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Tax Update

To whom it may concern

The Swedish government has proposed new legislation that will lead to further restrictions when it comes to the possibility to obtain tax deductions for interest costs in Swedish tax jurisdiction on loans to affiliated companies. We ask the reader to observe that the suggested legislation contains a broadening of the definition of the term "affiliated companies". Below you find an abstract of the main parts of the proposed legislation and the suggested preparations that we advise clients to undertake:

All internal debts will be comprised by the proposed law!

The current legislation is limited to deductions for interest costs on loans deriving from a group internal acquisition of shares between affiliated companies. The proposed legislation will lead interest deduction limitations that will apply to all group internal loans, no matter what the purpose of the loan, for example a loan aimed at purchasing machinery & equipment, patents and also loans granted in order to finance capital injections or dividend distributions.

The exemptions from the legislation are being narrowed!

- The 10 per cent rule

The current legislation contains exemptions stating that the interest deduction limitations do not apply if the recipient of the interest income, for example a foreign group finance company, is taxed on the interest with a level on at least 10%. This exemption Will be replaced by à reversed exemption stating that if the STA can provide evidence that the debt has arisen as à result of a transaction mainly aimed at obtaining a tax benefit for the group, tax deduction for interest costs is not granted, even if the beneficial owner of the interest income is actually taxed for this income at à level of at least ten per cent.

Short term debts that are due within a couple of months, for example in a cash-pool setup, will not be comprised by the reversed exemption. It has not been defined what should constitute a tax benefit, and this Will be defined by case law. This will of course result in a substantial uncertainty of how to interpret the regulations and therefore the proposal is likely to meet heavy criticism.

- The exemption

Even if the recipient is not taxed at a level of at least ten per cent, tax deduction for interest costs is granted if it can be proved by the taxpayer that the transactions were made mainly for business reasons. The exemption will still apply, but only if the recipient of the interest income resides within the EEA or has a tax treaty with Sweden that doesn't contain specific exemptions. When pursuing the analysis whether the transaction has business reasons, it should specifically be observed if any Group company was able to grant a capital injection instead of à loan, which is likely to cause problems at least in bigger multinational groups.

The new legislation will have retroactive effect!

The law is suggested to come into force with effect from 1 January 2013. The STA cannot challenge tax deductions made before the new legislation came into force. However, the STA can from the 1st of January 2013 go back many years in time and pursue an analysis of how the loan was setup and then the STA can challenge tax deductions made from 1 January 2013 on new as well as on old loans. Thus, the proposed legislation will have a retroactive effect.

New definition of affiliated companies!

The current rules apply for parent and subsidiaries where the ownership, directly or indirectly, is above 50 %. Under the new proposal, companies are considered to be affiliated companies with each other if one company, directly or indirectly, through ownership or otherwise have a significant influence over the other company. The proposal is aimed at being an extension of the number of companies covered by the rules. It is not described what significant influence is in detail, but it does in any case, involve a structure with a holding of just below 50 percent.

No definition of what constitutes interest!

The bill has not defined interest is, but says that that part of lease payments could be considered interest and that such part in that case could be limited by the new rules.

Suggestions for action!

- An inventory of existing debt relationships, focusing on whether the new definition of affiliated companies means that any existing debt relationship will be hit by the new rules.
- An analysis if the existing debt relationships are commercially justified. This should be done regardless of whether the recipient is taxed at 10 % or more. Prepare a defense file. The existing debt relationships must be commercially justified for both debtor and creditor.
- If the recipient is taxed at less than 10 % there is a need to conclude if the recipient is situated in an EEA country or in a country in which Sweden has an extensive tax treaty.
- An analysis if the company has current expenses to affiliated companies that could be treated as an interest expenses in a broad definition.

The corporate tax rate could be lowered!

The proposal shows that tax revenues are expected to increase by 6.29 billion, which could mean that the corporate tax rate is lowered. A rough estimation would say that this would allow for a corporation tax of 25 % instead of the current 26.3 %.

Concluding remarks

Our view is that the proposal in some parts will be very difficult to apply. The proposal, as it reads now, will create a significant legal uncertainty for companies that have internal debt relationships because each debt must be deemed commercially justified in a way consistent with the Tax Agencys assessment of what constitutes a commercially justified debt. It is also not clear which companies that are covered due to the new definition of affiliated companies. Because of the large subjective elements, it will be impossible for companies to know with certainty if the existing interest payments are tax deductible. The bill will be subjected to harsh criticism and how it is finally formed is uncertain, but it is very likely to restrain the right to interest deduction.

We are available to discuss what actions that may be appropriate at this stage. In our opinion, it is now about being aware of the bill and that it may require a heightened state of readiness for the need to implement refinancing in certain groups if the proposal goes through.

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