Tax as a key driver in motivating company investments: The case of debt push down

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Abstract

The aim of this thesis is to examine the legal situation with regard to debt push down structures in Sweden. Debt push down structures aims at collecting return on capital in the form of interest and that this will be deductible for tax purposes as a result. Structuring an investment in a Swedish company as a debt push down transaction commonly results in the Swedish company becoming thinly capitalised. It is of crucial importance that the there are no tax rules that limit the right to deduct the resulting tex expense. The Swedish correction rule, the rules governing profit sharing notes and the tax avoidance act is investgated and discussed using modern theory of corporate finance as a tool of analysis. It is concluded that Sweden does not have specific rules governing thin capitalisation as such and the investigated rules seems limited in their application to this phenomena. Therefore, it is concluded that the Swedish tax rules can be a key driver in motivating debt push down transactions involving acquisitions of Swedish companies.

Keywords: Debt push down, thin capitalisation, interest expense, corporate finance, debt capital, equity capital, hybrid capital, correction rule, profit sharing note, tax avoidance act, shareholder loan

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1. Introduction

1.1 Background

A number of considerations are present when deciding on investing in a company or not, or which company to invest in. These considerations differ between investors. A distinction is commonly maid between operational and financial investors.1 The former are primarily involved in creating value by improving the actual business operating in some fashion whereas the latter are primarily involved in creating value by innovative financial solutions. Although this is true there is no perfect distinction between the two categories and investors could obviously be illustrated with in a spectrum with purely operational investors on one end and purely financial investors on the other. In recent years there has been, in addition to increased activity in company investments in general, a shift towards a larger relative activity in financial investments. This has been driven to a large extent by the boom in the so called private equity sector. These investors are commonly involved in investments where it is possible to take on additional financial risk and thereby increase the expected return on their investments. This is primarily achieved by funding investments with excessive amounts of debt capital. Further it has been stated that the key to creating value in private equity investments is tax planning.[2] This indicates that tax planning is a key issue in company investments and that these considerations could drive the decisions that investors undertake.

From a tax point of view intra-group prices are of vital importance for an international group companies since these prices in the affects the total tax burden of the group.[3] However, a problem often arises since there is a conflict of interest between states national interest to tax companies' profits and the companies' goal to minimise costs and maximise value. Companies often wish to structure business so that tax is minimised or eliminated whereas involved governments wish to collect taxes in order to finance its activities. From this background it is important to stress that negotiated conditions between associated companies within a group do not always coincide with those that would have been negotiated in an open market. Profits may be transferred from one group company to another, or vice-versa, by setting prices on goods or services below or above market value.

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[1] Grinblatt-Titman, p. 694.
[2] Jonsson, p 51.
[3] Wiman 1987, p. 15.

In connection to a company investment, an important aspect is the appropriate financing of the deal. A company can generally be financed with either equity capital or debt capital and the choice will in most cases have tax implications. A company is always financed with some equity capital, but additional capital contributions can be either equity capital, debt capital or some combination of the two. In most countries, using debt capital instead of equity capital results in an advantageous tax position since the distributions from the company in the future will generally be deductible in the case of debt capital but not in the case of equity capital. If only considering tax implications, the broad effect would be that company investments would be financed with large amounts of debt capital. This is commonly referred to as thin capitalisation. Thin capitalisation is thus a broad term describing a company with large amounts of debt capital in relation to equity capital.

Interest expense resulting from a debt agreement is generally fully tax deductible for the company paying the interest according to Swedish tax legislation. On the other hand, dividends resulting from an issue of equity capital are generally not tax deductible for the paying company. Due to these differences, it could be tempting to disguise contributed equity capital in a company investment as debt capital. This holds true if a Swedish company is to be acquired by a foreign entity located in a country with a relatively lower corporate tax rate. In this case the deducted interest expense will be worth more in the Swedish company since the implicated tax deduction will be higher. It could hence be tempting to apply thin capitalisation to a Swedish company in connection to an acquisition. This would lead to a structure where the untaxed profits of the Swedish company are distributed to the foreign parent company in the form of interest payments instead of dividend payments. The result would be that the overall tax burden would be lower and that the company in effect would seem like a more favourable investment object.

Despite the obvious risk of loosing some of its tax base, Sweden does not apply any specific rules with respect to thinly capitalised companies. One could argue that the situation at hand is similar to a transfer pricing situation and hence apply the Swedish rules regarding this phenomenon. It has also been proposed that the rules governing profit sharing notes and the Swedish tax avoidance act is potentially applicable to these situations.

1.2 Purpose

The purpose of this thesis is to examine the Swedish tax rules concerning company investments using a high degree of debt financing and whether these rules can truly be a key driver in motivating such investments. In specific, debt push down transactions will be investigated from a tax point of view since this alternative to financing a company investment has been stated as a highly tax driven investment. The thesis will focus on the phenomenon of thin capitalisation that follows from debt push down investments and how Swedish tax legislation applies to such situations. This includes an investigation of transfer pricing rules as well as the rules governing profit sharing notes and tax avoidance legislation. The question I will try to answer reads as follows; *"How does Swedish tax rules cope with debt push down investments and is it in fact the Swedish tax rules that motivate these transactions?"* Even though the purpose of this thesis is not to study debt push down from a corporate finance perspective, corporate finance theory will be used to analyse the situation from an economic point of view.

1.3 Method

The traditional juridical method will be used to investigate the Swedish tax rules governing the thin capitalisation situation that follows from debt push down investments. This means the legal rules will be analysed using a pre-described hierarchy. This is based on Swedish legislation, preambles of the legislation, usage of national court practice as well as available law doctrine. In addition, corporate finance theory is used as a framework in discussing the situation. This means that the information gathered and investigated mainly pertains to litterature in the form of articles and books and publicly published information.

1.4 Delimitation

This thesis does not aim at making a comparison of different states legal systems nor treat the legal systems that emerge through the interaction of different legal systems such as EC-law and double tax treaties. Whenever these concepts are discussed it is solely for the purpose of enlightening that this legislation exists and that this could have consequences. The taxation of cross-border financial investments will always involves the interaction between two or more legal systems and even though I recognise the flaw of not investing these particular rules, the

purpose of this paper – namely the investigation of whether the Swedish tax rules could be a key driver in motivating debt push down transactions - should not be distorted.

Also, the thesis includes a chapter on principles of corporate finance. This is for the sole purpose of making the discussion on the Swedish tax rules more interesting and to use as a framework in discussing the rules. The thesis has no aim at discussing the concepts of corporate finance in general or to draw conclusions on the commercial features of certain financing arrangements. The chapter of corporate finance is hence only used as a framework in analysing the Swedish tax rules with respect to debt push down structures.

The Swedish corporate taxation regime is presented in short although mentioning certain specific rules such as the group contribution regime, participation exemption and reorganisation rules. There is no aim at investigating these rules in specific but rather to give the reader an understanding of the relevant rules that can be applied when investing in a Swedish company.

A make no further attempt to treat the special rules pertaining to either closely held companies nor CFC-legislation. This could be interesting since these rules will obviously be of importance in many of the types of investments discussed in the thesis. However, it seems to be out of the scope for the purpose of this paper.

Finally, since the scope of the paper is to investigate the tax rules potentially applicable to debt push down investments and which the economic consequenses this could have, I have focused on the broad set of Swedish rules rather than investigating a specific rule. This means that the paper tends to be rather broad in the investigation which have implications for the scope. One alternative could have been to analyse the correction rule in isolation for example which would allow a more thorough investigation. Since this thesis aims at lifting a broad set of rules forward with corporate finance theory as a tool of analysis, I have tried to present the investigation as deeply as possible without loosing the focus on the rules in general. For these reasons, the investigations performed within each subarea does not investigate all potential aspects but rather those that help in giving a picture of how debt push down investments can be conducted.

1.5 Outline

The thesis is structured with two introductory chapters. These are included to present some background to the reader. Chapter 2 of the thesis gives an introduction to principles of corporate finance and general theory of the value of a firm. A short discussion is also included on the optimal capital structure. In addition, an introduction to the concept of hybrid capital with examples and general problems is included. In Chapter 3, the concepts of debt push down and thin capitalisation are defined for the purpose of this thesis. Chapter 4 of the thesis gives an overview of the Swedish regime for corporate taxation and some of the rules that can potentially be applied in connection to company investments. In order to investigate the specific rules that could potentially be applicable to situations of debt push down and thin capitalisation, Chapter 5 is fully devoted for this purpose and investigates these rules. Finally, Chapter 6 contains conclusions from the findings in the paper and how this relates to debt push down structures in Sweden. These findings are then discussed with the background of the chapter on corporate finance and the value of enterprises.

2. Principles of Corporate Finance

2.1 Introduction

Funding assets requires that capital is allocated to a company. This funding can take various forms and a distinction is commonly maid between equity capital and debt capital.[4] Equity capital is considered the capital that actual owners of the company have contributed. These contributors are generally said to be in control of the company and make decisions on the strategy and operations. On the other hand, debt capital is said to be contributed by external parties.

In general, return on debt capital takes the form of interest payments while the return on equity capital takes the form of dividend payments. The main difference is that a creditor is entitled to a fixed payment of return on the investment, even if the debtor corporation had not earned benefits, in contrast to a shareholder who is entitled to a return on the investment only if the company makes a decision to distribute profits. The exact amount of interest may not be known in advance, but at least the formula according to which the return is calculated will be. Interest is, generally, a fixed amount of return agreed upon in a loan contract, whereas the amount of a dividend distribution is based on a decision of a shareholders meeting. The potential for interest is limited, whereas the potential for a dividend is unlimited. The unlimited return potential compensates for the higher risk of equity as compared to debt. A shareholder is also generally entitled to direct control of the company unlike creditors.[5] The required rate of return – for equity capital as well as debt capital – depends on several circumstances, such as the general level of interest rates and risks in the economy as well as specific factors that affect the risk of the capital not delivering as expected.[6]

Most states treat debt and equity, and interest and dividends differently for tax purposes. The tax treatment of debt and equity is not neutral, even though economically both debt and equity investments in a company have the same function, i.e. to enable the company to generate profits. Because the tax treatment of equity finance and debt finance is not neutral, tax implications have a great impact on finance decisions. Generally, debt finance tends to be

[4] Grinblatt-Titman, p. 5.
[5] Helminen, p. 254.
[6] Jonsson, p. 520.

favoured over equity finance in taxation. The total tax burden on finance in the form of debt capital is often lower than it is on equity finance. Therefore, corporations tend to prefer debt finance in order to minimise the total tax burden on corporate finance. A dividend is normally not deductible from the paying corporations taxable profits, whereas interest reduces the corporations taxable profits.[7]

2.2 Corporate Finance Theory

Modern theory of corporate finance originates from theories presented by Modigliani-Miller in 1957. In their theory of the irrelevancy of financing structures it is stipulated that with perfect capital markets, no taxes, no transaction costs and no costs of financial distress the capital structure of a company is irrelevant to the firm value.[8]

However, in the real world, the assumptions necessary in Modigliani-Millers theory does of course not apply. For example, since governments do tax companies and – as in Sweden – debt financing is treated differently from equity financing revised theories are needed. Incorporating the fact that interest costs are tax deductible, but that dividends are not, results in a new proposition:

Value of firm = value if all equity financed + value of tax shield[9]

Further, if the theory is to be adjusted to the fact that companies experience bankruptcy costs an even more tuned theory can be presented:

Value of firm = value if all equity financed + value of tax shield – value of the costs of financial distress[10]

Even though this model is closer to reality the problem of assuming no transaction costs and perfect capital markets still remain. In any case the most important factor to consider when

[7] Helminen, p. 251.
[8] Brealey-Myers p. 447.
[9] Ibid, p. 472.
[10] Ibid, p. 476.

deciding on a capital structure should be the characteristics of the assets – or the operations - in the company.[11]

Costs of financial distress are usually divided into direct- and indirect bankruptcy costs.[12] Direct bankruptcy costs relate to the legal process involved in reorganizing a bankrupt firm. For example, these include paying for lawyers and investment bankers in a bankruptcy process. Indirect bankruptcy costs are not directly related to the reorganizing and can arise among financially distressed firms even though the company never defaults. These are further divided into indirect costs arising in the operations of the company and costs arising from the debt capital holder – equity capital holder conflict. Examples of costs arising in the operations are the costs of employees not working because they are looking for new jobs and the loss of customers due to bad reputation in the market. An example of a debt holder – equity holder conflict is that equity holders usually become more risk willing in the case of a potential default whereas the opposite is true for debt holders.[13] This follows from the fact when a company is close to default, only debt capital holders potentially receive return on their capital investments since they are entitled to get paid in advance of the equity capital holders. This means that the equity holders are just as bad off if the company defaults or continues to struggle as it currently is since they do not get any return in any case. However, if the company succeeds to become more profitable, there is a chance that the equity capital holders can receive some payoff. Therefore, the equity holders are willing to take on more risk in order to achieve this profitability. The debt holders will however not have this incentive and the additional risk will be added on their expense. It is the handling of this conflict that gives rise to indirect bankruptcy costs.

2.3 The optimal degree of debt capital

To summarise the discussion, a company has an incentive to take on more debt capital since the resulting interest expense is generally tax deductible. This creates a tax shield that can be used to lower the company's overall tax burden which result in a higher value of the firm. However, this additional debt capital also gives rise to additional costs of financial distress since the firm will be burdened by additional interest payments. The costs of financial distress

[11] Ibid, p. 487.
[12] Grinblatt-Titman p. 558.
[13] Ibid, p. 569.

arise from the fact that the probability of the company's default increase with these interest payments. A company's risk sensitivity to additional burden of interest rate payments depends on the firms operations. A company with low level of risk in operations are less sensitive since it can afford to take on more risk. Therefore, the optimal level of debt capital will always depend on the risk characteristics in the company's assets.

2.4 Hybrid Capital

It is a simplification – although quite practical – to only consider equity capital and debt capital. This is because there are actually a number of forms that corporate financing may take within the bounds of company and contract law. Some of these financing arrangements can be difficult to ascertain whether it is equity capital or debt capital. The arrangements are usually labelled as hybrid capital since they are characterised by both equity capital features and debt capital features. Hybrid capital may be placed on an imaginary line, depending on the debt and equity characteristics involved. At one end of this line, there is a pure loan with fixed rent and, at the other end there is a pure equity investment with a shareholder position with all its rights attached, including the right to a dividend. Next to the pure debt, there is a loan, the interest on which is not fixed but is dependent upon the profits of the company. Next to the pure equity investment, there is an investment in capital stock, which does not carry a voting right but carries a preferential right to a dividend. Depending on how much of either typical debt or equity characteristics are included in an instrument, the closer it may be to either the pure debt or pure equity.[14]

For various legal, economic and commercial reasons, companies use mixed financing forms to combine the advantages of both equity and debt. For example, a hybrid capital arrangement may allow an investor to share in the earnings and growth of a corporation in the way that a shareholder is allowed to, while allowing the investor to cut its exposure or possible loss in the way normally possible only for debt capital holders. Hybrid capital is often used, for example, to lower the cost of debt capital, to make debt investments more attractive to investors or to attract equity investors.[15]

[14] Helminen, p. 255.
[15] McCormick-Creamer, p. 3.

The main difference from a legal point of view is that the relationship between a debtor and a creditor is based on based on a loan contract, whereas the shareholder relationship is based on company law.[16] The setup of debt capital thus creates a contractual claim whereas a setup of equity capital does not lead to a debtor-creditor relationship. Therefore, the return on equity capital in the form of dividends is based on the shareholders meeting whereas the return on debt capital in the form of interest is based on the loan contract. Another primary difference between debt capital and equity capital is the requirement of repayment. A creditor has a right to a refund at the end of a fixed period of time. A shareholder, on the other hand, is not entitled to repayment before the liquidation of the company. Equity capital is, thus, perpetual in its nature, whereas a debt capital is temporary. Also, in a company's liquidation, the rights of equity capital investors are subordinated to those of debt capital investors. Creditors must be repaid before the equity capital investors can share the proceeds. In the same fashion, any return on debt must be paid before any dividend may be distributed. The priority ranking of debt and interest to equity and a dividend is what makes up the risks involved with each type of investment.[17] Since dividends may only be paid if there is a surplus left after all other obligations have been fulfilled, the return on equity capital is characterised by more risk than debt capital.[18] In addition, only an equity capital investor, and not a debt capital investor, is allowed to take part in the decision-making process of a company in the form of voting rights.

Hybrid instruments are often formed by adding certain elements of equity capital to debt instruments. Interest on a loan contract may depend on company profits, the loan may be subordinated compared to other debt, it may be convertible to equity capital or it may be perpetual. As a result the return and risks of a debt investment may be economically closer to the return and risks of equity capital. The opposite case is also possible, equity capital may be attached with a fixed return, or the investment may be redeemable. Therefore, sometimes a debtor-creditor relationship may be, in its economic substance, very close to a shareholder relationship and vice versa.[19]

Examples of hybrid capital include perpetual debt capital, convertible debt capital and option loans, subordinated debt and preferred shares. Contractual freedom makes it possible to structure a wide range of hybrid capital. For example, preferred shares may also be

[16] Helminen, p. 254.
[17] Ibid, p. 304.
[18] Ibid, p. 285.
[19] Ibid, p. 252.

redeemable or convertible into ordinary shares.[20] Perpetual debt capital postpones the primary right of the creditor to recover the contribution indefinitely. Perpetual debt is therefore, by its economic substance, very close to equity. Convertible debt capital is interest-bearing debt instruments containing either the right or the obligation to convert the debt capital into equity capital in the same company, usually at a pre-determined price and within a specified time period. The right to convert debt capital to equity capital allows the creditor to enjoy unlimited return potential, just like the holder of equity capital. An option loan is similar to convertible debt capital. It actually includes two components: a loan, the interest rate of which is generally lower than the market rate for regular loans and a warrant, the value of which depends on the value of the shares that it entitles the investor to subscribe for. Option loans differ from convertible debt since option loans entitle the investor to make an additional investment in equity capital and that the warrant to acquire the equity capital can be separated from the debt capital investment.[21] Subordinated debt capital includes a subordination clause that signifies that the creditor becomes last on the list of the company's creditors in the event of liquidation. On the contrary, preferred shares are equity capital that carries certain preferential rights over equity capital, usually with respect to either a dividend or repayment of capital or both. Usually the holders of preferred shares are either totally barred from voting or are entitled to vote only in circumstances directly affecting the holders of the preferred shares.[22] Subordinated debt is senior to preferred share in the case of liquidation even though the two are very similar to each other. As can be seen, there are a number of different financing alternatives available where it is not clear cut whether the form is debt capital or equity capital.

The question arises of how hybrid capital solutions should be treated for tax purposes. As have been shown, debt capital can include characteristics of equity capital and vice versa. Since hybrid capital instruments are difficult to ascertain whether they are debt capital or equity capital, incentives arise for tax planning.[23]

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[20] Ibid, p. 311.
[21] Ibid, p. 298.
[22] Ibid, p. 311.
[23] Ibid, p. 276.

2.5 Shareholder loans

Another possibility can also be that equity capital owners also supply debt capital to the company. In this sense the investors are both equity capital holders and debt capital holders.[24] Debt arrangements from equity holders are commonly provided without collateral and the risk attributed to the capital is hence similar to the risk of equity capital. The financing arrangements usually contain interest expense although not paid until interest expense from other debt arrangements has been paid or until the financial position of the company allows for this. This is motivated since the company might have to be liquidated otherwise and this would not be aligned with the interests of the holders which also hold equity capital. Interest due to these arrangements is thus often expensed but accrued.[25] Debt capital funded by equity capital holders is usually used in order to avoid liquidation of a company.[26] Therefore, the fact that the capital is supplied only in order to avoid company liquidation it could be argued that the debt capital is in fact equity capital in disguise.[27]

In Sweden, debt capital funded by equity capital holders are usually divided into unconditional additional shareholder contributions and conditional additional shareholder contributions. These are structured as subordinated debt capital. The unconditional debt capital is only to be repaid in a company's liquidation. On the other hand, conditional additional shareholder contributions are to be repaid after other debt has been repaid. It can hence be repaid before equity capital has been repaid in a company's liquidation but is subordinated to other debt capital.[28] In practice, it is common that shareholders make investments in a corporation in the form of an investment that has no reservation as to repayment or that may be repaid only if there is free equity that covers the repayment in the company. An unconditional additional shareholder contribution is by its nature closer to equity capital than conditional additional shareholder contributions.[29]

[24] Gäverth 1994, p. 13.
[25] Jonsson, p. 521.
[26] Estberg 1993, p. 99.
[27] Ibid, p. 107.
[28] Helminen, p 306.
[29] Ibid, p. 279.

3. Debt Push Down and Thin Capitalisation

3.1 Introduction

In order to investigate the phenomena of debt push down from a tax point of view it will be necessary to introduce the concept of debt push down and the relevant tax issues that arise as a consequence. Therefore, it will be appropriate to include a general discussion on the topic of debt push down as well as an introduction to the tax implications that arise. The single most significant feature of a debt push down structure from a tax point of view is that the company being financed, or a related holding company, will result as being thinly capitalised. An introduction to the concept of debt push down is hence in order.

3.2 The concept of debt push down

Initially, an acquisition is characterised by deciding on appropriate corporate financing. In general, the acquirer at least to some part takes on external finance in the form of debt capital. Since the resulting interest expense is usually deductible for tax purposes it is appealing to take on more debt if the target company is located in a country where the corporate tax rate is high. This is true since the tax deductions then will be worth more as a consequence.[30] The idea is that the investing unit is formed in a country that allows that corporate taxation is transferred to that country through debt arrangements. One suggestion of how this can be done is by forming a company in a country that one wishes to finally be subjected to corporate taxation in. Thereafter, a holding company is formed by this foreign company and in connection; a debt arrangement is setup between the two companies. The debt arrangement is large enough to stand for the majority of the funding of the target company and as an effect, it is heavily leveraged. The levered company then acquires the target company that is to be taken over and the interest expense that arises from the debt arrangement can be netted against the taxable profits that arise in the acquired company.[31]

There is no standard definition of debt push down since the concept can be achieved in numerous different ways. Debt push down is also used as a concept in financial accounting – although usually labelled as push down accounting - where the purpose is to have an impact

[30] Estberg 1991, p 19.
[31] Jonsson, p. 522.

on how a group of companies is presented in financial statements rather than to have tax implications.[32] In general, tax is collected primarily by the state of residence of the investor whereas the tax revenue from direct investment equity, in particular, is realised by the state of residence of the financed company. On the other hand, the use of debt finance instead of equity distributes tax revenue from the source state to the state of residence of the recipient of the return on an investment. Therefore, in order to avoid taxation in the source state, a corporation may be financed excessively with debt. This kind of tax planning through the excessive use of debt finance compared to the use of equity finance within a group of companies is referred to as debt push down. So in general, from a tax point of view, debt push down is the concept of attributing debt to a subsidiary from a parent company and achieve transfer of income between the two as a result. This kind of tax planning will generally result in the subsidiary being viewed as thinly capitalised.

3.3 The concept of thin capitalisation

As in the case of debt push down there is no standard definition of thin capitalisation. Thin capitalisation usually refers to an abnormally high debt-to-equity ratio of a company.[33] In other words, a thinly capitalised company is a highly leveraged company. This is a highly discussed phenomenon, interesting from several perspectives. Therefore, it seems obvious that many alternatives are available when defining the concept of thin capitalisation which has also been stated many times. The purpose of this paper is to study the tax rules in connection with thin capitalisation so the definition used should rely on that. In general, thin capitalisation means that a company has very little equity capital in relation to debt capital and that this relationship has considerable effect in terms of taxation.[34] Thin capitalisation differs from the concept of debt push down although the two expressions often are used interchangeably. For the purpose of this paper the two concepts are separated. The concept of debt push down is based on a financial structure constructed within a group of companies where the companies are located in different countries and debt is used to transfer taxable income. Thin capitalisation on the other hand is broader term and includes all cases where a company is heavily financed with debt and this has tax implications for the company. This can be the case in several situations also including finance contributed by external parties

[32] White-Sondhi-Fried, p. 533.
[33] Helminen, p. 321.
[34] Lodin-Lindencrona-Melz-Silfverberg, p. 532.

such as bank loans or bond arrangements setup in financial markets. Thin capitalisation as defined in this paper is primarily not economic in nature but rather tax related. In broad terms however, thin capitalisation is an expression for a company with poor solidity.[35]

[35] Gäverth 1994, p 71.

4. Swedish Corporate Taxation

4.1 The Fiscal Unit

Public and private companies registered in Sweden are liable to national income tax when performing business operations according to Chapter 1, Section 3 of the ITA (Swedish income tax act). According to civil law, a company is resident in Sweden if it is registered with the Swedish Companies Registration Office. Since companies are taxable for all their operations, business conducted in foreign countries is also taxable in Sweden. The corporate tax rate is 28 percent although due to several special rules the effective tax rate for most companies is 25-26 percent.[36]

4.2 Deductible expenses

The taxable result of a company is calculated by deducting expenses from revenues where expenses are defined as the costs necessary in order to earn and maintain revenues according to Chapter 14, Section 21 and Chapter 16, Section 1 of the ITA. All business expenses incurred in obtaining or safeguarding income subject to taxation are deductible according to Chapter 16, Section 1 of the ITA. Examples are wages, cost of goods sold and interest expense. All expenses are however not deductible such as bribes, fines and excess entertainment charges.

4.3 Loss carry forward

Accumulated losses between multiyear periods can be carried forward indefinitely and are to be deducted whenever profits emerge according to Chapter 40, Section 2 of the ITA. However, although this is the general principle there are exceptions. The most important exceptions for the purpose of investigating the rules with regards to investments in Swedish companies are the rules that limit infinite loss carry forward when there are changes in the ownership structure.

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[36] Öhrlings PriceWaterHouseCoopers, p.4.

4.4 Dividends

4.4.1 Dividends Received

The main principle is that dividends are taxed as capital income according to Chapter 42, Section 1 of the ITA. However, since the income of legal entities is always taxed as business income, companies' income in the form of dividends will be taxed as business income according to Chapter 1, Section 3 of the ITA. An effect of structuring the rules in this fashion is that if there is a group consisting of two companies i.e. one of the companies (called A) owns the other (called B) and B earns some profit, this will be taxed as business income at B. Further if the earnings are distributed to A as a dividend, A will be taxed for the dividend as business income. If A then wishes to distribute these earnings to its own owners they will be taxed as well. Chain taxation occurs. In order to avoid these kinds of effects, the Swedish legislator has chosen to implement complementary rules.

4.4.2 Dividends Paid within Sweden

Dividends are distributions to the company's investors rather than expenses necessary in order to earn and maintain revenues. Hence dividends are not deductible in the company paying the dividends.

4.4.3 Outbound Dividends

A withholding tax of 30 percent applies to dividends paid to non-residents as a general rule according to Withholding Tax Act Section 4-5. However, this tax is not levied on dividends paid to a legal person residing in a EU member state, provided the shareholding amounts to at least 20% of the share capital of the distributing company.

4.5 Interest

4.5.1 Interest Received

The main principle is that interest income is taxed as capital income according to Chapter 42, Section 1 of the ITA. However, since the income of legal entities is always taxed as business

income, companies' income in the form of interest received will be taxed as business income according to Chapter 1, Section 3 of the ITA.

4.5.2 Interest Expense

Interest expenses are deductible since it is considered to be costs necessary in order to earn and maintain revenues. No test is carried out to investigate what purpose the interest expense is a result of. There is no withholding tax levied on outbound interest payments.

4.6 Capital gains/losses

Income originating from assets or debt in the form of capital gains/losses is taxed as capital income to the extent it is not taxed as business income according to Chapter 41, Section 1 of the ITA. However, since the income of legal entities is always taxed as business income, companies' income in the form of capital gains/losses will be taxed as business income according to Chapter 1, Section 3 of the ITA. This is also clarified in the business income rules according to Chapter 15, Section 1 of the ITA.

4.6.1 The Participation Exemption for Dividends and Capital Gains/Losses

Some inter-corporate dividends have been given special treatment and the rules can be found in Chapter 24 and 25a of the ITA as a participation exemption. The rules are limited to share holdings motivated by the owning company's business operations. There are three different alternatives for companies wishing to qualify their holdings for the participation exemption according to Chapter 24, Section 14 of the ITA:

The share is not traded on a public market.
The owner's total shareholdings constitute 10% or more of the total voting rights in the owned company.
The shareholding is motivated by the business conducted by the owning company or a company close to the owning company in terms of ownership or organizational relationships.

If shares fulfill any of the three alternatives necessary for the participation exemption the effect will be that dividends paid from these shares will not be taxed at the owner level. On a

cautionary note it should be acknowledged that if the share is traded on a public market and is then sold or for some reason will not be considered as hold for business reasons any longer within a year from the date that the holding first qualified, the effect will be that paid dividends will be taxed at the owner according to Chapter 24, Section 20 of the ITA. Taxation will occur at the year of the disposal or when the shares seize to be qualified for the participation exemption.

In the case where shares qualified for the participation exemption are to be sold, these will not be object to capital gains tax according to Chapter 25a, Section 5 of the ITA. In the case of a capital loss, this will not be tax deductible. There are however exceptions from these rules when the shares sold are connected to so called shell companies according to Chapter 25a, Section 9 of the ITA.

4.7 Group contributions

In order for the tax rules to be neutral and compatible special rules have been designed for groups of companies. The main goal throughout the group taxation regime has been to construct the rules so that the tax burden for a group of companies should not be greater or less than it would have been if the operations would have been organized in one single company.[37] The mentioned rules concerning participation exemption contribute to this goal but they do not make it easier for a group to deduct expenses in one company against income in another company within the same group. The legislator has chosen to accomplish this objective by allowing for group contributions. The rules on group contributions can be found in Chapter 35 of the ITA. Hence, the purpose of the group contribution rules is to tax the result of a group of companies as if it was one single company by making group contributions deductible for the giving company and the receiving company taxable.[38] There are no rules regulating the sizes of the amounts involved.

A group contribution from a parent to a wholly owned subsidiary or in the opposite direction is deductible against income given that the subsidiary have been wholly owned during the giving- and the receiving companies taxable years or since the subsidiary started its business according to Chapter 35, Section 3 of the ITA. A parent is defined for the purposes of the

[37] Wiman 2002, p. 21.
[38] Lodin-Lindencrona-Melz-Silfverberg, p. 350.

group contribution rules as a company that owns more than 90% of the shares in a company and that this specific company is defined as a wholly owned subsidiary.

Group contributions between companies that are open are regulated in Chapter 35 in the ITA and are accounted for in the section above. It also seems possible to give group contributions through the pricing mechanism in day to day transactions.[39] These contributions are in this sense equivalent to hidden group contributions. When these hidden contributions are constructed involving foreign companies' special rules exists in order to avoid the avoidance of taxation in Sweden. These are discussed below with regards to financial investments.

4.8 Reorganisation Rules

If there where no specific complementary rules dealing with reorganizations, taxes could be a major obstacle which could in effect limit the extent of these investments.[40] However, in order to avoid situations where taxes become a major motivating force in these transactions, special rules have been implemented. Perhaps the most influenced rules are those involving the right to carry forward losses. The legislator have made an effort to structure the loss carry forward rules so that they are neutral in the meaning that newly formed groups should have the same abilities for carrying losses forward as if they had not chosen to go through with the reorganization.41 The rules concentrate on situations where changes occur in the significant influence over a company according to Chapter 40, Section 5 of the ITA.

There are two types of limitations that could be applicable in reorganisations. The first is a limitation in the size of the loss carry forward. This type of limitation is applicable when the acquired company has accumulated losses and aims at limiting the ability to trade in companies with accumulated losses.[42] One can image situations where an accumulated loss company is scrapped from assets and then sold. This is often referred to as creating a shell company.

The limitation in the size of accumulated losses carried forward is defined in Chapter 40, Section 15 of the ITA and means that an accumulated loss company cannot deduct

[39] Wiman 2002, p. 84.
[40] Lodin-Lindencrona-Melz-Silfverberg, p. 423.
[41] Wiman 2002, p. 100.
[42] Ibid, p. 113.

accumulated losses saved from years before the year when the limitation is applied to a greater extent than 200% of the acquisition cost.

If a company own a number of shares and then acquires an additional amount then all shares are allowed to be included in the limit calculation above. All acquisition should also be included if the acquirer decides to 100% of the shares. This means that the limit will be set higher if more shares are acquired.

There could also be a limitation in the right to give group contributions. A limitation in the right to give group contributions means that the accumulated loss company cannot deduct accumulated losses to a larger extent than profits for the year of the acquisition according to Chapter 40, Section 18 of the ITA. This does not mean that the accumulated loss company cannot receive group contributions but rather that these group contributions cannot be used to net against accumulated losses. If the size of the loss carry forward limitation is also applicable in the situation the group contribution limitation will be applied to the amount that is not limited due to the former limitation according to Chapter 40, Section 18 of the ITA.

There are two types of relevant situations when these limitations are applicable. The first relevant situation is when a change in ownership structure takes place which will lead to a company gaining significant influence over an accumulated loss company and the effect is that both the size of the loss carry forward limitation and the group contribution limitation will be applied according to Chapter 40, Section 10 of the ITA.

When assets and liabilities are sold between companies taxation normally occurs if the price paid exceeds the taxable value of the asset or liability. Selling an asset from one business to another for a price below market price without this being commercially motivated is also treated as if the asset has been sold at market price according to Chapter 22, Section 7 of the ITA. The market price is defined as the price that the taxable subject would have paid if a similar asset has been purchased in the local market according to Chapter 61, Section 2 of the ITA. In order to make it easier for groups of companies to reorganize their businesses, special rules have been implemented to achieve this objective. The open alternatives when reorganizing a group of companies are selling assets below market price according to Chapter 23 of the ITA, transfer of business operations according to Chapter 38 of the ITA, exchange of shares according to Chapter 49 of the ITA and mergers and demergers according to

Chapter 37 of the ITA. If the rules regarding these open alternatives are followed, taxation is deferred and not triggered at the time of the relevant investment.

5. Specific rules

Swedish law does not have specific rules that govern thin capitalisation as such. This holds true for both tax law as well as civil law. However, different sources have claimed that the correction rule is applicable to these situations concerning the level of interest rate.[43] Also, it has been said that the correction rule could be used to re-classify debt capital to equity capital is certain situations. This requires that tax law does not follow the classification of the investment according to civil law. Disregarding the correction rule, other rules that could potentially be used to motivate a deviation from the classification according to civil law are the rules governing profit sharing notes and the tax avoidance act. The rules governing profit sharing notes apply to debt capital with interest dependent on the development of the company and could refuse deductibility of the interest pertaining to these notes. The tax avoidance act can be applied in situations where an instrument is created in order to avoid tax. According to the tax avoidance act, if a debt capital instrument is created in order to avoid tax, substance over for arguments can be used to re-classify the debt capital to equity capital. However, even though these possibilities exist, it is uncommon for this to happen in practice. This creates a situation where the tax treatment for certain instruments is not clear cut. In any case, the topic of re-classifying debt capital to equity capital is complex and the determination of whether an instrument constitutes debt capital or equity capital for tax purposes requires a case-by-case approach where the different equity and debt characteristics must be evaluated.

When considering whether the correction rule is applicable to these situations one need to ask the following questions. Would a company totally independent of both the parent as well as the subsidiary had agreed to set up a similar debt arrangement, a debt arrangement different from the one at in terms of less advantageous terms, or would not have been willing to set up any debt arrangement at all.[44] If the first situation is true it is obviously not possible to apply the correction rule. However, if the second situation is at hand the parent and the subsidiary have agreed on terms that deviate from what would have been the case if the arrangement had been set up between two independent parties. Since the parent company is not taxable for the income in Sweden while the subsidiary is, it would follow that the subsidiary should be refused to deduct the interest expense not marked to market that arises. Hence, the part of the interest rate exceeding market interest rate cannot be deducted for tax purposes. The other part

[43] Arvidsson, p. 347.
[44] Gäverth 1994, p. 106.

– the part in accordance with market interest rate – is not a problem and can be deducted in full. The part that is refused to be deducted in the Swedish subsidiary is instead viewed as dividend and one need to consider whether the rules governing profit sharing notes or the Withholding Tax Act is applicable. Finally, it is necessary to consider the third possible situation. In this case further questions rise. Relevant to consider are: What would the independent fund supplier have done if it had decided to finance the subsidiary in some form? The independent fund supplier perhaps would have contributed with some form of profit sharing note or other hybrid capital. If the financing has characteristics of equity financing the result will be that the fund supplier is no longer independent from the subsidiary.[45] This relationship could lead to several consequences.[46]

5.1 The correction rule

There is an obvious risk that companies within the same group or companies with joint economic interests and objectives in general will contract with each other, using prices which deviate from the prices that would have been used in an arms length transaction. These non-market based prices can be set at an appropriate level when goods and services are sold within the group.[47] Consider the example where a subsidiary purchases a good directly from its parent company at a price above market price. This will result in a lower taxable income in the subsidiary. Simultaneously, the taxable income will in the parent company will increase. Further, assume that the two companies are located in different countries and that the subsidiary is located in a country where the corporate tax rate is greater than the applicable tax rate in the country where the parent is located. The net result will be that the incorrect pricing results in a situation where some of the subsidiary's taxable income has been transferred to the parent and that the total tax burden for the group as a total has decreased.

In order to protect the tax basis, legislators usually use a method where the taxable result is corrected as if a transaction had been established at an arms length distance. This principle is commonly referred to as the arms length principle.48 In Swedish law, the arms length principle is established in the so called correction rule. This can be found in Chapter 14, Section 19-20 of the ITA.

[45] Sandels, p. 344.
[46] Gäverth 1994, p. 106.
[47] Dahlberg, p. 115.
[48] Wiman 2002, p. 90.

For the purpose of this paper it is interesting to investigate how the correction rule might be applicable to financial transactions between a parent company and its subsidiary. In specific, thin capitalisation situations are of interest. An important topic is obviously the position of the correction rule as regards to interest rate payments. Additionally, it is interesting to investigate the separation of shareholders equity and debt financing.[49]

5.1.1 Preambles to the Correction Rule

The purpose behind the correction rule has been to protect the Swedish tax base from untaxed profits moving from the country through transfer pricing mechanisms.50 This was to be carried out using the arms length principle. The correction rule was implemented to govern all sorts of transactions where untaxed profits risk the chance of being moved within related companies, such as a group of companies.[51] It has also been stated that the correction rule is applicable to financial investments between a parent company and its subsidiary although this needs to be considered on a case to case basis.[52] It has not been stated that the correction rule aims at governing situations of thin capitalisation.

5.1.2 The Correction Rule

According to the Swedish arms length principle, a correction of income is to be conducted for tax purposes if an entity's income is lower than it would have been as a consequence of a transaction differing from what had been the case, if the transaction had been conducted at an arms length principle. Three criteria must be fulfilled before a correction can take place according to Chapter 14, Section 19 of the ITA:

1. The entity which will have a greater income as a result of the contracting terms is not taxable for this income in Sweden due to regulations in the ITA or a double tax convention.
2. There are probable reasons to assume that the two parties have joint economic interests.

[49] Arvidsson, p. 323.
[50] Prop 1965:126, p. 15.
[51] SOU 1962:59, p. 212.
[52] SOU 1964:29, p. 122.

3. It can not be concluded from the specific circumstances that the contracting terms have been established for reasons other than the joint economic interests.

What constitutes probable reasons according to the second criterion have been a topic of discussion. On the one hand it has been said that the incorrect pricing as such should be considered as an indicator that joint economic interests are present. However, this is not sufficient. There must be some causality between the incorrect pricing and the joint economic interests at hand. At the same time, it should be noted that incorrect pricing can arise from reasons other than economic interests. The introduction of a product into a new market is one example.

The third criterion is specified in Chapter 14, Section 20 of the ITA. Joint economic interests rise in two alternative situations. The first situation is specified as when a business conductor, directly or indirectly, is involved in the organisation or governance of another business conductors company or own shares in this company. The alternative situation is at hand these business conductors, directly or indirectly, is involved in the organisation or governance of the both companies or own shares in these companies according to Chapter 14, Section 20 of the ITA.

5.1.3 RÅ 1970 Fi 923

RÅ 1970 Fi 923 played an important role for many years concerning the question whether the correction rule is applicable or not to intra-group debt arrangements with no applicable interest rate. When the verdict of the case was presented there was an intensive discussion in the academic and professional discourse.[53]

The circumstances in the case were as follows. A Swedish Industrial owned a subsidiary in England that mainly operated as a manufacturing entity. The activity present between the two companies in the group was minimal. The parent also possessed a long term debt investment in the subsidiary amounting to about MSEK 12.7. This debt arrangement was set up in connection to an investment in machinery by the subsidiary. The subsidiary resulted in being thinly capitalised. In addition, the subsidiary was performing poorly and the risks involved

[53] Arvidsson, p. 323.

where very likely to result in a situation where the subsidiary could not be burdened with stipulated interest rate payments to the parent without defaulting or at least showing great losses. In order to avoid this scenario, the parent company adjusted the applicable interest rate. The question was which effects that would arise since the subsidiary was not debited with an interest rate marked to market.

In the verdict, it was concluded that if the parent company had in fact contracted with its subsidiary so that the size of the applicable interest rate was set in a way differing from what would had been the case if the same situation would have been present in a case where the two parties where at an arms length distance. All the criteria necessary for applying the correction rule were present and the transaction was to be considered as a hidden transfer of wealth. Therefore, the parents result must be adjusted to the amount that would be the case if the reduction of interest rate had not happened. Thus, the fact that a company is performing poorly and will not be able to be burdened with interest rates marked to market is not sufficient to motivate incorrect pricing without the correction rule to be applicable.

5.1.4 Öberg & Co[54]

RÅ 1979 1:40 concerned a Swedish parent company (Öberg & Co AB) that had established a subsidiary in Portugal. The two companies were both highly active in producing tools, mainly files. Inputs were produced by the Swedish parent and the Portuguese subsidiary used these to produce the files. These were then sold to the parent company in Sweden. In addition, the parent company had invested surplus capital in the subsidiary through a debt arrangement and had chosen not to charge any interest expense. The debt arrangement was set up in connection to the initiation of the business in Portugal. The Swedish tax authorities claimed that the correction rule was applicable since the lack of an interest rate was to be considered to be a hidden transfer of wealth to another country.

Contrary to the outcome in RÅ 1970 Fi 923, the Supreme Court stipulated that the correction rule was not applicable. One reason was that if the subsidiary in fact would have paid interest rate due to the debt arrangement, the result would be that the costs of production would have risen with the same amount. It could be reasonably assumed that this would have resulted in

[54] RÅ 1979 1:40

an increase in the price that the subsidiary would have charged in the sale to the Swedish parent. Because of this, the profit in the parent company would be unaffected. Therefore it could not be established that the net income in the parent company would have been lower than it would have been if it had in fact charged interest rate to the debt arrangement. The Supreme Court also stated that the fact that the subsidiary was in a period of establishment and the parents company's purpose was to grow the Portuguese company to a solid production plant, further motivated the parent company not to charge interest expense to the debt arrangement. These arguments together were considered to be sufficient not to apply the correction rule.

5.1.5 LM-Ericsson[55]

The Supreme Court has maid interesting statements concerning substance over form arguments in deciding whether to classify finance as debt or equity in RÅ 1980 1:59. Also this case concerned a situation where a Swedish parent company chose not to charge interest expense in a debt arrangement with its foreign subsidiary. The telephone company LM Ericsson (LME) had set up a debt arrangement supplying funds to an Australian subsidiary, Teleric Proprietary Ltd. There was no interest expense charged to the subsidiary. The Swedish tax authorities claimed that the net income of LME should be adjusted as if it had charged an interest expense amounting to a specified rate in accordance with the correction rule. LME on the other hand stated that the debt arrangements in fact were equity investments in substance and that it was unfortunate that they were classified as debt. In addition, the arrangements made it possible for LME to gain extra revenues and reduce some expenses mainly through licences and income from delivered goods and rendered services. These more than enough outweighed the return on capital from the invested capital. Therefore, LME claimed that no correction should be conducted.

The Supreme Court reasoned that LME had considered both economic reasons as well as political reasons when setting up the interest free debt arrangements. Also, when applying the correction rule there need to be some cause and effect so that the taxable income in Sweden results as lower than it otherwise would have been. When considering if this is the case or not one cannot limit oneself to one step in the transaction chain. It can be considered motivated,

[55] RÅ 1980 1:59

not to charge interest expense to debt arrangements also in the case when two independent parties contract with each other, if sufficient compensation is given in return through pricing of goods or other activities. The Supreme Court stated that the correction rule was not applicable to the given situation. As mentioned, this statement rests on two arguments. Firstly, by considering the whole chain of activities other income effects from the arrangement can be revealed. Secondly, regarding the arrangement according to substance and not form leads to viewing the capital as equity and not debt.

5.1.6 Edet[56]

This case is similar to the Öberg & Co AB case. The situation at hand was as follows. Edet AB had several subsidiaries located in the Netherlands. Edet had supplied funds to one of the subsidiaries through interest free debt arrangements. The funds were supplied in order for the Dutch subsidiary to develop its production capacity and enter new markets. The main idea was that the subsidiaries were to buy inputs from the parent company and add value in the production process for these new markets. In similar fashion to the Öberg & Co case the majority of the funds had been used to invest in new machinery used in the process of paper manufacturing. The actual development in the Dutch subsidiaries did unfortunately not turn out as expected and the financial position of the companies was constantly weak. The investments were considered to be risk capital. As a result, the debt arrangements were written off in the parent company or re-classified as equity capital investments. In addition, there was little or no activity present between the parent and its subsidiaries. The tax authorities claimed that net income in the parent was to be adjusted by interest income in accordance to the correction rule.

The Supreme Court made a reference to the preambles of the correction rule[57] and stated that when investigating the affairs of a Swedish parent and its foreign subsidiaries it is of great importance to be prudent when applying the correction rule depending on the economics of the situation at hand that could potentially have an impact on the pricing. The specific investigation in the case showed that the circumstances surrounding the parent company’s attempt to enter new markets were of such kind that it could be considered reasonable not to burden the subsidiaries with interest expense for the relevant investments. The Supreme Court

[56] RÅ 1984 1:16
[57] SOU 1964:29 p 119

hence stated that the parent company had sufficient reasons not to charge interest expense to the relevant debt arrangements. In a phase of development it is reasonable not to charge interest expense to subsidiaries and as a consequence the correction rule is not applicable. By stating this the Supreme Court expressed the principle that if an action can be considered being motivated by commercial reasons, a prudent view must lead the decision whether the correction rule is applicable or not. Making an effort to enter a new market was considered as being commercially motivating not to charge interest expense. Whether or not this effort succeeds or not is of less importance. This means it is necessary to look at the circumstances when the investments were conducted and that this investigation must be performed on a case to case basis.

5.1.7 Mobil Oil/Norsk Hydro[58]

As mentioned, the Mobil Oil case has had great impact on the view of thin capitalisation in Sweden. Svenska Mobil Oil AB (later changed its name to Norsk Hydro AB) had an obligation to an American company which belonged to the same group as Svenska Mobil Oil AB:s parent company, Mobil Oil Co. This was a result of some deliveries of goods. The debt was accounted for as a long term debt to its parent company. For some years, there were no dividend payments from the Swedish subsidiary. After a couple of years half of the accrual – or MUSD 16 - was transformed into a long term debt arrangement. Interest was to be paid quarterly with a specified interest rate. The equity capital of Svenska Mobil Oil was at the time MSEK 13 and hence there was no doubt that the company was thinly capitalised and this had also been the case for some time. There were no terms specifying amortization, loan security or consequences for late payment. During a period of years there were no interest rate payments at all while there were interest rate payments during some years. The interest was expensed when they were de facto paid. The interest rate payments were highly correlated with profitability in the company. In addition, there was no amortisation at all during the relevant period. Svenska Mobil Oil AB was later sold to Norsk Hydro. The conflict concerned two questions, both with origin in the correction rule. The first question relates to whether the financial arrangement could be considered to be an equity arrangement rather than a debt arrangement as it was labelled. This is a so called substance over form argument. The second

[58] RÅ 1990 ref. 34.

question concerned the level of the interest expense and whether they were marked to market or not.

The Supreme Court starts by questioning whether the situation at hand could lead to the long term debt arrangement could be considered as in fact being an equity arrangement due to the fact that the company was thinly capitalised. Firstly, a fact is that there are no specific rules governing the ratio of debt to equity in Swedish law. The only rules that govern corporate finance are those that are stipulated in company law. The fact that the company was thinly capitalised is not in itself sufficient to motivate applicability of the correction rule. Secondly, applying the correction rule to the situation would require a comparison of the terms that the Swedish company could have contracted if the transaction would have been conducted at an arms length distance. In connection to this consideration, the Supreme Court states that financing arrangements between independent actors are set up in the form of debt arrangements, not as risk capital. Therefore, if a comparison is to be done with a hypothetical situation at arms length distance, this situation would be a debt arrangement. Hence, the capital in question cannot be re-classified as equity capital from a tax point of view in accordance with the correction rule. Considering the relevant facts in the specific case the Supreme Court states that the capital in question was to be considered as debt capital and not equity capital as argued by the tax authorities. As a consequence, the resulting payments are considered being interest rate payments. Hence, the fact that a company is thinly capitalised does not lead to any specific consequences from a tax law point of view in Sweden.

Concerning the level of the applicable interest rate it can be noted that there seemed to be of no doubt that if the debt arrangement would have been contracted at an arms length distance the applicable interest rate would most likely have been greater than the actually contracted interest rate. However, this would have led to a smaller net income in Svenska Mobil Oil. In this sense, a correction would lead to the opposite of what the correction rule aimed at. Income would be transferred from the Swedish tax base abroad instead of the other way around. The purpose of the correction rule is to protect the Swedish tax base. The correction rule was hence not applicable at all.

5.1.8 Svenska Shell[59]

[59] RÅ 1991 ref. 107

Even though the verdict in RÅ 1991 ref. 107 is not based on thin capitalisation it is still meaningful for the analysis. This case treated the situation of Svenska Shell AB and its purchases and transports of crude oil from the British company Shell International Petrolium Company (SIPC). SIPC belonged to the same group as Svenska Shell AB. The Shell group was vertically integrated and the companies within the group were involved with each other to a large extent. SIPC played the role of an international trading company. Even though Svenska Shell was also involved in trading activities within Sweden it was primarily an operating company through a refinery in Gothenburg. The issue at hand was whether the prices paid by Svenska Shell AB to SIPC were greater than what would have been the case if the transactions would have been conducted at an arms length distance.

Considering the situation at hand, the Supreme Court stated that SIPC was relatively independent of the group and that SIPC was entitled to make a profit on the services delivered within the group. In order to establish the arms length price a thorough investigation was performed. This mainly discussed the pricing mechanisms in the crude oil industry which are by themselves interesting although for the purpose of this paper of less importance. However some interesting reasoning by the Supreme Court is in order to account for. It was emphasised how important it is to make careful considerations when doing these price comparisons. The danger of setting up fictive transaction examples were stressed and that this was only an alternative if no other comparisons could be made. If fictional prices still are to be used the difference between the fictional prices and the relevant prices to compare need to be substantial in order for the correction rule to be applicable. In addition, one has to take into account long term effects of the pricing arrangements. According to the Supreme Court, overpricing in one year can normally be netted against underpricing in another year. A common principle in the Swedish tax system is that the year of taxation is closed. That is, it is usually not possible to net out circumstances from different years of taxation. Even though this is the general case, the Supreme Court concluded that in the case of incorrect pricing from the correction rule point of view the analysis must be of a long term nature and the principle could hence be motivated to be broken. Guidelines concerning when this could potentially be the case was left out so the question need to be judged on a case to case basis.

Finally, an important statement was made concerning the relevant sources to base judgement to correction rule applications. The Supreme Court concluded that the problem of incorrect

pricing in multinational groups is an international problem and that these problems are treated in the OECD model treaty and specifically referred to an OECD report from 1979 (Transfer Pricing and Multinational Enterprises). This means that the material presented by OECD had legal value in the Supreme Court and that OECD guidelines should be considered when analysing the correction rule and its applicability.

5.1.9Discussion on the correction rule

The applicability of the correction rule to intra-group debt arrangements can be summarised as follows. An interest rate too high or too low can be corrected. Not charging interest rate, or charging interest rate too high or too low, to intra-group financing arrangements is in Swedish tax law considered as unacceptable transfer of income. The correction rule will always be potentially applicable in these situations. Considering the situation where a Swedish subsidiary as a result of a debt issue to its parent located in another country is burdened with an interest expense obviously higher than the interest rate marked to market. In this case it unquestionable that the correction rule is potentially applicable. However, the Supreme Court has in some cases established that certain circumstances motivate the use of an interest rate differing from the rate marked to market.[60]

In RÅ 1970 Fi 923 the Supreme Court stipulated that the correction rule is applicable to situations where the the contracted interest rate deviates from market interest rate. The fact that the financed company performs poorly and cannot pay market interest rate does not change this.

The Supreme Court has later stipulated that - under certain circumstances – it can be reasonable to deviate from the principle of interest rate marked to market. In Öberg & CO a Swedish parent company had not charged any interest rate to a debt arrangement to its foreign subsidiary. However, if interest rate would have been charged, the subsidiary would have to bear increased expenses and would charge higher prices in the business activity with its parent. This would have resulted in the parent company's taxable income not becoming lower and the correction rule would not be applicable. Reasoning like this, the Supreme Court adopted a comprehensive view of the companies' transactions. Interesting with this verdict is

[60] Gäverth 1994, p. 105.

the reasoning carried out by the Supreme Court. By adopting the comprehensive view on the companies' affairs it is concluded that not charging interest rate does not lead to change of taxable income. One cannot simply analyse the interest rate transactions in isolation but rather take in all circumstances that might affect taxable income. It is this kind of reasoning that in literature on tax law that is labelled as a comprehensive view. The result is that it is not necessary to isolate and analyse all transactions as the Supreme Court did in RÅ 1970 Fi 923 but rather analyse all transactions conducted between the companies. This could very well lead to realising that one transaction have compensated for another.61 The Supreme Court also state that pricing within a group in order to cover expenses in the manufacturing company can be accepted. To which extent this can be done needs however to be considered on a case to case basis. This level of tolerance is in accordance with the correction rule and its function since the causality built in which mean that one need to consider how taxable income follows from pricing decisions.

The Edet case has moreover shown that the correction rule should be applied prudently and that under certain circumstances it can be acceptable not to charge interest rate to intra-group finance even if this results in a lower taxable income in Sweden. Entering new markets was considered sufficient with regard to this respect. However, one question remains from the case. For how many years can it be accepted not to charge interest rate? One view is that a company in a similar position as Edet could at least for a few additional years continue not to charge interest rate or a lower interest rate than the market interest rate. Once the subsidiary has reached a sound enough financial performance and position to pay interest rate it would seem reasonable for the company to be burdened with these expenses. If the parent company had chosen to explore the new market by itself it would have had to bear these expenses anyway. The verdict also helped in making the application of the correction rule to intra-group financing more clearly. It was stated that charging an interest rate too high should be judged with higher degree of suspicion than charging an interest rate too low.62 Hence, the prudence principle seems to be applicable to a higher degree for lower interest rates.

If the company's taxable income does not become lower as a consequence of not charging interest rate then the correction rule is simply not applicable.[63] One view states that there are

[61] Arvidsson, p. 354.
[62] Ibid, p. 337.
[63] Ibid, p. 326.

at least three reasons motivating this. Firstly, consider the technical construction of the correction rule. There has not been any loss of taxable income for the Swedish company. If the interest rate would have been marked to market this would in fact have been higher and the taxable income even lower. This means that there has not been any deviation from the market interest rate. Secondly, the correction rule was not formulated to include situations where transactions need to be reclassified in accordance to their real meaning in substance. The rule is simply applicable to correcting the level of prices. This is also noted in the Mobil Oil case. Finally, it has been stated that the Supreme Court has made a point when stating that the correction rule is not aiming at correcting situations of thin capitalisation. There are no such claims in the preambles to the correction rule.[64]

Another view has also been presented. This view agrees that there has not been any change in taxable income. However, it does not agree to the statement that there has not been any deviation from the market interest rate. Rather, there is a deviation but one that profits the Swedish company and its taxable income not the other way around. The fact that there has not been any decrease in taxable income in the Swedish company follows from the fact that an external debt arrangement would have been even more expensive.[65]

Another important question is how the correction rule is positioned as regards to the separation of shareholders equity and debt financing.[66] If it can be established that from a legal point of view, a subsidiary's debt issue in favour of its parent is in fact a contribution of shareholders capital, the result must be that the payments from the subsidiary to the parent as a result of the contributed capital from a tax point of view is to be considered as dividend payments rather than interest rate payments.[67] There is a potential threat that situations characterised by deviating economic substance and legal form arise. In these cases it is necessary to consider whether the correction rule can be used to express substance over form.

When deciding whether an investment is to be classified as an equity issue or a debt issue, the Supreme Court supports the view that that civil law should guide the tax law. This primarily follows from the Mobil Oil case. On the other hand it has been stated that this verdict was dependent on the fact that the issue concerned a real accounts payable that was later converted

64 Gäverth 1994, p. 111.
65 Ibid, p. 113.
66 Arvidsson, p. 323.
67 Gäverth 1998, p. 31.

into a long term debt arrangement. It was also accounted for in the financial statements as long term debt. Because of these circumstances, it is necessary to be careful when drawing general conclusions. If the case had instead originally concerned a debt arrangement, the re-classification to equity capital would have been closer at hand. This reasoning nevertheless agrees with the fact that thin capitalisation by itself does not have any meaning on its own concerning this issue. It is one of many facts to consider.

Several comments have been made concerning the Mobil/Oil case. The tax authorities questioned whether an independent investor in a similar situation would have agreed to the relevant terms in the debt arrangement or if they would have insisted on gaining owner influence in the company. If this was the case, then the capital should be re-classified as equity capital. The Supreme Administrative Court neglects this but is not specific in its motivation.[68]

Also, it has been pointed out that in the Shell case the Supreme Court stated that comparisons to arms length situations should be based on real comparisons as often as possible. Hypothetical comparisons need to be avoided and is only a last resort if there are no comparable transactions to be found. This is of importance since in the Mobil Oil case, no such comparison was carried out. Since the tax authorities had questioned if this could be provided it seems as this would perhaps have been appropriate.[69]

It would seem difficult to draw specific conclusions on the topic of reclassifying debt capital to equity capital motivated by substance over form arguments using the correction rule. It has also been questioned to which extent it matters who represents the Supreme Court in the verdicts. This has to do with whether the representatives in the Supreme Court are dependent on formal investigation or if they feel free to perform a more realistic interpretation of the situation.[70] One view is that Swedish tax law in general gives no room to re-classify a formally correct debt arrangement to be treated as equity capital even though this has been done at some occasions. This holds true for the correction rule as well. The correction rule and its applicability to substance over form in intra-group financing hence seem limited.[71]

[68] Gäverth 1994, p 111.
[69] Ibid, p. 112.
[70] Gäverth 1998, p. 733.
[71] Gäverth 1994, p. 105.

Another view states that it is in principle inappropriate to compare the parent company as a debtor to an independent debtor. An independent party would never have invested by using the debt capital arrangement used in the Mobil/Oil case due to the fact that the subsidiary was thinly capitalised. The only reason the parent company in this particular case did so anyway was because of the common interests at hand.[72] Another issue in the Mobil/Oil case was that even if the parent company had debited interest in full the subsidiary would not under the actual circumstances have had the possibility to pay this and taxation would not be at hand at all. Despite this fact, correction could still be relevant to consider. This correction should on the other hand be based on the fact that the debt arrangement, fully or partially, is reclassified as equity capital. The result will be that the correction is to be considered at an earlier point in time, when the debt arrangement was setup in the first case.[73]

On the other hand it has been stated that the verdict in the Mobil Oil case could not have had any other result than the given due to the fact the company only questioned what the consequences would be from the de facto applied – too small – interest rate. It was first on a later point in time in the Supreme Court that the company asked how taxable income would be calculated. Considering these circumstances, it is only natural that only the principal question is discussed as a consequence. That is whether charging a lower interest than market interest would lead to correction according to the correction rule.[74]

On another note, the most important question for the Supreme Court to focus on should have been whether the consideration would have been done by an independent debtor and had reached the result that no reduction of the interest rate would have been necessary because it is irrelevant if the financed company was profitable or not.[75]

One could also question whether the correction rule can be applied to financial transactions already from the beginning or not. Since an independent investor would never supply capital in the first place it is not possible compare what interest rate that would have been applied. If a comparison is to be done in this manner it is necessary to compare financing forms to each other not interest rates of similar debt arrangements. But this would result in correction being conducted at an earlier stage, at the time the financing was set up. The idea would instead be

[72] Sandels, p. 344.
[73] Arvidsson, p. 324.
[74] Björne, p. 503.
[75] Mattsson, p. 466.

to investigate if debt arrangements have been given false form that should be treated in accordance from a tax law point of view. It would be problematic and difficult to administrate such an analysis each time a debt arrangement is set up and then, at a later point in time the analysis need to be carried out again and investigate whether there is a deviation or not.[76]

The problem concerning intra-group financing from a tax law point of view is, as can be noted, a very complex issue. In the Mobil Oil case, the tax authorities meant that since thin capitalisation was used to such a large extent, some of the debt should be re-classified as equity. In the Edet case however, the tax authorities instead meant that the parent company which had invested capital should be taxed for interest income in a similar debt arrangement. This seems to be totally different views on how to treat the topic.[77]

Finally, it is interesting that the Supreme Administrative Court in the Mobil Oil case first did investigate whether the debt arrangement was actually to be considered as equity due to its economic substance. As already noted this was not the case. However, an important conclusion is that there might very well exists situations – similar to the one at hand – where debt can in fact be re-classified as equity.[78]

The Swedish tax authorities have also commented thin capitalisation issues and the correction rule. To begin with, the Swedish tax authorities are of the view that special rules would be the best alternative on how to deal with issues of thin capitalisation. However, it would be difficult to legislate before an international harmonisation is at hand. Until this is the case, the Swedish tax authorities proposes that the OECD model treaty, article 9.1 should be used as internal law and that the principles stipulated there should be applied in thin capitalisation situations. Specified guidelines concerning implementation are needed. Further, the Swedish tax authorities suggest that re-classification of interest to hidden dividend distribution and limited deductibility as a result should be possible to achieve through the correction rule when the debt-to-equity ratio is abnormally high compared to the industry. A number of factors are given as examples of what to consider when investigating potential re-classification of debt to equity. It is necessary to consider if the debt is subordinated to other debt, if the solidity is not typical, if there is not a fixed date when the debt needs to be repaid, if contracted and actually

[76] Arvidsson, p. 337.
[77] Sandels, p. 345.
[78] Estberg 1993, p. 104.

paid interest deviate from an arms length interest, if the debt has been invested as a consequence of the lack of operating capital contrary to the case if the investment was maid to purchase fixed assets, if the debt is issued specifically for equity holders in relation to their equity holdings, if the debt can be converted into equity shares and finally if the interest in some manner is dependent on the profits if the debtor company. Even if these situations are at hand, the Swedish tax authorities stipulate that a debt-to-equity ratio of 3:1 should always be accepted for tax purposes. If one or more than one of these situations are at hand, it should be possible to re-classify debt to equity. No guidance is given on the topic of how these circumstances should be given weight in an actual situation.[79]

5.2 The rules governing profit sharing notes

5.2.1 Introduction

Due to various legal, economic and commercial reasons, companies use mixed financing forms to combine the advantages of both equity and debt. The object may also be to attain the security of equity finance but the tax treatment of debt finance. If there is a difference in tax treatment between debt capital and equity capital, this could create incentives for tax planning. Therefore, it is of great importance that debt capital and equity capital – and interest and dividend return - are distinguished and defined for tax purposes.[80]

In order to govern these kinds of situations, the Swedish legislator has implemented special rules governing interest expense on debt capital where the interest rate is dependent on the development of the company. The rules governing profit sharing notes can be found in Chapter 24 Section 5-10 of the ITA. These rules are of special interest when separating debt capital from equity capital, and hence deciding on whether the resulting interest is deductible for tax purposes or not.

5.2.2 Preambles to the rules governing profit sharing notes

In 1931, it was brought up to discussion to which degree debt capital with interest dependent on the company's decision making process or performance resembled equity capital and

[79] Riksskatteverket, pp. 42.
[80] Helminen, p. 252.

whether this could motivate the interest as being regarded as a dividend rather than interest and not be deductible as a result.[81] This was also stated in 1964, where it was argued that profit sharing notes resembled equity capital since risk and return was closer to equity capital than debt capital. It was argued that these types of investments where often structured in order to avoid double taxation.[82] This motivated that the rules needed to be changed in order to avoid this type of tax planning. It has also been proposed that interest on profit sharing notes should be deductible to the extent that it represents what is considered reasonable from a market perspective for common debt capital. The interest that the investor receives from taking on more risk due to the specific characteristics of the profit sharing notes was not to be deductible on the other hand it was argued.[83] In 1976/77, it was argued that interest resulting from debt capital in the form of profit sharing notes need to be deductible in full, as long as the capital has been offered to the public, without preferred right to equity capital holders or by a company with publicly traded equity capital.[84] This was motivated by the fact that profit sharing notes should not be mistreated relative other debt capital and that profit sharing notes needed to be promoted as an alternative to financing companies. The reason public companies and private companies as well as management with equity capital are treated differently is to avoid capital structures setup at terms deviating from market terms.

5.2.3 The rules governing profit sharing notes

Swedish company law allows for companies to finance their operations through debt arrangements, where the interest rate is fully or in part connected to dividend payments or the performance of the company. One of these debt arrangements are profit sharing notes. The deductibility of the interest rate from these financing instruments is governed in Chapter 24 Section 5-10 of the ITA.[85] Both interest that is fixed and interest dependent on the company's performance can be deducted if they follow these rules.

The ITA defines profit sharing notes as debt capital where the interest is dependent on the development of the company in terms of profit or dividend. The main principle is that the fixed part of the interest on a debt capital investment is deductible while the variable part is

[81] SOU 1931:40, p. 231.
[82] SOU 1964:2 p. 85.
[83] SOU 1972:63, p. 112.
[84] Prop 1976/77:93, p. 52.
[85] Gäverth 1994, p. 22.

not. In certain cases however, even the variable part can be deductible, depending on whether the rules specified in Chapter 24 Section 5-10 of the ITA are fulfilled.

Fixed interest is deductible if is marked to market. Variable interest is on the other hand only deductible if the debt is issued in the public market or to a group of investors that are independent from the company. If the company issue these kinds of debt arrangements with specific rights for equity owners or to any person not independent from the company, the interest expense will not be deductible. The process of deciding whether a person is independent or not is analysed using the correction rule. Publicly traded companies are excluded from these limitations.[86]

5.2.4 RÅ 2001 ref. 12

This verdict, as in the previous case, also concerned profit sharing notes – although a discussion concerning the tax position of the receiving party was also included. A consultancy company active in the IT sector wished to offer its employees the possibility to sign convertible profit sharing notes in the company. The purpose was to finance the company's future expansion as well as to create extrinsic motivation with employees. The company was to be considered as a closely held company. The deal was structured so that employees were to supply additional funds to the company in return for a profit sharing note that could be converted into equity capital in the future on behalf of the employee. The total capital provided in the form of profit sharing notes was given with a required rate of return. They were obviously considered to be a profit sharing notes as defined in the ITA. If the company performs poorly and do not deliver profits, the holders of the notes are not entitled to any return on their investments in that year. If the notes have not been converted at their maturity, holders receive the face value of the notes. The question raised – along with others not accounted for here – was whether the interest expense resulting from the notes would be deductible for tax purposes in the company in accordance with the ITA and potentially in accordance with the Tax Avoidance Act.

In the verdict, it was stipulated that the interest expense could not be deductible in the company. The question is governed by the rules concerning profit sharing notes in the ITA.

[86] Ibid, p. 115.

The rules stipulate that in order for profit sharing notes to be deductible the issue cannot be directed towards someone who owns shares in the company, have aligned interests or are a director as defined in the rules governing closely held companies or are in a close relationship with such mentioned. Since at least some of the employees own shares in the company, the interest expense cannot be deductible. The Supreme Court agreed and also stipulated that the Tax Avoidance Act was not applicable since the ITA refused deductibility.

5.2.5 Discussion on the rules governing profit sharing notes

The discussion on the deductibility of variable interest has been stated as follows. Firstly, if interest is not considered as being fixed it could be governed by Chapter 24 Section 5-10 of the ITA. Secondly, if the interest is contracted to be fixed but in reality is variable since it is only paid when the company in question can afford to do so it is necessary to investigate the probability that the sacrifice will be made concerning the liability that arise. Thirdly, it could be necessary to consider whether the resulting liability could instead be re-classified as equity capital. If the transaction fails any of these tests, the interest expense should not be deductible for tax purposes.[87]

If a situation is characterised by a debt arrangement where the interest is variable – but marked to marked – it seems obvious that deduction of interest expense can be refused. This follows from the rules governing profit sharing notes specified in Chapter 24 Section 5-10 of the ITA.

A difficult question is whether these rules are limited to the profit sharing notes defined in company law or if the rules are more general in their application. It has been stated in the preambles that these rules govern all cases where Swedish companies issue debt where the level of the interest rate is dependent on the performance of the company or dividends to equity investors. This means that any non-public company could be refused deduction of interest expense resulting from debt capital where the level of the interest is dependent on the development of the company. Hence, it seems like the rules are not limited to the profit sharing notes mentioned in company law. Chapter 24 Section 5-10 are more general in their

[87] Ibid, p. 117.

applicability and can to some extent be said to govern hybrid capital in general as long as the interest is dependent on the development of the company.

Further, it is interesting to examine what is required for the rules governing profit sharing notes to be applicable. Not paying interest rates due to thin capitalisation or poor performance in certain periods seems ineffective as arguments against applying the rules. If this would have been the case, the interest treated in the Mobil Oil case (although however in relation to the correction rule) should not have been deductible. Also, since it seems like since the rules governing profit sharing notes stipulated in the ITA are more general in their application than are the respective instruments in company law, it should follow that all kinds of variable interest should be governed by the rules.[88] However, since there is obviously a difference if fixed interest marked to market is used but payment only occurs when the financial position of the Swedish subsidiary allows this, this does not seem to be the case. This means that if interest is expensed – and deducted for tax purposes – but not paid until later and accounted for as interest payable in the subsidiary's balance sheet, the situation is accepted and the interest expense is to be deducted for tax purposes. In this manner it seems possible to avoid the restrictive rules. So instead of contracting a variable interest rate, a fixed interest rate is contracted where payments only occur at special occasions. Deferred payments, with additional compounded interest rate, are only paid when the financial position allows this. In an objective investigation of the situation it could very well be the case that this structure is setup because the parent company wishes not to tie up additional equity capital or that it would cause the subsidiary to liquidation if interest payments where enforced.

As mentioned, it would be required that the deferred payments are accounted for as a liability in order for the interest expense to be deducted. This means it needs to be probable that the obligation is enforced in the future. That the interest rate is not paid does in principle not have any independent meaning. It can however be questioned whether it is in accordance with established accounting principles to convert not paid interest rate expenses to liabilities on an ongoing basis. There is a trade off here. On the one hand the prudence principle of conventional accounting needs to be considered but on the other hand it is inappropriate to expense a cost before it is probable that a sacrifice must be made. Another question that arises from the discussion is if interest rate payments are in fact deferred and accounted for as a

[88] Gäverth 1998, p. 261.

liability, is it then possible that the capital at some point in time should be re-classified as equity. There is a possibility that this situation could trigger the consideration of re-classification of debt to equity. The fact that a debt relationship exists where there are no claims could signal that the capital should rather be viewed as equity.[89]

5.3 The tax avoidance act

5.3.1 Introduction

Even though it has been argued that the correction rule could potentially be used to re-classify debt capital to equity capital, the open possibilities to do this in practice seems rather limited. The starting point when deciding on how to classify corporate finance should be that the legal form of an investment is respected for tax purposes as well. The issue of defining the line between debt capital and equity capital is complex since accounting principles and practice influence the tax law. The main principle is that accounting practice is used as a starting point for taxation but if specific tax rules exists these must be followed according to Chapter 14 Section 2-4 of the ITA. In addition, the starting point when considering debt capital is usually its classification according to civil law since it is generally accepted that tax law should follow company law.[90]

When analysing thin capitalisation situations it is necessary to take several steps. First it is necessary to find relevant contracts governing the situation. When these have been identified it is necessary to examine whether they mirror the actual intents of the parties or have only been entered into in appearance. If they are formally acceptable contracts the next step will be to examine whether the contracts have been given the correct legal form, or is if the substance is the same as the legal form. If the situation is characterised by several transactions and all transactions in isolation have been given the correct legal form it is also necessary to perform a comprehensive analysis and investigate whether the aggregate transactions together could have been given any other form due to its economic substance. A more thorough analysis is hence performed and the economic substance is compared to the form according to civil law. If the transactions hold these tests there is only one alternative left, to investigate if the tax

[89] Gäverth 1994, p. 117.
[90] Gäverth 1998, p. 591.

avoidance act is applicable.[91] The last resort when examining thin capitalisation situations from a tax point of view is hence the tax avoidance act.[92]

5.3.2 Preambles to the Tax Avoidance Act

The Tax Avoidance Act was introduced in 1981. A common feature in the development of the rules has been that a tax benefit must have occurred. Even if it was not at first stipulated in the rules that the benefit would accrue to the fiscal unit this has always been mentioned in the preambles. It was early suggested that tax benefits to persons with common interests should also be included in the rules but this was disliked at the time.[93] Only the fiscal unit at hand can be subject to the tax benefit mentioned in the rules in question.

The rules where discussed again some years later and it was again mentioned that the mentioned tax benefit should also be included to be applicable when it arises at a person with common interests with the fiscal unit at hand. This would mean that the Tax Avoidance Act would be applicable to all connections between companies within a group.[94] This suggestion was once again disregarded.

A new Tax Avoidance Act was introduced in 1995. In connection with this the government maid a statement concerning the need for the rules needed to be investigated.[95]

5.3.3 The Tax Avoidance Act

The tax avoidance act makes it possible to apply substance over form, which in practice can result in a chain of legal actions performed in order to avoid tax, to be taxed as if the actions had never taken place. This could be the case for various hybrid capital investments which have been set up in order to avoid tax. The rules are structured in Section 2 of the tax avoidance act so that four criteria need to be fulfilled.

[91] Gäverth 1996, p. 768.
[92] Gäverth 1998, p. 260.
[93] Prop. 1980/81:17 p. 27.
[94] SOU 1989:81 p. 76
[95] Prop. 1994/95:209 p. 34.

The first criterion states that the law can only be applied in cases where material tax benefits can be achieved. This means that a material value in terms of relief from tax burden must be the result if the rules are not applied. According to the second criterion, the fiscal unit need to have contributed actively to the relevant situation. Also, according to the third criterion, the tax benefit must have been the motive behind the legal action. This means that if there are reasons motivating the legal action to a larger extent than the pure tax related reasons the tax avoidance act cannot be applicable. Finally, it is required that the taxation resulting from the legal action need to striding against the purpose of the rules being avoided. Hence, it is necessary that the situation is characterised by tax planning.

5.3.4 RÅ 1998 not. 195

The case concerned a Swedish company that intended to issue convertible profit sharing debt. The question at hand was whether the interest applicable to the issue would be deductible for tax purposes for the company. Many characteristics of the issue motivated that the issue was an equity issue rather than a debt issue. The capital was to be repaid in 2096, the interest rate could be considered as variable, the holders of the new issue would control the company and the instrument functions like equity in general. On the other hand, the company stated that the issue did not lead to any formal voting rights at the general shareholders meeting, that the capital is intended to be repaid if conversion does not take place and foremost that the capital was labelled as debt according to civil law.

The verdict supported by the Supreme Court meant that since the issue was directed towards the public market, interest that is dependent on the performance of the company is deductible according to the ITA. However, since the holders of the capital would gain control over the company this argument is no longer relevant and it would be contrary to the purpose of the ITA to approve the deduction. Hence, the company was refused deductibility for the interest expense. The Supreme Court agreed aligned with this view and refused the deduction since it would have been in conflict with the purpose of the rules in ITA governing profit sharing notes and the Tax Avoidance Act was hence applicable.

5.3.5 Discussion on the tax avoidance act

The reclassification of a debt capital to equity capital from a tax law point of view would need to be motivated on the grounds of substance over form. It seems undutiful that a transaction from a tax law point of view should be based on its economic substance. If a transaction is of importance from a tax law point of view, and its economic substance is of other kind than its legal form, then it should be clear that the economic substance should be the basis for the interpretation in the tax law matter.[96] In this manner substance over form should be separated from transactions that are based on synthetic contracting – a simulated act with legal consequences. In these situations, the transactions have been conducted not to engage the contracting parties but rather to mislead a third party – such as the tax authorities. Substance over form in tax matters means that a series of transactions, which economic substance deviate from their legal form in isolation, should be interpreted for tax purposes in terms of their economic substance. This requires that the whole chain of transactions need to be considered and what economic substance they constitute together. A comprehensive view needs to be applied.[97]

Using substance over form arguments, a series of transactions could be re-classified using the tax avoidance act. Regarding situations of re-classifying debt capital to equity capital it is questionable whether the tax avoidance act could be applicable. It seems difficult for tax authorities to motivate the application.[98] The deductibility of these interest expenses are potentially refused for non-public companies and concerns interest rates with some dependence on the profits of the company. These kinds of interest rates are not unusual in cases of thin capitalisation. If it can be found that a non-public company has issued debt capital which interest varies with the performance of the company there are reasons to question if a thin capitalisation structure has been set up in order to avoid these rules. If so, the tax avoidance act seems potentially applicable and refusal of the deductibility of the interest expense could follow as a consequence.[99]

The most obvious purpose with regards to the third criterion is the rules concerning deductibility of interest expenses. These are the general rules governing deductibility of

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[96] Gäverth 1996, p. 731.
[97] Ibid, p. 737.
[98] Gäverth 1998, p. 40.
[99] Gäverth 1998 p 40 st 2

expenses necessary in a business in order to achieve revenues. It is necessary that the interest expense is necessary in order to maintain the business and is not a covered dividend or equity capital transfer of some kind. Dividend payments are to be paid from already taxed funds. Other relevant regulations are the rules governing exemption tax on outbound dividends. The rules governing the deductibility of interest expense from profit sharing notes are also relevant.[100]

In order for the tax avoidance act to be applicable, it is necessary that the activities conducted have created a substantial tax benefit for the fiscal unit and that the fiscal unit has actively contributed to create such a situation. Regarding thin capitalisation situations this criterion is usually fulfilled. The return payments are viewed as deductible interest expense rather than non-deductible dividends resulting from the company's choice of corporate finance.[101] Also, it is necessary that gaining access to the tax benefit has been the predominant reason for conducting the activities at hand. Hence, the tax benefit must be weighed against other benefits of hybrid capital and it seems like these outweigh the tax benefits in many cases. It is difficult to draw general conclusions for the thin capitalisation case with this regard and it would seem necessary to investigate this on a case to case basis. Performing an objective analysis might very well show that other reasons than the tax reasons could have been the predominant motivation for thin capitalisation. It can also be the case that when performing an objective analysis it reveals that there are many motivating factors involved and the thin capitalisation can not be extinguished as predominant. If this criterion is not at hand it is unnecessary to further investigate the situation. It is generally necessary that tax reasons are to account for more than fifty percent of the motivation to capitalise thinly. However, it is probably the last criterion that causes problems in the tax law consideration. The thin capitalisation structure needs to be contrary to the purpose of the relevant rules directly applicable to the situation or that have been avoided through the structure. To summarise, the last two criteria are of crucial importance to investigate if they are at hand in thin capitalisation situations.[102]

[100] Ibid, p. 261.
[101] Gäverth 1998, p. 42.
[102] Gäverth 1998, p. 243.

5.6 An additional note on shareholder loans

Debt capital supplied by equity capital holders is special since the investors will be both equity capital holders as well as debt capital holders. This creates an incentive to label the investments as debt capital and hence be able to deduct future interest expense for tax purposes. The tax treatment on these kind of investments has historically been a discussed phenomena but the situation has to be said to have been cleared in Swedish case law.[103]

5.6.1 RÅ 1987 ref 145

The case concerned a Swedish company that for a number of years had performed poorly. The single shareholder of the company had covered these losses by contributing additional capital in the form of equity in order to avoid liquidation of the company. The contribution was labelled as conditional since it was to be paid back to the shareholder as soon as the financial position of the company could allow it. An interest rate was also attached to the capital which meant that when the capital was to be paid back, interest expense for the applicable time period was also due. A condition for the interest to be paid was hat it could be paid from uncommitted equity. After some years the company turned around and even started to deliver yearly profits. Hence, the conditional capital contribution was due to be paid back to the once contributing shareholder. The question arose whether the interest expense was to be considered as deductible for tax purposes.

The tax authorities meant that the interest was in substance dividend payments and that they as a result could not be accepted as tax deductible. The Supreme Court followed this line and stipulated that the contributed capital could not be paid back before this had been decided at the shareholders meeting. Therefore the capital cannot be considered as a liability for the company equivalent to any debt arrangement where interest expense is to be charged. Deduction of interest expense can only be accepted if there is any additional capital left in the company after a decision has been maid to pay it back to the shareholder. Interest rate applicable to this additional capital can be deducted for tax purposes to the extent the interest rate is marked to market.

[103] Estberg 1993, p. 100.

5.6.2 Discussion on shareholder loans

The unconditional contribution has no fixed date of maturity; it is comparable to perpetual debt and is regarded to be equity for tax purposes. Based on case law, a shareholder investment with a conditional repayment clause can however be considered to be debt attributed by following interest. Based on the court decision RÅ 1987 ref 145, interest on a conditional contribution is deductible only after the shareholders meeting has made a decision to repay the invested capital. The case law does not, however, give an answer as to whether the interest should also be re-classified as a dividend. A shareholder investment with only a conditional repayment clause is not considered to be a debt on which interest could be paid if there is no decision with regards to repayment.[104]

5.7 An additional note on hybrid capital and international transactions

Financial transactions conducted in an international environment includes interaction between more than one legal system. This means that terms and definitions can vary in the legal systems involved.[105] This could lead to potential conflicts generally which are generally aimed at resolving through double tax treaties. However, legislation is not always perfect and the terms and definitions used in double tax treaties, as well as for example European Community-law, and there may very well be situations where there are still discrepancies in definitions used.

Dividends and interest have different definitions in different legal systems. In cross-border situations, each state may tax transactions without being obliged to pay any attention to the taxation regime of the other state involved. This means that the same income item may very well be treated as an interest expense under the tax law of one of the states but as a dividend under the tax law of the other state. This inconsistent classification may, in turn, lead to international double taxation or the transaction not being taxed at all.[106] This can be the case if for example a return on capital payment from a Swedish subsidiary to its foreign parent company is classified as a deductible interest expense according to Swedish tax law but classified as a dividend payment according to the tax law applied in the parent company's

[104] Helminen 1999, p. 306.
[105] Ibid, p. 9.
[106] Ibid, p. 43.

country. If there are rules similar to those of the Swedish participation exemption rules in the receiving country, this could in fact lead to the transaction not being taxed at all. This risk increases with the use of hybrid capital. Because of the mixed equity capital and debt capital characteristics of hybrid capital, the classification of the payments related to the investment is not always clear and there is a danger of inconsistent classification. One state may treat a certain financial transaction as debt capital whereas another state may treat it simultaneously as equity capital. The result will be that the payment will be treated as deductible interest in one country and as a dividend in the other. This asymmetry may be exploited for international tax planning purposes.[107]

[107] Ibid, p. 253.

6. Analysis

6.1 Introduction

The purpose of the thesis was to answer the question "How does Swedish tax rules cope with debt push down investments and is it in fact the Swedish tax rules that motivate these transactions?".

The thesis attempts to do this by examining the relevant Swedish tax rules. In order to do this, an introductory chapter was included to give the reader an understanding of the Swedish corporate tax regime. An introduction to debt push down and thin capitalisation was also presented. The specific rules interesting for this thesis were then examined following the hierarchy of the traditional juridical method. This was based on Swedish legislation, preambles of the legislation, usage of national court practice as well as available law doctrine. In addition, a chapter of modern corporate finance theory was used as a framework to discuss and analyse the rules for the purpose of this thesis.

6.2 What are the incentives for debt push down structures?

There are open alternatives in how to structure corporate finance. In general, these alternatives can be visualised as a spectrum with pure debt capital at one end and pure equity capital in the other. The actual difference, from an economic point of view, between debt and equity is the variability of the returns. The distinction should, therefore, be made according to the risk that is involved. A shareholders intention is to bear the risk of the enterprise, whereas a creditor does not have the intention to assume such a risk. In principle, a creditor bears a smaller risk than an equity holder that a return on the investment will not be paid and that the investment will not be paid back. Because the return on equity depends on company profits and on a distribution decision and because the remuneration of the investment is subordinate to creditors claims, equity generally bears a higher risk than debt.

Debt capital and equity capital are often treated differently for tax purposes. In general, interest paid on debt capital is generally deductible in the paying company while dividends paid on equity capital are not. According to principles of corporate finance, the value of an

enterprise will increase if additional debt capital is issued since the deductible interest creates a tax shield. This holds true as long as the costs of financial distress increases by a higher amount simultaneously. The optimal degree of debt capital in the company will have to consider these aspects. In the end, it will always be the risks of the company's assets that will have to be matched against the capital structure.

Debt capital and equity capital are often economically substitutable for one another. A debt investment is very close to equity in its economic substance if a debt contract includes conditions that allow the investor to participate in the issuer company's profits and risks. A loan may be perpetual and the repayment of a loan may be subordinated to other loans in the case of insolvency. Interest on a loan may depend on company profits and a loan may participate in hidden reserves and in the liquidation proceeds of the debtor company. A loan may also be convertible into the debtor company's shares. So in addition to pure debt capital and equity capital, there are also alternatives that are difficult to ascertain whether they should be classified as debt capital or equity capital. These are generally labelled as hybrid capital. These instruments can be used for many commercial reasons such as to distribute risks between investors. Since it is difficult to ascertain whether the instruments are debt capital or equity capital there is an incentive for the company to label the instrument as debt capital since the resulting interest will be deductible for tax reasons in the company. If the issuer and the investor are also located in different countries with different tax rates this incentive strengthens even more. Legal terms of different legal systems are not identical. The law of some states may include terms that are unknown in the law of other states. In addition, even though the same terms were used in different legal systems, the meaning of the terms may not be identical, and the legal facts that are covered by terms may be different at least in some respects. This could create a tax arbitrage where the tax authorities in one country may classify the investment as debt capital with deductible interest whereas the other country's tax authorities will classify the investment as equity capital with dividends that in some cases are exempt from taxation if they are paid within a group of companies. Hybrid capital may be largely economically equivalent to an actual investment in the equity capital of a company, but it is never identical, no matter how many equity capital characteristics are involved.

From an economic point of view, there is little reason for the distinction between the tax treatment of debt and equity. From an investors point of view, it may be irrelevant whether an investment is made in the form of debt or equity. Parent companies or equity capital holders

often make debt capital investments in addition to equity capital investments in their subsidiaries. A shareholder loan is difficult to ascertain whether it should be classified as debt capital or equity capital. A shareholder loan especially may be distinguished from equity with reference to company law or tax law, but from an economic point of view, they are similar to each other. From an economic point of view, there is not much difference between the return on equity, i.e. between interest and a dividend. Both interest and dividend are, by their economic nature remuneration to the investor for the use of the invested capital. An investor may simultaneously be in the position of a shareholder and a creditor, and receive both dividend and interest. In such a mixed position, the form used for an investment does not necessarily correspond to the actual economic nature of the investment, but debt and equity investments are largely substitutable for each other. Therefore, tax considerations may be decisive in selecting the form of finance as debt or equity.

A debt push down transaction aims at pushing debt down to a subsidiary by setting up a debt capital structure within a group of companies so that the result will be that the taxable profits in the subsidiary is to be transferred to the parent company in the form of tax deductible interest expense. If this is done to such an extent that the debt capital in the subsidiary relative to its equity capital become very large, the company will as a result become regarded as thinly capitalised. Thin capitalisation refers to a phenomena where a company has a very high debt to equity ratio and this has implications from a tax point of view.

In Sweden, as in many countries, interest is deductible for tax purposes while dividends are not. There are also no withholding tax on outbound interest although this could be the case for outbound dividends. Hence, there is a discrepancy between the tax treatment of debt capital and equity capital. However, if dividends are paid within a group, the dividend will often not be taxed in the receiving company due to the participation exemption. This also often holds true for capital gains where the company being acquired is sold by another company. Sweden also allows for a number of other open alternatives in how to reorganise groups of companies. Finally, the Swedish group contribution regime can also be used to transfer taxable profits within a group of companies. Based on the reasoning above there should exist incentives to structure company investments so that the invested capital is classified as debt capital and so that future distributions from the acquired company can be deducted for tax purposes. To which extent it is possible to do this needs to be considered using the specific rules that might apply to situations of thin capitalisation.

6.3 The correction rule

The purpose of the correction rule is to protect the Swedish tax base from untaxed profits moving from the country through transfer pricing mechanisms by applying the arms length principle. Although the correction rule is applicable to financial transactions between a foreign parent company and its Swedish subsidiary it is difficult to draw general conclusions and the judgement needs to be carried out on a case to case basis. It will be necessary to investigate whether a party at arms length distance would have agree to supply funds trough a debt arrangement at similar terms or if this party would have demanded control in the company, voting rights, share of profits, representation on the board of directors or any other influence similar to that of an equity holder. But also other circumstances, like security to back up the debt arrangement need to be considered.

Even if a company performs poorly and cannot afford to be burdened by interest payments the correction rule applies according to RÅ 1970 Fi 923. This means that any interest rate not market to market or not applying interest at all is to be corrected for tax purposes using the correction rule. However, under certain circumstances exceptions are maid. The judgement concerning when this could be the case needs to be conducted on a case to case basis. In the Öberg & Co case, the fact that the net result would not change due to the fact that interest was not marked to market and that the company was in a development phase was considered as sufficient. The correction rule can also be used to re-classify debt capital to equity capital or vice versa according to the LM-Ericsson case. A comprehensive view needs to be applied. This means that a series of transactions is to be judged in accordance to its economic substance rather than its legal form. However, when the correction rule is to be applied, it is necessary to have a prudent view on the situation since it is so difficult to draw general conclusions on the subject of transfer pricing. This was stipulated in the Edet case. With regards to situations of thin capitalisation in general, it is clear that Sweden do not have rules governing thin capitalisation in specific and the fact that a company is characterised by thin capitalisation is not sufficient by itself to motivate application of the correction rule. This view is strongly supported by the Mobil/Oil case. When considering the application of the correction rule to financial transactions between a foreign parent company and its Swedish subsidiary, thin capitalisation is one of many things to consider. Again, it was stipulated that a case to case consideration needs to take place. Also, according to the Shell case, not charging

price in full in one year can be motivated by overpricing in another year. When judging whether a Swedish company's taxable income is to be corrected due to deviations from market interest rate in intra-group financing arrangements the Swedish company need to show that it has received something in return that compensate for this decrease. In other words, the net result should not have been changed. According to the verdict in the Shell case, it seems possible to claim that such compensation arise in other years than the one where interest rate deviates.

The applicability of the correction rule to situations of thin capitalisation is thus relatively clear when it comes to correcting the level of interest rate to that of the market interest rate. However, exceptions could be made depending on the situation at hand and it also seems difficult to judge when a deviating market interest rate is at hand. The fact that a company is thinly capitalised should motivate a high interest rate since the risk of default should be high. This means that the correction rule should actually support the transfer of profits to other countries in situations of thin capitalisation, actually opposing its own objective.

When it comes to reclassifying debt capital to equity capital it seems as this is possible to achieve using the correction rule. However, this has not been performed to any large extent in reality and it also seems difficult to draw general conclusions on the topic. Also, many different views exist on the topic which complicate the situation further. It seems like it should be fairly difficult for tax authorities to reclassify debt capital to equity capital using the correction rule even though this has been done. The situation seems to be somewhat unclear. Obvious to consider should be if the debt arrangement has no amortisation- or other repayment terms – or it could be the case that these exist although not followed, whether the debt arrangement is junior to other debt capital, whether the financed company is in desperate need for capital and cannot survive if this needs to be obtained from an external part. If these circumstances, or some of them in combination, are at hand re-classification according to substance over form could very well be a possibility.

For the purpose of this thesis it seems fully possible to structure debt push down transactions where a subsidiary as the result becomes thinly capitalised without being subject to the correction rule. Since a situation like this should motivate a high level of interest rate, it should be fairly easy to transfer taxable profits to a foreign parent company using interest payments. Consideration is however needed since there in theory could be the case that the

debt capital is re-classified to equity capital using the correction rule. Since thin capitalisation is one of many things to consider, it is necessary that other characteristics is preferred to be avoided since for example characteristics of certain hybrid capital could very well motivate the application of the correction rule together with the existence of thin capitalisation.

6.4 The rules governing profit sharing notes

The rules governing profit sharing notes aims at limiting the interest is dependent on the development of the company in terms of profit or dividend. Hence, Swedish companies may issue debt instruments, the amount of interest on which depends on the dividend distributions of the company. According to the ITA, the fixed portion of an interest on a profit-participating loan, is deductible in the same way as interest on regular loans. The portion of interest on profit-participating loans that is partially or wholly dependent on the company's profits or dividend distributions is only deductible, in general, if the loan was offered to the public or to persons other than shareholders and the debtor corporation is not a small, closely-held company. It seems obvious, and also supported by RÅ 2001 ref. 12, that debt capital invested by a parent company in its subsidiary, with interest dependent on the development of the subsidiary cannot under any circumstances be deductible in the subsidiary. So even though interest on taxation of profit-participating loans would not be re-classified as a dividend, the deductibility of interest on profit-participating loans is limited by ITA.

The rules governing notes can further be regarded as not limited to the profit sharing notes mentioned in company law. The rules are more general in their applicability and can to some extent be said to govern hybrid capital in general as long as the interest is dependent on the development of the company. This means that all types of interest on debt capital where the risks involved are to be considered close to those of dividends resulting from equity capital can be refused deductibility on the grounds of the rules governing profit sharing notes.

However, it seems like the rules can be avoided since it can be possible that if interest is expensed, and deducted for tax purposes, but not paid until later and accounted for as interest payable in the subsidiary's balance sheet, the interest expense can be allowed to be deducted for tax purposes. So instead of contracting a variable interest rate, a fixed interest rate is contracted where payments only occur at special occasions. Deferred payments, with additional compounded interest rate, are only paid when the financial position allows this. In

reality, this means that a sort of synthetic profit sharing note has been created that avoids the rules and interest can be deducted for tax purposes. The question however arises whether the resulting debt can be regarded as debt in the balance sheet if it is not probable that the obligation will be fulfilled. If this is the case, it could be possible that the debt capital would have to be re-classified as equity capital and the return on capital would be re-classified as dividends and not be deductible. It seems unclear if this would actually be the in practice however.

In a debt push down transaction, this kind of procedure could be used in order to setup an investment in a company with large amounts of debt capital supplied by a foreign parent company and thereby have the opportunity to distribute the profits in the subsidiary when the financial position of this company allows for this. This means that the risk of default would decrease substantially.

6.5 The tax avoidance act

The tax avoidance act is the last alternative when attacking a situation of thin capitalisation. The tax avoidance act makes it possible to apply substance over form to a series of transactions and thereby judge the situation in accordance to its economic substance. This could be the case for various situations of thin capitalisation and hybrid capital investments which have been set up in order to avoid tax.

Even though the tax avoidance act have been used to refuse interest expense to both situations of thin capitalisation as well as interest due to hybrid capital arrangements, the situations where this has been done seems specific in nature and in general, the tax authorities have not been particularly successful in applying the tax avoidance act. The difficulty is in majority attributed to the criteria of the actions predominant reasons and that the actions need to be contrary to the purpose of specific tax law. The applicability of the tax avoidance act has also been heavily criticised and it seems very unclear and doubtful whether the tax avoidance act will be applied to situations of thin capitalisation.

6.6 Conclusion concerning Swedish debt push down structures

Foreign companies considering establishing in Sweden experience a number of tax related issues other than the strictly business related issues. Of crucial importance is obviously how the finance the company investment. Important is also to identify the actual acquirer. Several alternatives exists including acquiring the company directly by the foreign parent company, setting up a Swedish holding company or even including other foreign holding companies in order to channel funds tax efficient through these. Using several holding companies in several different countries within a group is a common procedure in order to organise and rationalise the operations and administration. These usually include holding companies with the sole purpose of owning other companies in other countries in order to reduce or fully eliminate different types of taxes. In Sweden it seems like the acquirer can be financed with large amounts of debt supplied by its parent company and have great opportunities to deduct the resulting interest expense. This creates an incentive to supply a shareholder loan to either a Swedish holding company or to the acquired object directly.

An alternative for investments in Swedish companies is therefore to form a foreign holding company in a country with a low corporate tax rate. This company further forms a new holding company in Sweden which in turn acquires the shares or the assets of the target company. This can usually be done without triggering taxes by using the open reorganisation alternatives that exist in Sweden. The majority of funding is supplied to the Swedish holding company by its foreign parent in the form of debt capital. Financing is hence supplied through a shareholder loan. As have been discussed in this thesis, it is of crucial importance that this shareholder loan is strctured in a manner so that the debt capital will not be treated as equity capital. It is important that the debt capital need to have a fixed date of maturity. Interest also need to be marked to market. The advantage is that the interest can be fully deductible in the Swedish holding company or in the acquired company and there are no specific rules that govern the capitalisation decision. The additional risk that comes with additional debt is due to to increased risk of the company defaulting. If the company cannot afford to pay interest market to market, the company will finally default if additional capital is not invested in the company. One alternative to avoid this is to setup an interest that is dependent on the profits of the company but since the rules governing profit sharing notes will refuse deductibility of the interest in this case it is not an attractive alternative. However, since it seems possible to contract a fixed interest that will be expensed in each future year, but only paid when the

company's financial position allows for this it seems like the rules can be avoided. It is necessary that the interest is accrued and accounted for as debt in the balance sheet. To which extent this can be done is however somewhat unclear. Nevertheless, it seems fully possible. Since the parent company is both the debt capital holder and equity capital holder, there are no indirect risks of financial distress since the risk of the company defaulting does not increase and there is no conflict of interest between the debt capital holders and the equity capital holders since these are indeed the same subject. A debt push down structure in this manner would obviously create additional enterprise value.

If a holding company is used to acquire the target company, future profits in the target company can be transferred to the Swedish holding company using the group contribution regime. However, this cannot be performed during the year of acquisition due to the limitations in the right to give and receive group contributions within a group in the case of significant changes in ownership structure. Hence, in reality, the financing has been supplied through future profits in the acquired business. The interest payments have thus been deducted in Sweden with a high corporate tax rate relative to that in the country of the foreign holding company. This is an interesting alternative both when the corporate tax rat outside of Sweden is lower as well as if deductibility of interest expense is refused in the foreign country. The overall cost of capital is thus lowered as a result. The concept of debt push down is particularly appealing in Sweden since transfer of income from the target company to the holding company can be done either through the group contribution regime or by using the reorganisation rules and merging the target and the holding company. This is primarily possible since it seems like there are limited possibilities for the tax authorities to refuse deductibility of interest expense for tax purposes. The fact that a Swedish company acquires a company and finances this with debt funding with deductible interest expense flowing to a foreign company should normally not be in violation with the Swedish tax rules. The fact that debt arrangements of this kind are a common feature of Swedish business also strengthens this view. Whether the tax avoidance act could be potentially applicable is however open to discussion. Even though it seems difficult to motivate this kind of application, this is not a clear cut issue.

Also, the debt push down alternative to structure company investments in Sweden is even more appealing if a tax arbitrage could be structured. Since legal systems are different with respect to definitions and the fact that it seems fairly easy to have interest deduction approved

by the Swedish tax authorities, it might very well be possible that a debt push down transaction in Sweden with a foreign parent company supplying the funds, will result in the transaction as being classified as equity capital in the country where the parent company is allocated and that the payment as a result can be subject to some sort of patricipation exemption. In this case, tax could even be avoided in full. The problem with setting up debt push down transactions where the debt capital is in fact a sort of hybrid capital is however that it will be more probable that the debt capital might be re-classified as equity capital since it will be characterised by equity capital to a larger extent. The major conclusion is that debt push down structures in Sweden seems like an attractive alternative when conducting a company investment. It seems like the Swedish corporate tax regime could very well be one of the key drivers motivating the increased activity in financial investments in Swedish companies.

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