OPINION STATEMENT

Opinion Statement ECJ-TF 1/2021 on the CJEU decision of January 20, 2021, in Case C-484/19, *Lexel AB,* concerning the application of Swedish interest deductibility rules

Prepared by the CFE ECJ Task Force
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This is an Opinion Statement prepared by the CFE ECJ Task Force[1] on Case C-484/19, Lexel AB, in which the Court of Justice of the EU (First Chamber) (ECJ) delivered its judgment on 20 January 2021.[2] The ECJ rendered its judgment without an opinion of an Advocate General.

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 the different treatment of interest payments made to other EU companies and 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 against 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 which are in line with the arm's length principle must be deductible.

The judgment is of particular interest as many EU Member States have introduced similar interest deductibility rules, and also for the proposed Source State rules in the Pillar 2 Blueprint of the OECD.[3]

I. Background and Issues

1. 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 were to have only that income), the payments are deductible at the level of the group member making the interest payments ("the 10% rule"). As an exception to that "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").[4] However, and 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.
2. 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 with a loan received from a French internal bank of the Schneider electric group. In 2013 and 2014, Lexel AB made interest payments of

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[2] SE: ECJ, 20 Jan. 2021, Case C-484/19, *Lexel AB v. Skatteverket*, Case Law IBFD (accessed 26 Mar. 2021).

[3] See the proposed Undertaxed Payments Rule in: OECD, Tax Challenges Arising from Digitalisation – Report on Pillar II Blueprint, Paris, November 2020, p. 121 et seq.

[4] 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 the EEA or in a state with which Sweden has concluded a tax treaty.

approximately 5.5 and 5.9 million Euros to the French bank. The French bank could offset the interest income with losses incurred from other transactions.

3. The Swedish tax administration refused the deduction of the interest expenses. Although it acknowledged that the requirements of the 10% rule were met, it argued that the Schneider Electric group wanted to obtain a substantial tax benefit by transferring the shares from a Spanish group member to a Swedish group member and intending to deduct the interest expenses in Sweden instead of deducting them in Spain.

4. Lexel AB appealed against the decision of the tax administration. Both the Court of First and Second Instance upheld the decision of the tax administration. The Courts analyzed the compatibility of the Swedish rules with the freedom of establishment but came to the conclusion that the restriction of the freedom of establishment could be justified by overriding reasons in the general interest. Then the case went to the Swedish Supreme Administrative Court, which decided to stay the proceedings and to 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?"

II. The Judgment of the Court of Justice

5. The Court started its analysis by examining whether there was a different treatment.[5] 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 raised in a domestic context. By contrast, the exception might be applicable in the case 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.[6]

6. 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.[7] A situation where a company established in one Member State makes interest payments to a company established in another Member State and belonging to the same group is no different from a situation where the recipient of the payments is a company of the same Member State and belonging to the same group.

7. 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.[8] The Court examined whether the different

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[5] *Lexel*, supra n. 2, para. 35 et seq.

[6] *Lexe*l, supra n. 2,, para. 42.

[7] *Lexel*, supra n. 2,, para. 43.

[8] *Lexel*, supra n. 2, para. 46.

treatment could be justified first by the need to fight against tax evasion and, secondly, by the need to maintain a balanced allocation of the power to impose taxes between the Member States.

8. 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 which do not reflect economic reality. For the determination of whether a transaction represents a purely artificial arrangement entered into for tax reasons alone, the taxpayer must be given the opportunity, without being subject to undue administrative burdens, to provide evidence of any commercial justification that there may have been for that arrangement.[9] In addition, the Court stated that even if a purely artificial arrangement without any underlying commercial justification can be assumed, the principle of proportionality requires that interest payment of arm's length transaction are nevertheless deductible.[10]

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 which 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.[11]

10. The ECJ went on to examine whether the different treatment could be justified by the need to safeguard the allocation of the power to impose taxes between the Member States. Such justification is possible where the system in question is designed to prevent conduct that is liable to jeopardise 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. However, such an objective 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 if the French bank had not been a group member. However, where 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 taxes between the Member States.[12] 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.

11. The Court then analyzed whether the justification was possible by taking both grounds of justification together. It referred to *SGI*,[13] where a restriction was justified by the need to fight against 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 with each other. Conduct involving the creation of wholly artificial arrangements very often undermine the right of the Member State to exercise its tax jurisdiction in relation to those activities and to jeopardise a balanced allocation between the Member States of the power to impose taxes. However, if 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 by taking to grounds of justification together.

[9] *Lexel*, supra n. 2, para. 50.
[10] *Lexel*, supra n. 2, para. 51.
[11] *Lexel*, supra n. 2, para. 57.
[12] *Lexel*, supra n. 2, para. 69.
[13] ECJ of 21 January 2019, *SGI* (C-311/08), EU:C:2010:26, para. 66.

12. 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.[14]

III. Comments

13. In many regards, *Lexel* confirms the prior jurisprudence of the ECJ. The judgment further illustrates the meaning of the two grounds of justification "fight against tax evasion and tax avoidance" and "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"[15] are relevant to safeguard a restrictive domestic measure under the first justification only to the extent that the domestic measure is targeted to wholly artificial arrangements. Furthermore, fighting against 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 aims merely at safeguarding the tax revenue of a Member State, which is not an overriding reason of public interest allowing justification of a domestic measure. [16]

14. The judgment in *Lexel* shows that a *prima facie* restrictive or discriminatory domestic measure can only be applied to deny (domestic) tax benefits with the specific objective of targeting wholly artificial arrangements, following a proportionality analysis.[17] Furthermore, the Court reaffirms that arm's length standard works as a sort of taxpayer's safeguard insofar as if a transaction is at arm's length, it shall never be considered as a wholly artificial arrangement.[18] This strong taxpayer "safe harbor", which is already known from cases such as *Thin Cap Group Litigation*,[19] *SGI*[20] and *Hornbach-Baumarkt*,[21] is upheld strongly by the Court: First, the Court notes that even where a transaction "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".[22]. Second, the Court found that the Swedish "exception" (and the consequential denial of deductibility) also covered transactions which 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".[23] This effectively elevates the arm's length standard to

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[14] *Lexel*, supra n. 2, para. 78.

[15] *Lexel*, supra n. 2, para. 52.

[16] *Lexel*, supra n. 2, para. 67.

[17] *Lexel*, supra n. 2, paras 46 et seq., confirming, e.g., UK: ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case Law IBFD (accessed 26 Mar. 2021). 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, 48 Eur. Taxn. 1 (2008), Journal Articles & Opinion Pieces IBFD (accessed 26 Mar. 2021).

[18] *Lexel*, supra n. 2, para. 51. BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, Case Law IBFD (accessed 26 Mar. 2021).

[19] ECJ, 13 Mar. 2007, C-524/04, *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, EU:C:2007:161.

[20] ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, Case Law IBFD (accessed 26 Mar. 2021). 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 (accessed 26 Mar. 2021).

[21] ECJ, 31 May 2018, C-382/16, *Hornbach- Baumarkt-AG v. Finanzamt Landau*, EU:C:2018:366. See also CFE ECJ Task Force, Opinion Statement ECJ-TF 1/2019 on the CJEU decision of 31 May 2018 in Case C-382/16, *Hornbach-Baumarkt*, concerning the application of transfer pricing rules to transactions between resident and non-resident associated enterprises, 59 Eur. Taxn. (2019), 446-452.

[22] *Lexel*, supra n. 2, para. 51.

[23] *Lexel*, supra n. 2, para. 56.

the contraposition of finding a "purely artificial or fictitious arrangements" and seems to bar Member States' rules from denying the deduction of payments that are at arm's length.[24]

15. *Lexel* also sheds further light on the possibility to combine several grounds of justification. Such combination was first recognized in *Marks & Spencer*,[25] even though the importance of relying on multiple grounds of justification remained opaque.[26] However, if none of the justifications is applicable in the first place, a combination of them (non-accepted justifications) does not succeed either. As the Court states:

> "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".[27]

16. The judgment is highly relevant with regard to interest deductibility rules implemented by many Member States. First, *Lexel* may put a question mark on the use, by the EU Member States, of the option granted by article 4(1) of the ATAD. This provision allows the Member States to treat domestic tax groups as a single taxpayer, which means that domestic intra payments between members of such 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 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 for ascertaining the compatibility of outbound minimum taxation rules, such as those of the OCDE's Pillar II, with EU law. One should stress that the decision in *Lexel* did not concern a domestic source state reaction to low(er) taxation on the other State. In those matters, the leading cases hence remain *SIAT*[28] and *Eurowings*,[29] and likely not *Schempp*.[30] However, the Court clarified that different treatment of interest payments depending on whether its 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,

[24] However, it is still unclear if the Court views the arm's length principle as being relevant for merely "pricing" a specific transaction (e.g., with regard to the interest rate) or if it will take a broader approach. Such broader approach could mean that the Court applies an arm's length analysis to the whole commercial "relationship" between associated enterprises (e.g., whether a loan would be given between unrelated parties in the first place), and even consider underlying transactions that have lead to the commercial "relationship" in the first place (e.g., the debt-financed transfer of shares between associated enterprises). Indeed, the Court in *Lexel* refers to the absence of any artificial transfer in para. 55.

[25] ECJ of 13 December 2005, *Marks & Spencer* (C-446/03), EU:C:2005:763.

[26] In *Lidl* (ECJ, 15 May 2008, C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, EU:C:2008:278), for example, the Court was already satisfied with only two of the three grounds of justification taken together in *Marks & Spencer*. In *Lexel AB*, 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*, supra n. 2, para. 73, referring to EJC, 18 July 2007, C-231/05, *Oy AA*, EU:C:2007:439, paras 58 and 59, and ECJ, 21 January 2010, *SGI*, C-311/08, EU:C:2010:26, 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*, supra n. 2, para. para. 75, referring to ECJ, 18 July 2007, C-231/05, *Oy AA,* EU:C:2007:439, para. 63, and ECJ, 21 January 2010, C-311/08, *SGI*, EU:C:2010:26, para. 66).

[27] *Lexel*, supra n. 2, para. 76.

[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 (accessed 26 Mar. 2021).

[29] DE: ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna*, Case Law IBFD (accessed 26 Mar. 2021).

[30] DE: ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*, Case Law IBFD (accessed 26 Mar. 2021).

e.g., the undertaxed payments rule (UTPR) in the OECD's Pilar II 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 a global consensus, such as an agreement on the OECD's Pillars in the Inclusive Forum, would impact the Court's approach in assessing such measures (e.g., with regard to possible grounds of justification) or if remaining concerns could be addressed through secondary EU legislation.

IV. The Statement

17. The Court's decision in *Lexel* constitutes a continuation of the Court's prior case-law regarding the interpretation of the grounds of justification "fight against tax avoidance and tax evasion" and "balanced allocation of taxing rights". The CFE welcomes these clarifications.
18. 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 harbor for taxpayers.
19. Although not dealing explicitly with the relevance of the level of taxation at the level of the recipient, *Lexel* is also relevant for assessing the compatibility with EU law of existing source state deductibility rules and for the proposed Source State rules in the Pillar 2 Blueprint of the OECD.

[31] OECD, Tax Challenges Arising from Digitalisation, supra n. 3, p. 121.