European Union

*CFE ECJ Task Force**

Opinion Statement ECJ-TF 1/2021 on the ECJ Decision of 20 January 2021 in *Lexel AB* (Case C-484/19) Concerning the Application of the Swedish Interest Deductibility Rules

This CFE Opinion Statement, submitted to the EU Institutions on 9 April 2021, addresses the decision of the Court of Justice of the European Union (First Chamber) (ECJ) of 20 January 2021 in *Lexel AB* (Case C-484/19).[1] The ECJ gave its decision without an Opinion of an Advocate General. The case concerned the application of the Swedish interest deductibility rules.

1. Executive Summary

The case concerned the Swedish interest deductibility rules. In Sweden, interest payments are generally deductible. As an exception to this rule, interest payments made to an associated company are generally not deductible. Interest may be deductible, however, if the underlying debt is justified on commercial grounds. Interest payments between two Swedish associated companies are always deductible due to the intra-group financial transfer system. The ECJ had to decide whether or not the difference in treatment of interest payments made to other EU companies, in comparison to interest payments made to Swedish companies, can be justified by overriding reasons in the general interest.

The ECJ held that the Swedish rules were not compatible with the freedom of establishment. It held that the different treatment could neither be justified by the need to fight tax evasion and tax avoidance nor by the need to maintain a balanced allocation of the power to impose taxes between the Member States. In addition, the Court also stated that even if the transaction in question represents a purely artificial arrangement, the principle of proportionality requires that interest payments that are in line with the arm's length principle must be deductible.

The decision is of particular interest as many EU Member States have introduced similar interest deductibility rules. Further, it is of interest in respect of the proposed source state rules under the OECD's Pillar Two Blueprint.[2]

2. Background and Issues

Swedish law provides special rules for companies that are members of an associated group. In general, interest payments made by a group member to another group member are not deductible for tax purposes. However, if the interest is taxed at the level of the recipient group member at a nominal rate of at least 10% (under the assumption that the recipient only has that income), the payments are deductible at the level of the group member making the interest payments ("the 10% rule"). As an exception to the "10% rule", interest payments are not deductible if the main reason for incurring the debt is that the group would receive a substantial tax benefit ("the exception").[3] However, and what was decisive as a comparator in the case, the "exception" could not be applied in a purely internal Swedish situation, as two Swedish group companies would be in a position to carry out intra-group financial transfers and hence achieve deductibility without being subject to any limitation referring to a substantial tax benefit.

Lexel AB is a Swedish company that is part of the French multinational Schneider Electric group. In December 2011, Lexel AB acquired 15% of the shares of a Belgian group member from a Spanish group member. This acquisition was financed through a loan from a French "internal bank" (Bossière Finances SNC), a member of the Schneider Electric group. In 2013 and 2014, Lexel AB made interest payments of approximately EUR 5.5 and 5.9 million to the French bank. Bossière Finances SNC was able to offset the interest income against losses incurred in respect of other transactions.

The Swedish tax administration denied the interest expense deduction. Although it acknowledged that the requirements of the 10% rule were met, it argued that the

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1. SE: ECJ, 20 Jan. 2021, Case C-484/19, *Lexel AB v. Skatteverket*, Case Law IBFD.

2. *See* the proposed Undertaxed Payments Rule in OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar II Blueprint* p. 121 et seq. (OECD 2020).

3. On the other hand, interest is deductible even if the 10% rule is not met if the underlying debt is justified primarily on commercial grounds and the group member receiving the interest payment is established in an EEA country or in a state with which Sweden has concluded a tax treaty.

Schneider Electric group wanted to obtain a substantial tax benefit by transferring the shares from a Spanish group member to a Swedish group member with the intention of deducting the interest expenses in Sweden instead of in Spain.

Lexel AB appealed the decision of the tax administration. Both the Court of First and Second Instance upheld the decision of the tax administration. The Courts analysed the compatibility of the Swedish rules with the freedom of establishment but came to the conclusion that the restriction on the freedom of establishment could be justified by overriding reasons in the general interest. The case then reverted to the Swedish Supreme Administrative Court, which decided to stay the proceedings and refer the following questions to the ECJ for a preliminary ruling:

> Is it compatible with Art. 49 TFEU to refuse a Swedish company a deduction for interest paid to a company which is in the same group of associated companies 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 companies 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 financial transfers?

3. ECJ Decision

The Court started its analysis by examining whether or not there was a difference in treatment.[4] It held that Lexel AB was treated in a more burdensome way, as it was not allowed to deduct the interest payments made to the French group member. The deduction was denied, as the Schneider Electric group allegedly wanted to obtain a substantial tax benefit. It is for the company seeking the deduction to show that the debt was not incurred mainly for tax reasons. In a purely domestic setting, intra-group financial transfers would be deductible. As a result, the substantial tax benefit exception is never an issue in the domestic context. By contrast, the exception might be applicable where the recipient of the interest is established in another Member State. Such a difference in treatment is only compatible with the freedom of establishment if it relates to situations that are not objectively comparable or if it is justified by an overriding reason in the public interest and is proportionate to that objective.[5]

The Court then concluded that the cross-border situation was comparable to a purely domestic situation. Comparability has to be examined having regard to the purpose and content of the national provisions in question.[6] A situation in which a company established in one Member State makes interest payments to a company established in another Member State, belonging to the same group, is no different from a situation in which the recipient of the payments is a company of the same Member State and belongs to the same group.

The Court then turned to the issue of justification. Citing its long-standing case law, it stated that a restriction on the freedom of establishment is only permissible if it is justified by overriding reasons in the public interest, if it is appropriate to ensure the attainment of the objectives and if it does not go beyond what is necessary to attain those objectives.[7] The Court examined whether or not the different treatment could be justified first by the need to fight tax evasion and, second, by the need to maintain a balanced allocation of the power to impose taxes between the Member States.

With regard to the fight against tax evasion and tax avoidance, the Court held that the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality. In determining whether or not a transaction represents a purely artificial arrangement entered into for tax reasons alone, the taxpayer must be given the opportunity, without being subject to an undue administrative burden, to provide evidence of any commercial justification that there may have been for that arrangement.[8] In addition, the Court stated that even if a purely artificial arrangement without any underlying commercial justification can be assumed, according to the principle of proportionality, an interest payment under an arm's length transaction should nevertheless be deductible.[9]

The Swedish rule did not specifically target wholly artificial arrangements. It also applied to transactions that were carried out at arm's length and that were not purely artificial or fictitious arrangements. As a consequence, the Swedish rule was not proportionate and could not be justified by the need to fight tax evasion and tax avoidance.[10]

The ECJ went on to examine whether or not the different treatment could be justified by the need to safeguard the allocation of the power to impose taxes between the Member States. Such a justification is possible where the system in question is designed to prevent conduct that is liable to jeopardize the right of a Member State to exercise its power to tax in relation to activities carried out in its territory. The provision at issue seeks to prevent the erosion of the Swedish tax base through interest payments to foreign companies. Such an objective, however, should not be confused with the need to preserve the balanced allocation of the power to impose taxes between the Member States. A mere reduction in tax revenue cannot be regarded as an overriding reason in the public interest that may be relied upon to justify a measure that is, in principle, contrary to a fundamental freedom. Moreover, as an additional argument, the Court noted that the interest payments made to the French internal bank would have been deductible had the French bank not been a group member. Where, however, the conditions of a cross-border intra-group transaction and an external cross-border transaction correspond to those on an arm's length basis, there is no difference between those transactions in terms of the balanced allocation of the power to impose

4. *Lexel* (C-484/19), *supra* n. 1, para. 35 et seq.
5. Id., at para. 42.
6. Id., at para. 43.
7. Id., at para. 46.
8. Id., at para. 50.
9. Id., at para. 51.
10. Id., at para. 57.

taxes between the Member States.[11] As a result, the restriction could not be justified by the need to preserve a balanced allocation of the power to impose taxes between the Member States.

The Court then analysed whether the justification was possible by taking both grounds of justification together. It referred to *SGI* (Case C-311/08),[12] wherein a restriction was justified by the need to fight tax avoidance taken in conjunction with the objective of preserving the balanced allocation of the power to impose taxes between the Member States. It explained that both objectives are linked to one another. Conduct involving the creation of wholly artificial arrangements very often undermines the right of the Member State to exercise its tax jurisdiction in relation to those activities and jeopardizes a balanced allocation between the Member States of the power to impose taxes. If, however, a measure is clearly not based on the need to preserve a balanced allocation of the power to impose taxes between the Member States, it cannot be justified based on two grounds taken together.

The ECJ concluded that a justification was not possible and that, as a consequence, the Swedish rules were not in line with the freedom of establishment.[13]

4. Comments

In many regards, *Lexel* confirms the prior ECJ case law. The decision further illustrates the meaning of the two grounds of justification, i.e. the "fight against tax evasion and tax avoidance" and a "balanced allocation of taxing rights". The Court also clarified that arguments such as "counteracting aggressive tax planning in the form of the deduction of interest expenses"[14] are relevant to safeguard a restrictive domestic measure under the first justification only to the extent that the domestic measure targets wholly artificial arrangements. Furthermore, fighting the erosion of a Member State's domestic tax base is not a justification ground and cannot be considered under the balanced allocation of taxing powers because it merely aims to safeguard the tax revenue of a Member State, which is not an overriding reason of public interest justifying a domestic measure.[15]

The decision in *Lexel* shows that a prima facie restrictive or discriminatory domestic measure can only be applied to deny (domestic) tax benefits for the specific objective of targeting wholly artificial arrangements, following a proportionality analysis.[16] Furthermore, the Court reaffirmed that the arm's length standard works as a sort of taxpayer's safeguard to the extent that, if a transaction is at arm's length, it shall never be considered a wholly artificial arrangement.[17] This strong taxpayer "safe harbour", which is already known from cases such as *Thin Cap Group Litigation* (Case C-524/04),[18] *SGI*[19] and *Hornbach-Baumarkt* (Case C-382/16),[20] was strongly upheld by the Court: first, the Court noted that even where a transaction:[21]

> represents a purely artificial arrangement without any underlying commercial justification, the principle of proportionality requires that the refusal of the right to a deduction should be limited to the proportion of that interest which exceeds what would have been agreed had the relationship between the parties been one at arm's length.

Second, the Court found that the Swedish "exception" (and the consequential denial of deductibility) also covered transactions that are carried out at arm's length "and which, consequently, are not purely artificial or fictitious arrangements created with a view to escaping the tax normally due on the profits generated by activities carried out on national territory".[22] This effectively elevates the arm's length standard to a contraposition of "purely artificial or fictitious arrangements" and seems to bar Member States' rules from denying the deduction of payments that are at arm's length.[23]

Lexel also sheds further light on the possibility to combine several grounds of justification. Such a combination was first recognized in *Marks & Spencer* (Case C-446/03),[24] even though the importance of relying on multiple grounds of justification remained opaque.[25] However, if

11. Id., at para. 69.
12. BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 66, Case Law IBFD.
13. *Lexel* (C-484/19), para. 78.
14. Id., para. 52.
15. Id., para. 67.
16. Id., para. 46 et seq., confirming, for example, UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case Law IBFD. *See also* the *Opinion Statement of the CFE ECJ Task Force on The Concept of Abuse in European Law, Based on the Judgments of the European Court of Justice Delivered in the Field of Tax Law–November 2007*, 48 Eur. Taxn. 1 (2008), Journal Articles & Opinion Pieces IBFD.
17. *Lexel* (C-484/19), para. 51 and *SGI* (C-311/08).
18. UK: ECJ, 13 Mar. 2007, Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, Case Law IBFD.
19. *SGI* (C-311/08). *See also* CFE Fiscal Committee, *Opinion Statement of the CFE on the Case Law of the European Court of Justice on Transfer Pricing Related to Loans (Decision of 21 January 2010 in Case C-311/08, SGI): Submitted to the European Institutions in February 2012*, 52 Eur. Taxn. 6 (2012), Journal Articles & Opinion Pieces IBFD.
20. DE: ECJ, 31 May 2018, Case C-382/16, *Hornbach-Baumarkt-AG v. Finanzamt Landau*, Case Law IBFD. *See also* CFE ECJ Task Force, *Opinion Statement ECJ-TF 1/2019 on the ECJ Decision of 31 May 2018 in Hornbach-Baumarkt (Case C-382/16) Concerning the Application of Transfer Pricing Rules to Transactions between Resident and Non-Resident Associated Enterprises*, 59 Eur. Taxn. 9 (2019), Journal Articles & Opinion Pieces IBFD.
21. *Lexel* (C-484/19), para. 51.
22. Id., para. 56.
23. However, it is still unclear whether the Court views the arm's length principle as being relevant in merely "pricing" a specific transaction (for example, with regard to the interest rate) or if it will take a broader approach. Such a broader approach could mean that the Court applies an arm's length analysis to the whole commercial "relationship" between associated enterprises (for example, whether a loan would be given between unrelated parties in the first place), and even consider underlying transactions that have led to the commercial "relationship" in the first place (for example, the debt-financed transfer of shares between associated enterprises). Indeed, the Court in *Lexel* (C-484/19) refers to the absence of any artificial transfer in para. 55.
24. UK: ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Case Law IBFD.
25. In DE: ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v. Finanzamt Heilbronnl*, Case Law IBFD, for example, the Court was already satisfied with only two of the three grounds of justification taken together in *Marks & Spencer*. In *Lexel* (C-484/19), the Court moreover indicated that "the taking into consideration of those grounds of justification together has been accepted by the Court in very specific situations, namely where the fight against tax avoidance constitutes a particular aspect of the public interest linked to the need to preserve a balanced allocation of the power to impose taxes between the Member States" (*see Lexel* (C-484/19), at para. 73, referring to FI: ECJ, 18 July

none of the justifications are applicable in the first place, a combination of them (non-accepted justifications) does not succeed either. As the Court states:[26]

> However, where, as in the main proceedings, the Member State in question cannot validly assert the justification based on the need to preserve a balanced allocation of the power to impose taxes between the Member States, a measure, such as that at issue in the main proceedings, cannot be justified on the basis of taking account together of the need to preserve a balanced allocation of the power to impose taxes between the Member States and of that of the fight against tax avoidance.

The decision is highly relevant with regard to the interest deductibility rules implemented by many Member States. First, *Lexel* may question the use, by the EU Member States, of the option granted by article 4(1) of the EU Anti-Tax Avoidance Directive (2016/1164).[27] This provision allows the Member States to treat domestic tax groups as a single taxpayer, which means that domestic payments between members of such a tax group are effectively disregarded (as the interest expense of one group member matches the interest income of another), whereas no similar group perspective is available for cross-border groups. Second, it might have a broader impact on international tax reform. While, in the particular case, the 10% nominal tax rate requirement was not decisive, *Lexel* does not seem to be directly relevant in ascertaining the compatibility of outbound minimum taxation rules, such as those of the OECD's Pillar Two, with EU law. One should stress that the decision in *Lexel* did not concern a domestic source state reaction to low(er) taxation in the other state. In these matters the leading cases hence remain *SIAT* (Case C-318/10)[28] and *Eurowings* (Case C-294/97)[29] and likely not *Schempp* (Case C-403/03).[30] However, the Court clarified that a different treatment of interest payments depending on whether the recipient is located in the same jurisdiction or abroad must be justified, and that, in any event, transactions at arm's length must be considered as neither purely artificial nor fictitious arrangements. That said, for example, the undertaxed payments rule (UTPR) in the OECD's Pilar Two Blueprint[31] is triggered, inter alia, by reference to low taxation of the recipient(s), which may lead to a denial of deductibility of cross-border payments. This could certainly create some tension with the Court's broader case law, including *Lexel*. It remains to be seen if global consensus, such as an agreement on the OECD's Pillars in the Inclusive Framework, would impact the Court's approach in assessing such measures (for example, with regard to possible grounds of justification) or if remaining concerns could be addressed through secondary EU legislation.

5. The Statement

The Court's decision in *Lexel* constitutes a continuation of the Court's prior case law regarding the interpretation of the "fight against tax avoidance and tax evasion" and "balanced allocation of taxing rights" justifications. The CFE welcomes these clarifications.

The Court further developed its jurisprudence and illustrated that transactions that are carried out at arm's length must not be considered to be purely artificial or fictitious arrangements, reaffirming the arm's length standard as a safe harbour for taxpayers.

Although not dealing explicitly with the relevance of the level of taxation at the level of the recipient, *Lexel* is also relevant in assessing the compatibility of existing source state deductibility rules with EU law, as well as the proposed source state rules under the OECD's Pillar Two Blueprint.

2007, Case C-231/05, *Oy AA*, paras. 58 and 59, Case Law IBFD and *SGI* (C-311/08), para. 67). It was only on that basis that the Court "has been able to hold that, given in particular the need to preserve the balanced allocation of the power to impose taxes between Member States, 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, such measures may nevertheless be justified" (*Lexel* (C-484/19), para. 75, referring to *Oy AA* (C-231/05), para. 63 and *SGI* (C-311/08), para. 66).

26. *Lexel* (C-484/19), para. 76.
27. Council Directive 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193/1 (2016), Primary Sources IBFD.
28. *See* BE: ECJ, 5 July 2012, Case C-318/10, *Société d'investissement pour l'agriculture tropicale SA (SIAT) v. État Belge*, Case Law IBFD.
29. DE: ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, Case Law IBFD.
30. DE: ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*, Case Law IBFD.
31. OECD, *supra* n. 2, at p. 121.