examination scheme of the CJEU is applied: restriction, justification, proportionality. Regarding the analysis of primary sources, the existing case law has to be examined, applied and, if possible, transferred to the present case and its unsolved questions. However, because *Lexel AB*, C-484/19 is a pending case, there is no CJEU case law that directly deals with such a situation. Accordingly, transferable case law can only be found to a limited extent.

Moreover, an analysis of secondary sources is made. Especially the existing literature will be examined. However, the literature on taxation does not (especially) deal with the Swedish provisions at hand in C-484/19. The recent case law on intra-group financing has not been examined at all in this context: especially *X BV*, C-398/16 of the year 2018. In the literature, the interest limitation rules have never been analyzed from the background of loss situations of the lending subsidiary, which is, however, the case in the request for a preliminary ruling in C-484/19. Furthermore, the current academic literature has not yet examined the arguments of the parties in the request for a preliminary ruling of June 5, 2019, in case C-484/19. Moreover, the literature has not yet analyzed whether secondary advantages of group taxation may be denied in cross-border situations. However, that is a relevant topic in the pending case C-484/19. Only the older literature (up to 2015) had been dealing in general aspects with the compatibility of the Swedish interest limitation rule at hand.

There is some older literature addressing the Swedish interest deduction limitation rules applicable to intra-group debt that are at issue in *Lexel AB*. This literature, however,

² Chapter 24, Paragraphs 10a to 10f of the Swedish Law on Income Tax.

provides no consistent picture of whether these rules may be in breach of the fundamental freedoms. Johansson (2011) shares the view that the rules lack justification³. The rules cannot be justified by the need to maintain a balanced allocation of taxing rights, in particular in conjunction with the need to prevent tax avoidance. Carneborn (2015) holds the view that the Swedish rules on interest deduction limitation may be incompatible with primary law⁴. Hilling (2013) takes the view that the aforementioned rules could be justified by the need to maintain a balanced allocation of taxing rights, especially in combination with an appeal to the need to prevent tax avoidance⁵. It is unclear, however, whether the rules would pass the proportionality test. On the one hand, the structure of the interest deduction limitation rules might meet the proportionality test. On the other hand, the rules may not be in line with the principle of proportionality because it is impossible to predict with sufficient precision whether the rules will be applicable. Thus, the rules may not meet the requirements of the principle of legal certainty as formulated in Paragraph 58 of SIAT (Case C-318/10). The principle of legal certainty can be viewed as part of the proportionality test. Importantly, the proportionality test is not applicable at all if the national rules lack justification under EU primary law.

Another unsolved question under primary law is whether an internal loan can be treated as non-tax motivated if the lender is a domestic subsidiary, but tax motivated if the lender is a foreign affiliate. More importantly, in *Lexel AB*, the financing group company had deductible loss carry-forwards. Assuming all other factors are equal, Sweden waives the taxation of profits in the amount of the interest in the comparable domestic situation. Actually, in loss situations, that is, where the lending subsidiary has losses to offset against the interest income, the controversial regulations clearly do not pursue the goal of maintaining a balanced allocation of taxing rights. These aspects have never been discussed in the literature on taxation.

From *Sofina*, case C-575/17⁶ regarding the taxation of dividends by the source state in a loss situation of the re-

cipient, one may carefully derive that the need to maintain a balanced allocation of the powers of taxation between the member states is not able to justify a restriction of the cross-border situation. This is because the member state does not tax the income in comparable domestic situations. Therefore, and pursuant to the decision in *Sofina*, the member state cannot argue a loss of tax revenue associated with the taxation of income received by non-resident companies, especially if the member state does not exercise its right of taxation in purely domestic cases in respect of profits shifted through intra-group financing.

Moreover, the more recent literature on taxation does not specifically deal with the Swedish provisions at hand in *Lexel AB*. The recent case law on intra-group financing has not been examined at all in this context (X BV, C-398/16). Furthermore, the current academic literature has not yet examined the arguments of the parties in the request for the preliminary ruling in *Lexel AB*, the main issue being whether secondary advantages of group taxation may be denied in cross-border situations. The following article addresses this question in the context of interest deduction limitation rules for intra-group financing. Is it compatible with the freedom of establishment to refuse a Swedish company a deduction for interest paid to an affiliate company in a different member state in circumstances in which the interest deduction would not be restricted if the lender was a Swedish subsidiary and the lender and borrower had the possibility to use a domestic group tax regime?

3 Initial issue and Swedish tax law

The Swedish company *Lexel AB* is part of a multinational group of companies. The applicable Swedish corporate tax rate was 22%. The ultimate parent company of that group is a French SE. The group also includes a Belgian company (*SESI*), which was 85% owned by a French group company (*SEISAS*) and 15% by a Spanish group company (*SEE*). In December 2011, *Lexel AB* acquired 15% of the shares in the Belgian company (*SESI*) from the Spanish group company (*SEE*). To finance this internal share deal, *Lexel AB* received an interest-bearing loan from the French company (*SNC BF*), which operates as an intra-group financing company. The French financing company *BF* has economic substance. It handles the group's cash pool and has granted loans to around 100 different affiliates. The French financing company *BF* is fully subject to French corporate income tax, the tax rate was 34.43%, and it was also part in a French group taxation. Because the French financing company *BF* had negative income in France (deficit) in the years receiving

³ See. J. Johansson, *Ränteavdragsbegränsningar – med anledning av att kapital är fungibelt*, SN 2011/9, p. 609 (2011).

⁴ See. C. Carneborn, *Swedish Interest Deductions – Quo Vadis?*, *Tax Notes Intl.*, p. 987 (2015).

⁵ See. M. Hilling, *Justifications and proportionality: An analysis of the ECJ's assessment of national rules for the prevention of tax avoidance*, 41 *Intertax* 5, p. 306 (2013).

⁶ See. CJEU, Judgment of November 22, 2018, C-575/17, *Sofina*, ECLI:EU:C:2018:943. To that judgment in general G. Kofler, *Foreign Losses and Territoriality*, in *CFE Tax Advisers Europe: 60th Anniversary*, pp. 147-168.

Figure 1

the interest payment from Lexel AB, the interest income was principally not subject to taxation. Lexel AB claimed tax-effective interest deduction in Sweden.

The Swedish Tax Administration (Skatteverket) and the Swedish Administrative Court of Appeal (Kammarrätten i Stockholm) refused tax deductions for the interest expenses on the loan from BF at the level of Lexel AB (borrower). The reason is that Lexel AB and BF were both in a group of associated enterprises, and in such circumstances and according to Chapter 24, Paragraph 10 b, of the Swedish Law on income tax, the interest expense is principally not deductible. Exceptionally, the aforesaid interest expense is deductible if the corresponding interest income is subject to taxation in the hands of the recipient and the applicable tax rate is at least 10% (so-called 10% rule⁷). Because the applicable tax rate in France at the level of the BF was 34.43%, the 10% rule was applicable. However, as a counter-exception⁸, no interest deduction is available if the main reason for granting the debt is that the group of associated enterprises receive a substantial tax benefit. It is the company that requests the deduction of interest expense that has to prove that the debt has not arisen mainly for tax-saving purposes, here Lexel AB⁹. Thus, the MNC group has to prove that the debt was incurred mainly for business reasons. In that respect, an assessment must be made in each individual case, taking all relevant circumstances into account, whether the main reason for the transaction

is to receive a substantial tax benefit. Such a tax-saving motive may principally be given if an internal share deal is financed. Moreover, another important factor that indicates a tax-saving motive is if financing is done by equity or internal debt. Other examples that may indicate a tax-saving motive are when a company with substantial deficits and lacking of funds acts as a lender and when funds were generated via a coordinated chain of transactions between subsidiaries in a group. Importantly, an unduly and substantial tax advantage is at hand if the internal debt obligation has been created to enable the lender (here BF) to offset the interest income against losses or loss carryforwards. In such a case, the group considers reaching a significant tax advantage by circumventing the rules on intra-group transfers. Thus, the transaction at hand is mainly tax-motivated, and the debt-funded group company (here Lexel AB) is not allowed to deduct the interest expenses. Interest from intra-group loans can be used to achieve similar tax affects as in a Swedish group taxation regime (intra-group transfers¹⁰). However, intra-group transfers are not available for cross-border tax consolidation between group companies by law (CJEU, 2007a).

Overall, The Swedish Tax Administration (Skatteverket) and the Swedish Administrative Court of Appeal (Kammarrätten i Stockholm) argued that the internal debt financing between the French BF (creditor) and the Swedish Lexel AB (borrower) was mainly tax-motivated. Moreover, both aimed to receive cross-border tax consolidation by shifting income from Lexel to the loss-bearing BF. Intra-group

⁷ First subparagraph of Paragraph 10 d Swedish Law on income tax.

⁸ Third subparagraph of Paragraph 10 d Swedish Law on income tax.

⁹ Prop. 2012/13:1 pp. 250–254 in the preparatory work to third subparagraph of Paragraph 10 d Swedish law on income tax.

¹⁰ Chapter 35 of the Swedish law on income tax, Paragraphs 1 to 6.

debt can be arranged to circumvent the rules on intra-group transfers, which is what the interest deduction rules seek to prevent (Skatteverket, 2019a). The interest deduction limitation rules in affiliated groups should prevent the tax base from being eroded, in both a purely domestic and cross-border situation. In cross-border situations, the interest deduction restriction hinders to transfer untaxed profits from Sweden to other member states. The Swedish interest deduction restriction also applies in pure internal situations; however, if there are no limitations on entitlement to intra-group transfers between Swedish companies, the examination will lead to the conclusion that internal debt financing is not mainly tax-motivated because those companies would have been able to achieve corresponding deductions by making intra-group transfers (Skatteverket, 2019b).

A first finding: granting the Swedish group taxation (intra-group transfers) means that the interest deduction limitation rules do not apply. Thus, in domestic cases in which the Swedish intra-group transfers is granted, the interest deduction limitation rules will not enter into force. Foreign group companies are not allowed to become part of a Swedish group taxation. In other words: secondary tax advantages of group taxation beyond the primary offsetting of income are denied for foreign companies, while Swedish companies are not affected. According to the CJEU judgment *Groupe Steria*, C-386/14, Para. 28, it is necessary to examine separately, whether a member state may reserve other advantages of a group tax system than the transfer of losses for foreign companies (CJEU, 2015). Moreover, the settled case law of the CJEU states that non-domestic affiliates cannot be excluded from other tax benefits of domestic group taxation systems than the consolidation of profit and losses: *X BV and X NV*, C-398/16, C-399/16, Para. 24 (CJEU, 2018a). Within a domestic group of companies, the possibility of the Swedish intra-group transfers leads to the effect that loans between the affiliates are disregarded or considered non-existent for Swedish tax purposes, and therefore, the interest deduction limitation rule does not apply. This secondary tax advantage of the Swedish intra-group transfers is not available in a cross-border situation, irrespective of the fact that Sweden is able to apply the interest deduction limitation rule in pure domestic cases. Moreover, it is also questionable why in cross-border situations, circumvention of the Swedish group taxation rules should exist if this taxation regime is from the very beginning not available in such cases. In reality, the Swedish regulations means that other tax planning options are indirectly restricted that have nothing to do with the circumvention of group taxation. This is inappropriate because debt financing is an independent matter and the freedom to finance or gen-

erally equipping a Swedish subsidiary by a foreign group is restricted, which is not the case within domestic groups. Furthermore, compared to multinational groups, domestic Swedish groups are principally not faced by any deduction limitations in regard to Swedish taxation. They are able to periodically offset losses and can avoid negative effects and a decrease in liquidity with regard to Swedish taxation.

Lexel AB and the EU Commission are of the opinion that it is contrary to EU law to refuse tax-effective interest deduction on the basis of the third subparagraph of Paragraph 10 d Swedish law on income tax. Skatteverket, the Swedish Government, and the Swedish Administrative Court of Appeal have a different opinion and have pointed out that the Swedish law is in line with the freedom of establishment. Thus, the Supreme Administrative Court (Högsta förvaltningsdomstolen) has requested for a preliminary ruling to the CJEU (C-484/19), because the existing case law is not clear and asked in that regard the following question (Högsta förvaltningsdomstolen, 2019a):

“Is it compatible with Article 49 TFEU to refuse a Swedish company a deduction for interest paid to a company which is in the same group of associated enterprises and is resident in a different Member State on the ground that the principal reason for the debt having arisen is deemed to be that the group of associated enterprises is to receive a substantial tax benefit, when such a tax benefit would not have been deemed to exist if both companies had been Swedish, since they would then have been covered by the provisions on intra-group transfers?”

This question is of great relevance and goes far beyond the issues of Swedish taxation at hand. First, the question deals with the fundamental aspect whether a member state is legally obligated to grant secondary tax advantages from a domestic group taxation system to companies resident in other member states on the basis of EU law. Examples for that are granting tax-effective deduction of interest expenses and royalties at the level of the domestic paying company in cross-border constellations, roll-over relief, dividend taxation (CJEU, 2015), tax-neutral passing through of profits from foreign permanent establishments, non-sanctioning of internal share deals, etc. Second, Art. 4 of the ATAD, the interest limitation rule, may be affected, and all member states had transposed that rule into their national law (COUNCIL DIRECTIVE, 2016/1164a). According to these rules, exceeding interest expenses and the Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) can be calculated at the level of the group and consists of the results of all its members. For this purpose, the member states often revert to national group taxation systems, and interest expenses and interest income equalize, and therefore, the interest deduction limitation

does not come into effect in domestic situations. As a foreign parent company and a domestic subsidiary regularly are not allowed forming group taxation according to national law, the interest limitation rule principally applies in cross-border constellations. However, if EU law obliges the member states to grant the secondary tax advantages of a domestic group taxation regime in cross-border situations, a consolidation of interest expenses and interest income would also take place for the purpose of applying the interest limitation rule (4 ATAD).

4 Analysis of European Union law and the freedom of establishment

4.1 Relevant fundamental freedom

First, the relevant fundamental freedom must be checked. The issue at hand is whether the Swedish law¹¹ on the limitation of interest deductions for debt financing within affiliated companies is compatible with primary law. For that purpose, companies are deemed to be associated with each other if one of the companies, directly or indirectly, through ownership or otherwise exercises a significant influence over the other company or the companies are mainly under common management¹². As this legislation concerns only relations within a group of companies, it primarily affects the freedom of establishment and must therefore be examined in the light of Art. 49 TFEU (CJEU, 2007b). Should that legislation also restrict the free movement of capital, those effects would be the unavoidable consequence of the infringement of the freedom of establishment. The interest and royalty directive 2003/49/EC is not applicable because it does not govern the question of interest deduction at the level of the borrowing company (CJEU, 2011). The issue at hand is to be examined solely on the basis of the freedom of establishment.

4.2 The difference in treatment

Articles 49, 54 TFEU contain for parent companies formed in accordance with the law of a member state and having their registered office, central administration, or principal place of business within the European Community, the right to exercise their activity in another member state through a

subsidiary. On that legal basis and in the case under consideration, the host member state Sweden has to guarantee the benefit of national tax treatment of Lexel AB, irrespective of the parent company has its corporate seat in Sweden or in another member state. Thus, Sweden must avoid any discrimination in the tax treatment of Lexel AB based on the fact that its parent company or affiliates doing business with Lexel are resident in other member states (CJEU, 2007c). In the case under consideration, the Swedish law on the limitation of interest deductions for debt financing between affiliated companies introduces a difference in the tax treatment of Lexel AB, depending on whether the lending affiliate company has its tax seat in Sweden or in another member state. In that respect, there is a difference in the tax treatment of Lexel AB. If a Swedish affiliate with losses grants Lexel AB the loan to finance the intra-group acquisition of shares, the loan is considered automatically not to be tax-abusive (Skatteverket, 2019c). The reason is that both domestic companies have the theoretical possibility to achieve the same tax result by making intra-group transfers¹³. Importantly, it is not crucial whether such a Swedish group taxation actually exists. In accordance with 10 d subpara. 3 of the law on income tax (preamble¹⁴) and the settled treatment of the Swedish tax authorities, an intra-group loan is not tax-abusive or primarily tax-motivated if the involved affiliates (lender and borrower) were theoretically able to make intra-group transfers. By contrast, if a French affiliate with losses grants Lexel AB the loan to finance the internal share deal, the loan is automatically considered to be tax-motivated according to Paragraph 10 d subpara. 3 of the law on income tax. This legislation introduces a different tax treatment of a Swedish group company in view of the tax-effective deduction of interest expenses from intra-group loans, depending on whether the lending group company is located in Sweden or in another member state. Pursuant to Chapter 35 of the Swedish law on income, it is not possible to make intra-group transfers between Swedish companies and foreign affiliates. As already mentioned before, affiliated Swedish companies¹⁵ do not actually need to practice group taxation to receive tax deduction from intra-group loans, even if these loans have been specifically concluded to offset losses. Thus, Swedish groups of companies receive tax-effective deduction of interest ex-

¹¹ Paragraphs 10a to 10f of the Swedish Law on Income Tax.

¹² Paragraph 10a of the Swedish Law on Income Tax.

¹³ Swedish “group taxation” according to Chapter 35 of the Swedish Law on income tax.

¹⁴ Preparatory working documents to the exception in the third subparagraph of Paragraph 10 d, prop. 2012/13:1 pp. 250–254. See also Högsta förvaltningsdomstolen, Request for a preliminary ruling of June 25, 2019, C-484/19, para. 33.

¹⁵ Swedish groups of companies.

Figure 2

pense in Sweden making it possible to offset Swedish gains against losses, while multinational groups gets excluded from these tax advantages in Sweden. The Swedish subsidiary Lexel AB of a French parent company receives less favorable tax treatment than enjoyed in cases in which the parents are a Swedish company. In the case at hand, this different tax treatment by Sweden makes it less attractive for companies established in other member states to exercise the freedom of establishment, and they may, in consequence, refrain from acquiring, creating, or maintaining a subsidiary in Sweden (CJEU, 2002a). What is more, the Swedish tax rules do defacto disadvantage multinational groups in comparison to Swedish groups (CJEU, 2020). In summary, the Swedish adverse tax treatment of Lexel AB constitutes a restriction on the freedom of establishment.

However, a difference in treatment stemming from a member state's legislation (here Sweden) to the detriment of companies exercising their freedom of establishment does not constitute an obstacle to that freedom if it relates to situations that are not objectively comparable or is justified by an overriding reason in the public interest and proportionate to that objective (CJEU, 2018b).

4.3 Objective comparability of the situations

The comparability of the cross-border and the national situation must be examined in regard to the purpose and the content of the national provisions in question (CJEU, 2014). In the present case, the difference in tax treatment stems primarily from Paragraph 10 d subpara. 3 and also from Chapter 35 of the Swedish law on income tax, according to which, foreign companies cannot be part of a Swedish group tax-

ation (intra-group transfers). Paragraph 10 d subpara. 3 qualifies intra-group loans between a Swedish company as borrower and an affiliate lender as not tax-motivated or abusive if the parties have, in theory, the opportunity to use the Swedish intra-group transfers. This means that the tax deductibility of interest expenses at the level of the borrowing Swedish company (Lexel AB) depends on whether the parties could principally be able to form a Swedish group taxation. Similar to the X BV case in C-398/16 (CJEU, 2018c), Paragraph 10 d subpara. 3 does not itself draw any distinction according to whether or not the relevant intra-group loan is cross-border (Högsta förvaltningsdomstolen, 2019b). The comparability of the situations must be examined in the light of the purpose of Chapter 35 of the Swedish law on income tax (intra-group transfers) (CJEU, 2018d) in conjunction with Paragraph 10 d subpara. 3. The mere possibility of Swedish group taxation (intra-group transfers) leads to the effect that intra-group loans between affiliate parties are recognized for tax purposes, especially at the level of a receiving Swedish company¹⁶. Therefore, in relation to this aim pursued by the Swedish tax rules the situation between a Swedish subsidiary having a parent company resident in another member state and a Swedish subsidiary with a Swedish parent company is objectively comparable (CJEU, 2007d). Both groups seeks to benefit from the Swedish group taxation system, which allows the tax recog-

¹⁶ Secondary tax advantage of the group taxation. Swedish companies do not necessarily have to practice group taxation (intra-group transfers) to get their internal loans recognised for tax purposes. See Paragraph 10 d subpara. 3.

inition of the internal loan for Swedish tax purposes¹⁷. The situation of a foreign parent company or group wishing to participate in the secondary tax advantages of group taxation in the subsidiary's state and a parent company, is resident in the subsidiary's state and who is automatically entitled to the secondary benefits of such group taxation, is objectively comparable (settled case law (CJEU, 2007e)). Therefore, the cross-border and the national situations are comparable in the light of the combination of the Swedish provisions (Paragraph 10 d subpara. 3 and Chapter 35 of the Swedish law on income tax), and there is a difference in treatment. Thus, an unlawful restriction of the freedom of establishment by the host member state Sweden can only be avoided if that difference is justified by overriding reasons in the public interest.

4.4 Justification

To justify the difference in treatment, the following arguments have to be reviewed: (1) the need to safeguard the allocation of the power to impose taxes between the member states, (2) the need to ensure the coherence of the Swedish tax system, and (3) the objective of the fight against tax evasion and fraud.

First, the aforementioned difference in treatment may be justified by the need to safeguard the allocation of the power to impose taxes between the member states. In this context, and following from settled case law, a member state may limit the primary tax advantages of a group taxation system, namely the consolidation of profits and losses, to pure domestic situations to safeguard its power to impose taxes. However, the deduction of interest expense from internal funding has nothing to do with intra-group transfers. The loan is a separate fact and far away from paying group contributions in the amount of losses to offset gains and losses. The deduction of interest expense from intra-group loans at the level of a Swedish group subsidiary is not an advantage of the Swedish group taxation system (intra-group transfers). The deductibility of such interest expenses is in principle equally restricted for affiliated companies, regardless of whether they are multinational groups or Swedish groups (Paragraph 10 d subpara. 3). However, only in the case of Swedish groups, the deduction restriction is waived due to the possibility of applying group taxation irrespec-

tive of whether they actually practice such group taxation, and the intra-group debt is, therefore, automatically not classified as tax-motivated. Furthermore, in these domestic cases, the interest on intra-group loan reduces the amount for group contribution payments, so only in domestic cases, intra-group debt financing is available for the shifting of Swedish profits in addition to group taxation, but not in comparable cross-border situations. In addition, Swedish groups do not actually need to practice group taxation and have to make any group contribution payments to be exempt from the interest deduction limitation of Paragraph 10 d subpara. 3 in regard to internal loans, even if those are related to the internal acquisition of shares. Importantly, in this context, the Swedish rules do not link the entitlement to deduct interest expense at the level of the paying Swedish subsidiary with the taxation of the corresponding interest income at the level of the recipient (lender), because in domestic cases, the deduction is not restricted even if the receiving Swedish affiliate is offsetting the interest earnings against losses¹⁸. In comparable domestic group situations, Sweden does not limit the deduction of interest expenses, although the receiving Swedish group company can offset the interest income against losses. In reality, the freedom of cross-border funding is restricted for foreign groups in connection with Swedish subsidiaries. To sum up, the difference in treatment at issue cannot be justified by the need to safeguard the allocation of the power to impose taxes between the member states.

Second, the need to ensure the coherence of the Swedish tax system could justify the difference in treatment. According to the settled case law, the coherence may constitute an overriding reason in the public interest if there is a direct link between the tax advantage concerned and the offsetting of that advantage by a particular tax levy. There must be a direct link between the tax advantage concerned and the offsetting of that advantage by a particular tax levy; the direct nature of that link must be examined in the light of the objective pursued by the rules in question (CJEU, 2018e). However, such a direct link does not

¹⁷ In relation to the aim purposed by the Swedish tax rules, the situation of a Swedish subsidiary that wants to deduct interest expense arising from internal loans and belonging to a multinational group and the same Swedish subsidiary, which is part of a Swedish group, is not different.

¹⁸ In its request for a preliminary ruling, Paragraph 61, the Swedish Supreme Administrative Court (Högsta förvaltningsdomstolen) seems to point out that the Swedish rules focus on the taxation of the interest income at the level of the recipient for Swedish tax purposes. However, this is not true. The restriction does not intervene even if the interest income is offset by losses at the level of the receiving Swedish company. Moreover, the taxation of a possible group contribution payment at the level of a Swedish company is not equivalent to the taxation of interest income. In contrast to the opinion of the Swedish Supreme Administrative Court, the findings in X BV, C-398/16 can be directly transferred to the Swedish rules.

exist. The coherence of the Swedish group taxation system (internal-group transfers) is not jeopardized because foreign companies have no access to this tax regime from the very beginning. Therefore, foreign companies cannot circumvent the Swedish group taxation system. The deduction of interest expenses is a completely different issue than group contributions and does not relate specifically to the consolidation. As a matter of fact, there is no tax advantage in relation to foreign groups that is offset by a tax burden. Rather, there is a double burden with regard to foreign groups. The failing access to Swedish group taxation is additionally combined with the restriction in deducting interest expense from internal loans at the level of a Swedish affiliate, whereas Swedish groups are not faced by this double burdens.

Furthermore, as already shown, Swedish groups have the additional option of intra-group financing to shift profits from profitable Swedish companies to loss-making Swedish group companies without jeopardizing the rules of the Swedish group taxation system. Thus, the Swedish group taxation system is not affected at all if the deduction of interest expense is granted in the same way to foreign groups. In the case under consideration, one should also bear in mind that the issue is really not about Swedish group taxation. The issue at hand has nothing to do with the coherence of the Swedish group taxation system (intra-group transfers). Actually, one and the same group loan is once treated as non-tax-motivated if the lender is a Swedish group company; and considered to be tax-motivated if the lender is a foreign group company. Only in the last case, tax-effective interest deduction is restricted at the level of the same paying Swedish group company, whereas in the first case, tax-effective deduction of the interest expense will be given, irrespective of the fact that the corresponding interest earnings get neutralized at the level of the receiving Swedish company (lender) by losses. Any coherence of the combined Swedish tax rules is not given and cannot be found, too. Rather, there is a lack of a coherent provision on the deduction of interest expense stemming from intra-group debt financing. In reality, there is a combination of regulations at hand that are worked in such a way that only domestic groups can fulfil the requirements¹⁹, and consequently, foreign groups are excluded from a tax advantage through this legislative framework. The tax benefit of deducting interest expenses stemming from group loans is reserved for domestic groups only, particularly with regard to internal share deals. Finally, there is not a direct link between the tax advantage (non-taxation of the interest in-

come in Sweden in the hands of the lending foreign group company) and the offsetting of that advantage by a particular tax levy (interest deduction limitation at the level of debt financed Swedish subsidiary) within the meaning of the coherence, as the taxpayer is not one and the same person; the lending foreign group company and the borrower, the Swedish group subsidiary, are different persons. With the *Lankhorst-Hohorst* case, C-324/00, Para. 42, the court has already decided this in the case of intra-group debt financing (CJEU, 2002b). In summary, the difference in treatment referred above cannot be justified by the need to ensure the coherence of the Swedish tax system.

Third, the difference in treatment may be justified by the objective of the fight against tax evasion and fraud. Therefore, the national tax legislation must specifically relate to wholly artificial arrangements aimed at circumventing the application of the legislation of the member state concerned (CJEU, 2006). According to settled case law, an internal loan is in principle not tax-abusive, and the reduction in tax revenue does not constitute an overriding reason in the public interest (CJEU, 2002c). Moreover, the Swedish interest limitation rule in consideration (Paragraph 10 d subpara. 3) does not have the specific purpose of preventing wholly artificial arrangements designed to circumvent Swedish tax legislation because one and the same intra-group loan is not considered tax-motivated if the lender is a Swedish company, instead of a foreign group company. In such situations, even in intra-group cases, the court already decided that there is no risk of tax evasion at hand if the shifted income is subject to the tax legislation in the member state of the receiving group company (CJEU, 2002d). The taxation of the interest income at the level of a French group company (lender) is equivalent to the taxation of a lending Swedish group company and cannot be regarded as tax-abusive in any way²⁰. What is more, the court has already decided on the tax abuse of debt-financed intra-group share deals (X BV, Para. 50). Pursuant to the CJEU, the risk that such a loan does not reflect a genuine economic transaction and is intended simply to create a deductible charge artificially is no less if the parent company and the subsidiary are both resident in the same member state than if the affiliates are resident in different member states (CJEU, 2018e). The fact that only domestic groups can enter into a group taxation system is irrelevant. Furthermore, the Swedish rules on group taxation are not circumvented in any way. Foreign companies have no access to

¹⁹ Defacto disadvantage of foreign groups.

²⁰ A low tax rate at the level of a company (recipient) alone cannot be regarded as tax-abusive. See CJEU (Grand Chamber), Judgment of February 26 2019, C-135/17, X GmbH, ECLI:EU:C:2019:136, para. 86.

the Swedish intra-group transfers. Thus, they are from the very beginning not able to circumvent these rules. A loan relationship is a separate and independent tax fact that has nothing to do with any group contribution payment. This becomes particularly clear if one looks at a domestic group of companies in which intra-group loans are tax recognized in addition to the payment of group contributions, but also irrespective of any group contribution payment. In fact only foreign groups gets restricted in the way of finance Swedish subsidiaries. Accordingly, foreign groups are restricted in the formation of the capital structure of Swedish subsidiaries. To conclude, the difference in treatment cannot be justified by the objective of the fight against tax evasion and fraud.

4.5 Unlawful restriction of the freedom of establishment

The Swedish interest deduction limitation rules²¹ on intra-group debt financing are not compatible with Articles 49 and 54 TFEU. According to the primacy of EU law, these rules are inapplicable in the case of Lexel AB, C-484/19. It is not compatible with Article 49 TFEU to refuse a Swedish subsidiary the tax-effective deduction of interest expense paid on intra-group loan if the lender is an affiliate company having its residence in another member state, whereas a full deduction is given if the internal lender is a Swedish group company. Moreover, it is irrelevant that in cases of intra-group lending, Swedish group companies could apply the rules of the Swedish group taxation (intra-group transfers), as a loan relationship is a separate and independent tax aspect and it has nothing to do with group taxation, especially nothing with the payment of group contributions. Moreover, according to EU law, a member state, here Sweden, cannot refuse foreign group companies' secondary tax advantages that are legally linked with a domestic group taxation regime.

5 Interest limitation rules and the theory of finance

The embedding of tax-oriented interest limitation rules in the theory of financing and practice of corporate finance should be reviewed. The Swedish interest deduction limita-

tion on affiliates is a prime example of how foreign groups' leverage is restricted against domestic groups. The freedom of financing gets limited in regard to cross-border situations and multinational groups. Compared to Swedish groups of companies, multinational groups are not free in choosing the financing method of their Swedish subsidiaries. Furthermore, the Swedish rules unilaterally restrict intra-group financing as a tax planning instrument, however, only for foreign groups of companies and create international double taxation. In terms of its practical application, the Swedish interest deduction limitation rule is very critical. The rule is working with a general abuse definition, a vague legal concept, and from a methodical point of view, it is hardly possible to define by law when exactly a tax abuse is at hand.

From the perspective of financing theory, such a concept is also inappropriate, as the leverage, including internal debt, should preferably depend on economic factors, like profitability, liquidity, and the ability to repayment (debt service) of the company. In that respect, there may be an improvement in sight, especially by the implementation of the interest limitation rule of Art. 4 ATAD as of January, 1, 2019, in all member states. In line with Art. 4 ATAD, the deduction limitation now applies in relation to the taxpayers' exceeding borrowing costs without distinction of whether the costs originate in debt taken out nationally, cross-border, or whether they originate from third parties, associated enterprises or intra-group (Council Directive, 2016/1164b). This is an advantage because there is no longer a distinction between external and internal debt financing and borrowing and companies, in particular multinational groups, receive more freedom to finance. Moreover, the equity-to-assets ratio test (equity escape) allows a kind of motive test, as the debt-financed company is able to demonstrate that its equity over total assets' ratio is broadly equal to or higher than the equivalent group ratio (Council Directive, 2016/1164c). This is really a more fine-tuned approach than a general abuse rule to identify inappropriate debt financing in a group of companies. Within a group of companies, it is possible to find out exactly whether a particular group company has excessive debt financing compared to the group. At the same time, the group companies have a wider scope to determine their individual leverage ratio. What is more, the safe harbor rule of net interest expenses in the amount of EUR 3,000,000 allows the single enterprise the totally free choice of the financing instrument without any restrictions or without having to adhere to a certain equity ratio. In numbers, this means that each single enterprise can have a volume of up to EUR 60,000,000 debt at an interest rate of 5% without suffering any restriction in the tax deductibility of inter-

²¹ Paragraph 10 d subpara. 3 in combination with Chapter 35 of the Swedish law on income tax.

est expense. Within the aforementioned safe harbor, debt ratios of more than 99% are possible without having to meet certain equity requirements. This leads to more flexibility in corporate financing, particularly helping small and medium-sized operations.

Finally, fixing the deductibility of net interest expense to the taxpayer's EBITDA²² is the right approach. That approach allows the prevention of excessive interest payments from the perspective of tax law and also gives enterprises at the same time the maximum freedom of financing in terms of the theory on financing. Moreover, this approach is economically justified. A single enterprise may deduct net interest expenses up to an amount of 30% of its EBITDA per fiscal year, Art. 4 (1) ATAD. The EBITDA stands for the liquidity of an enterprise and reflects the ability to meet its financial obligations and to pay back its debts. Analytically, EBITDA is often used as a cash flow approximation. Therefore, in the finance theory the "Interest Coverage Ratio" (ICR) is used and calculated as follows:

$$\text{Interest Coverage Ratio (ICR)} = \frac{\text{EBITDA}}{\text{Interest expenses}}$$

According to Art. 4 (1) ATAD, the taxpayer can deduct net interest expense up to 30% of its EBITDA. This can be transformed into an ICR: $1/0.3 = 3.33$. Thus, the 30% EBITDA ratio in Art. 4 (1) ATAD is economically and in the sense of the finance theory, nothing more than an inverse ICR. The ICR stands for the ability of an enterprise to generate cash from own operations to meet its interest obligations. Pursuant to the theory of finance, it is a warning signal when the ICR falls below 2.5. Investors and banks already see an ICR of 2.5 as a warning signal²³. Analysts normally want to see an ICR of 3 or better (Damodaran, 2010)²⁴. Otherwise, the enterprise is not generating enough cash to pay the interests and to repay the outstanding loan obligations (interest and principal). It cannot cover any cash flow fluctuations. Therefore, the 30% EBITDA rule is a suitable approach to prevent excessive debt financing, from the perspective of tax law and also economically and in terms of the theory of corporate finance. At the same time, the individual profitability of the borrowing company is taken into account because a company with a higher profitability can bear a

higher interest burden and can repay more debt and therefore receives a higher volume of debt financing. With the implementation of Art. 4 of the ATAD, the member states seem to be on the right way to cope with the problem of profit shifting by interest payments and also maintaining a balance to adequate corporate finance and preserving the freedom of finance.

Within the 30% EBITDA rule of Art. 4 ATAD, the member states are in principle not able to consider loans as tax abusive and cannot refuse in this relation the deductibility of interest expenses. In that respect, secondary law sets a fixed standard for adequacy and acts as a barrier for the member states. To that extent the current Swedish rules²⁵ on the limitation of the deductibility of interest expenses in a group of associated enterprises, referring to receive a substantial tax benefit, may infringe European secondary law²⁶. Receiving a substantial tax benefit by the use of intra-group financing is not in any way a relevant criterion of Art. 4 ATAD and must therefore be disregarded.

6 Summary and Conclusion

This article has been engaged in the examination of the freedom of financing in multinational groups against the background of EU law and the theory of finance. In that context, the pending CJEU case *Lexel AB*, C-484/19, dealing with Swedish tax law, has been analyzed in terms of its compatibility with the freedom of establishment (Art. 49, 54 TFEU). The faced Swedish interest deduction limitation rules on affiliates are a prime example of how intra-group financing within foreign groups gets restricted against domestic groups. Moreover, the Swedish rules consider cross-border intra-group financing principally as tax-motivated and abusive, whereas the same financial transaction within Swedish groups is fully recognized for tax purposes. Another symptomatic element of this tax legislation is that the permission to deduct interest expense in cases of affiliate groups is legally connected with the theoretical access to a domestic group taxation system. However, this requirement can only be fulfilled by domestic groups, and there are defacto disadvantages for foreign groups at hand. The Swedish interest limitation rules in affiliate groups (C-484/19) operate with a vague legal concept of a general abuse definition and are fully inappropriate to identify ex-

²² Earnings before interest, tax, depreciation, and amortization.

²³ An ICR of 2.5 is corresponding to a firm's synthetic (credit) rating of Baa2/BBB (larger firms with market cap > \$ 5 billion), respective B1/B+ (smaller firms). The rating provides information about the creditworthiness (obligor's overall financial capacity) and also default. See Standard and Poor's Definitions, Bankersalmanac.com. Retrieved June 22, 2020.

²⁴ An ICR of 3.0 is corresponding to a firm's synthetic (credit) rating of A3/A (larger firms), respective Ba2/BB (smaller firms).

²⁵ Prop. 2017/18:245 p. 184.

²⁶ Moreover, there is a breach of primary law (Art. 49 TFEU). See accordingly, Section 4.

cessive and tax-motivated debt financing. They are not in any way in line with settled case law and the concept of the CJEU to combat tax evasion and fraud, respective to the avoidance of circumventing national tax law of the member state concerned. From the perspective of the financing theory, the Swedish interest limitation rules in affiliate groups (C-484/19) have to be rejected because they do not consider economic factors of the debt-financed Swedish subsidiary, like profitability, liquidity, and the ability to repay. A detailed analysis under Union law shows that the Swedish interest limitation rules in C-484/19 breaches the freedom of establishment and therefore cannot be applied in the case of Lexel AB. Thus, the CJEU will find an unlawful discrimination in terms of the Articles 49 and 54 TFEU by the host member state Sweden. The implementation of Art. 4 ATAD will lead to improvement, especially in cross-border financing situations, because this approach is more focused on economic factors and the principles of the finance theory, like the ICR. With the implementation of Art. 4 of the ATAD, the member states seem to be on the right way to tackle with the problem of profit shifting by interest payments and also maintaining a balance to adequate corporate finance and preserving the freedom of finance, particularly in multinational groups. Importantly, European secondary law, the 30% EBITDA rule, also sets out a fixed standard for adequacy and acts as a barrier for the member states. Within this threshold, the member states can principally not refuse the deductibility of interest expenses with the argument of tax abuse or the achievement of substantial tax benefits. The achievement of substantial tax benefits by using intra-group financing is not a relevant criterion of Art. 4 ATAD and is therefore irrelevant. This enhances intra-group financing as a tax planning tool in multinational groups. Also, the current Swedish rules on the limitation of the deductibility of interest expenses in affiliated groups, which refer to receive a substantial tax benefit, may infringe European secondary and primary law. Consequently, these regulations are not applicable.

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