# Kluwer International Tax Blog

## The Contents of Highlights & Insights on European Taxation, Issue 9, 2022

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**Highlights & Insights on European Taxation**

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– ***PRA Group Europe AS v Norwegian Government*** (E-3/21). Combination of limited interest deduction rules and group contribution rules may infringe the freedom of establishment. EFTA Court

(comments by **Cécile Brokelind**) (H&I 2022/255)

Interest deduction limitation rules between associated taxpayers usually have a single purpose, which is to prevent domestic tax base erosion. Often classified as special anti-abuse rules ('SAAR', see for instance, **Article 4** of the Anti-Tax Avoidance Directive of (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, hereafter '**ATAD**'), these rules, whatever shape they take, have the purpose of preventing MNEs from choosing where to be taxed irrespective of their actual/real/territorial business situation. As noted by the EFTA Court in the present case, the purpose of such rules is to 'counteract tax adaptations whereby international groups place disproportionately large shares of a group's debts and thus interest expenses, in countries with high tax rates, whilst interest income and financial assets are channelled to group companies domiciled in countries with lower, or no taxation' (*PRA Group Europe AS*, hereafter *'PRA Group'* E.3/21, para 12). The disputed Norwegian rules (Section 6-41 of the Tax Act no. 14 of 26 March 1999) therefore limit the right to deduct net interest expenses paid to associated, both individual and corporate, taxpayers exceeding 5 million NOK (EUR 510,000.00) to an amount of 30% of the debtor's EBIDTA. Affiliated parties are individuals and corporate taxpayers in control of the borrower (direct or indirect ownership or control of 50% at any time of the tax year in question). The rules are *prima facia* non-discriminatory as they also apply in domestic situations.

It was a bit different in the 21 January 2020 *Lexel case* (C-494/19, n.y.r.) on which the EFTA Court relied in the present case involving Norway. The disputed Swedish rules provided that the deduction limitation always applied within associated companies (para. 10b, Chapter 24 of the Swedish law on income tax) unless the recipient was taxed at 10% on interest received, and even so, was able to prove that the loan transaction was not motivated mainly for tax reasons. It therefore appears that the Norwegian rules which apply regardless of the level of taxation of the recipient are even less challenging, as they simply provide for a threshold below which no deduction limitation occurs at all, irrespective of where and how much tax is paid on the interest received.

However, just as in the Swedish *Lexel* case, the interest deduction limitation can easily be set aside in domestic situations where both taxpayers qualify for the group relief regime (group contributions, Section 10-2 of the Tax Act in the case of Norway). Indeed, taxpayers can transfer taxable income to each other through a group contribution, increasing accordingly the EBIDTA of the recipient above the threshold triggering the limitation, which thereby is fully avoided. In practice, group contributions replace intercompany loans for the purpose of equalizing the tax situation within the same tax jurisdiction. True, when a contribution is transferred, it is tax deductible for the payor (like interest payment on a loan) without limitation. Nevertheless, the contribution is taxable in the hands of the recipient (unlike interest income paid to an affiliated

non-resident entity). So basically, group taxation achieves an economic neutrality, both for the group of companies and for the State, as long as no border is crossed. No tax base erosion occurs in domestic situations in respect of group taxation. There is, therefore, a kind of logic in domestic tax systems involving group contributions (Sweden, Norway, Finland), whereby taxpayers enjoy the possibility to choose which group entity will carry the weight of taxation, as long as the State does not lose its taxing powers. In other words, tax neutrality cannot be upheld when tax base erosion occurs, irrespective of whether it is cross-border or internal (domestic tax-exempt entities such as investment companies, associations and foundations cannot, as a rule, enjoy the benefits of the consolidation).

In the present *PRA Group Europe AS* case, a Luxembourgian parent company had agreed to a loan with its Norwegian subsidiary, claiming a tax deduction of interest above the limited amount of 5 million NOK for the tax years 2014 and 2015, which was refused due to the disputed rules. The Norwegian company litigated the rules for a breach of the EEA rules before the Oslo District Tax Court, which submitted on 1 July 2021 a request for a preliminary ruling to the EFTA Court (a few months after the judgment in the *Lexel* C-484/19 case was rendered). It should be noted that the ESA had delivered a reasoned opinion against Norway in October 2016, considering the limitation rules in breach of the freedom of establishment under Article 31 EEA, with no possible ground of justification. The present ruling of the EFTA Court goes in similar direction to the ESA and the previous case law of the CJ deciding that the Norwegian interest deduction limitation rules applicable to the years in question are in breach the freedom of establishment.

The EFTA Court follows a traditional legal analysis of the rules, establishing a comparability test, and finding a difference of treatment and a restriction of the freedom of establishment (point 1), without any valid justification ground (point 2).

Point 1. As regards the *comparability* of situations (i.e., a loan between domestic affiliates or between a loan between a non-resident and a domestic affiliate), the reasoning of the EFTA Court is not very lengthy. It states (para, 33) that both situations are comparable, referring to *Lexel,* para. 44 itself referring to a ruling in *X BV & X NV* (CJ 22 February 2018, C?398/16 and C?399/16, **ECLI:EU:C:2018:110**). In the *X BV & X NV* case, the Dutch deduction limitation rules were only triggered when the loan was taken out for the purpose of acquiring participations in foreign companies. In domestic situations, there was no need for a loan as the tax consolidation would have achieved a tax neutral operation, exactly as in the present Norwegian case. And of course, tax consolidation was reserved for domestic taxpayers, which, despite being restrictive of the freedom of establishment, was compatible with the fundamental freedoms, as otherwise, groups would be in a position to choose where to be taxed and the balanced allocation of taxing powers between States would be ruined (see CJ 25 February 2010, C-337/08 *X Holding*, **ECLI:EU:C:2010:89**, and CJ 18 July 2007, C-231/05 *Oy AA*, **ECLI:EU:C:2010:89**). In *X BV & X NV*, the CJ ruled that in line with previous case law (CJ 18 December 2014, C-87/13 *X,***ECLI:EU:C:2014:2459**, para. 27 and CJ 25 February 2010, C-337/08 *X Holding,* **ECLI:EU:C:2010:89**, para. 24) when the deduction limitation rules do not draw any distinction according to whether or not a group is cross-border, then the only rules that matter to *establish a comparison* are the tax consolidation rules. Also, regarding the latter, the situation of a resident parent company wishing to form a single tax entity with a resident subsidiary and the situation of a resident parent company wishing to form a single tax entity with a non-resident subsidiary are objectively comparable with regard to the *objective* of that tax scheme (to achieve group neutrality). Therefore, because cross-border and domestic groups are in comparable situations in respect of the objective of tax neutrality, so are cross-border and domestic loans

according to the EFTA Court.

One can really wonder whether this cross-referencing back to a case of 2010 explains why benefitting from group taxation rules with the purpose of neutralizing taxable income within the group makes that cross-border loans and domestic loans between affiliated taxpayers are 'comparable'. By contrast, and in *Lexel*, the CJ had identified a different legal issue, as the Swedish deduction limitation rules applied when the principal reason for the debt having arisen appears to be the obtaining of a substantial tax benefit, whereas such a tax benefit would not have been deemed to exist if both companies had been established in Sweden, as in that situation they would have been covered by the provisions on intra-group financial transfers. Accordingly, it was easier to find that 'the situation in which a company established in one Member State makes interest payments on a loan taken out from a company established in another Member State and belonging to the same group is no different, *so far as the payment of interest is concerned*, from a situation in which the recipient of the interest payments is a company belonging to the group and established in the same Member State, namely Sweden in the present case.' (C-484/19, *Lexel*, para. 44).

All cases in question bear a common feature for comparability, they all involve a special anti-abuse rule against 'thin capitalization' which apply in practice and in effect in cross-border situations only (E-3/21 *PRA Group,* para. 50). Their goal, therefore, is clearly set to protect each State's tax revenue, which never disappears in domestic situations, irrespective of whether consolidation is possible or not (neutrality means equalization of the tax burden between associated companies but not disappearing tax bases), and therefore, should be tested against the freedoms on their own merits. Usually, the CJ assesses the SAAR's compatibility with the freedom of establishment in isolation, as instructed in the generic cases CJ 12 December 2002, C- 324/00 *Lankhorst Hohorst*, **ECLI:EU:C:2002:749**, and CJ 13 March 2007, C-524/04 *Thin Cap GLO*, **ECLI:EU:C:2007:161**. However, the EFTA Court insists on the need to assess the rules in combination with the consolidation rules, given that the Norwegian rules are not *prima facie* discriminatory (even domestic taxpayers are limited in their deduction right depending on their EBIDTA). But none of the other rules in the previous cases were either.

Point 2. In respect of the justification grounds, the EFTA Court remains on the safe side, and dissociates the justification grounds usually upheld (and claimed by the Norwegian Government) for group contributions from those applying to SAARs such as the interest deduction limitation rules. Rejecting the balanced allocation of taxing rights as a valid justification ground, the EFTA Court focuses on the fight against tax avoidance and tax evasion already upheld in its previous case law (E-3/13 *Fred. Olsen* et al and E-15/16 *Yara*). It necessarily comes to the conclusion that absent a possible rebuttal of abusive practices, taxpayers may never deduct interest above the 30% EBIDTA threshold when the beneficiary is not a Norwegian resident. This is not in line with the CJ's case law on abusive practices, which sets the limit for non-abusive transactions up to the arm's length's value of interest (*Thin Cap* and *Lexel*). Therefore, the EFTA Court found the SAAR not in line with the freedom of establishment, not surprisingly. The justification ground based on the balanced allocation of taxing powers which was successfully upheld in cases dealing with group taxation, therefore, is of no value because the EFTA Court dismantles the two sets of rules for the sake of analyzing justifiable grounds. The explanation is to be found in *X and X* (CJ 22 February 2018, C-398/16, **ECLI:EU:C:2018:110**, para. 50), where the CJ states that 'when a parent company finances the purchase of shares in a subsidiary by a loan taken out with another related company, the risk that that 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 and together form a single tax entity than if the subsidiary is established in another Member State and is not, therefore, permitted to form a single tax entity with the parent company.'

A number of questions can be asked in respect of this decision.

First, one can wonder why the courts need to get so confusing on the comparison between cross-border and domestic situations, as it ends up being a subjective choice of the purpose of the rules by the Courts. In the *RPA* case, for instance, the EFTA Court claims that it does not matter for the comparability assessment that the non-resident affiliate was not able to provide for group contribution (with tax effect) to the Norwegian company (*RPA*, para. 37). But how can that be true? If the foreign affiliate cannot provide for anything but a loan to a Norwegian company, then how does this situation compare to a domestic one, where both a loan and a group contribution are possible, both with similar tax effects in Norway? It is true that thin cap rules that apply only to non-residents are a restriction to the freedom of establishment, so in the end, the Court's finding is correct, but why involve erroneous statements? Likewise, in *RPA* para. 48, the EFTA Court mentions that granting tax deduction of interest in domestic situation is a way for a State to renounce its taxation rights, but is that really so? In domestic situations, interest received is taxed in the hands of the recipient, and Norway does not give up on its taxing rights. It would be much easier to stick to the preparatory works of the Norwegian law, otherwise mentioned in the case, acknowledging that the limitation arises only when 'large groups place disproportionately large shares of a group's debt, and thus interest expenses, in countries with high tax rates' (*RPA*, para. 12). Clearly, the rules deal with anti-abuse practices, and should be drafted as such, with the possibility to show that there is no abuse for the taxpayer. Mechanical rules limiting a deduction to a certain amount do not meet these requirements and, unless authorized by secondary legislation such as the ATAD or the P2D if adopted, collide with primary law.

The authorization granted by Article 4.5 a or 4.5.b ATAD to compute the EBITDA at the level of the group is an option that could save the restrictive effects of the interest deduction limitation rules. However, neither Sweden nor Norway has such rules. Sweden has not opted for the more 'severe' computation of the ceiling at the group level, and Norway does not need to implement the ATAD. However, it could be argued that Article 3.1 in the Directive allows more severe measures against tax base erosion. Nevertheless, it remains quite clear that in this case, any measure not implemented by authorization such as Articles 4.5 a and 4.5.b ATAD needs to be validated under the fundamental freedoms. The EFTA Court makes it quite clear that it is not the case for the Norwegian rules, which will never fall under such an authorization anyway.

Second, one should also mention that Sweden kept its rules on interest deduction limitation despite the clear *Lexel* ruling, and despite the 13 December 2021 ruling of the Supreme Administrative Court (*Husqvarna* HFD 659-21) both declaring the Swedish interest deduction limitation rules (2013 and 2019) in breach of EU law and the freedom of establishment. The *PRA group* case confirms that any anti-abuse rule of the kind in question which hits market-based transactions without leaving the possibility for the taxpayer to demonstrate the business/commercial motivation are not in line with the fundamental freedoms. It is hoped that the current investigation into Swedish legislation will acknowledge the rulings and organize this possibility for taxpayers (DIR. 2022:28 Tilläggsdirektiv till utredningen En uppföljning av de nya skattereglerna för företagssektorn (Fi 2021:07).

The question of using the arm's length threshold for measuring the normality of the interest

payment was also mentioned in the *PRA group* case, and suggests that a convincing functional transfer pricing analysis (in line with OECD TP guidelines supposedly) is sufficient for justifying a cross-border interest payment, the limitation should be void. Given that the choice of financing activities between debt and capital is not tax neutral, as acknowledged in the DEBRA proposal (11 May 2022, COM(2022) 216 final), such a proof would be sufficient. It is, however, doubtful and not efficient that such an economic management decision should be steered by legislation, albeit tax legislation. As raised many times in academia, the arm's length principle is not really the appropriate answer to the need for more tax neutrality in this field – but is a good start (see Maarten de Wilde's and Ciska Wikman's comment on Kluwer International Tax Law Blog **http://kluwertaxblog.com/2022/06/10/after-cjeu-now-efta-court-too-embraces-arms-length-standard-as-a-beacon-whats-next/**.

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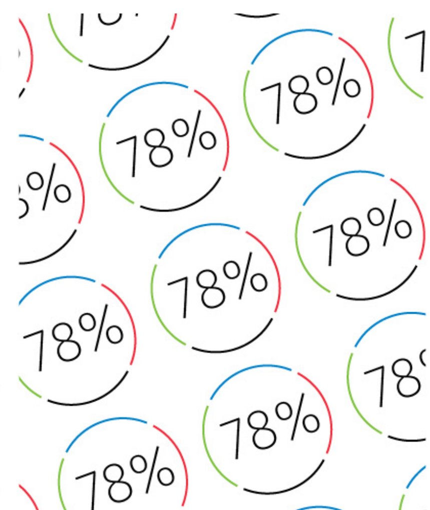

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