

Sweden proposes major corporate income tax changes

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Executive summary

On 21 March 2018, the Swedish Government submitted a draft bill regarding important changes in the corporate taxation area to the Council on Legislation for their consideration.

The main proposals are:

- ▶ A general provision limiting the deductibility of net interest expense to 30% of earnings before interest, tax, depreciation and amortization (EBITDA)
- ▶ Reduction of the corporate income tax in two phases, from 22% to 20.6%
- ▶ Limitation of interest deductibility in certain cross-border transactions (anti-hybrid provisions)
- ▶ Retention of the current interest deduction limitation rules on intercompany debt, however, with a narrower scope
- ▶ Introduction of tax rules regarding financial leasing
- ▶ Introduction of accelerated depreciation on tenement buildings
- ▶ Increased standardized income on tax allocation reserves
- ▶ Introduction of standardized income on contingency reserves for non-life insurance companies

The new rules are proposed to come into effect 1 January 2019.

Detailed discussion

Interest limitation rules based on EBITDA

Under the new general interest limitation rules, the deductibility of net interest expense would be limited to 30% of EBITDA. The proposal is consistent with the provisions set forth in the Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting (BEPS) project and the European Union (EU) Anti-Tax Avoidance Directive (ATAD). Special rules will apply to investment companies and cooperative associations.

The proposal also includes a safe harbor rule in order to ease the administrative burden on smaller companies. No limitation would be imposed on companies with a net interest expense below SEK5 million (approx. US\$610,000). To avoid evasion and undesired use of the safe harbor rule, the limitation would apply on the group level, meaning that the total amount deductible within a group under the safe harbor rule would be limited to SEK5 million.

Under the proposal, it would be possible to offset net interest income and expense among companies that can exchange group contributions (the Swedish mechanism for tax equalization within a group).

It is proposed that a non-deductible net interest expense could be carried forward for six years, although change of control would extinguish the carryforward. This is not the case, however, if the change of ownership occurs between two companies of the same group of companies. The same should apply for qualified mergers and divisions.

It is further proposed that inclusion of interest expense in the acquisition value (for tax purposes) of certain assets including e.g., inventory, buildings, machinery and equipment as well as intangible assets would not be permitted.

The definition of interest in Swedish tax law would be expanded in order to cover "costs which are comparable to interest costs" and in some cases currency exchange rate changes. The intention is that the definition shall correspond to the OECD recommendations from the BEPS project (Action 4 - *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*) and the ATAD.

Reduced corporate income tax rate and expansion fund tax rate

The present corporate income tax rate of 22% would be reduced to 21.4% in 2019 and then further reduced to 20.6% in 2021.

Hybrid mismatches

As the draft bill includes a general interest limitation rule, it is proposed that the interest limitation rules regarding hybrid mismatches provided in the BEPS Action 2 - *Neutralising the Effects of Hybrid Mismatch Arrangements* and the ATAD will be implemented simultaneously. As a first step, these would only concern affiliated companies. The Government states that it aims to return with additional legislative actions with respect to hybrids.

Existing interest deduction limitation rules

The amount of deductible net interest expense allowed under the EBITDA would also be subject to existing interest limitation rules regarding debts between affiliated companies. The rules will state that the interest expense on intercompany debt will be tax deductible only if the interest would have been subject to at least 10% tax, in the hands of the beneficial owner of the interest, had the interest income been the only income of the beneficial owner. Furthermore, the beneficial owner of the interest must reside in a state within the EU/ European Economic Area, or in a state with which Sweden has entered into a tax treaty.

Despite a taxation of at least 10%, the interest expense would still not be tax deductible if the debt relationship in question has been created "exclusively, or virtually exclusively," in order to provide the group with a significant tax advantage.

Introduction of tax rules regarding financial leasing

Under the proposed rules applicable to financial leasing, the leasing fee should be re-characterized into an interest component and an amortization of debt component. The leasing fee characterized as an interest component would be treated in the same way as other interest expense. If the leasing agreement explicitly includes an interest rate, this would apply for the lessee. However, if there is no agreed interest or if the agreed interest diverges from what would have been agreed between independent traders, other rules may apply.

The new leasing provision would be applicable on assets such as inventory, machinery and equipment, buildings, fixed installations/ground installations and land. A safe harbor rule is included. A lessee would not have to recognize an interest component if the yearly leasing-fees are below SEK1 million (approx. US\$122,000).

Accelerated depreciation on tenement buildings

Normally, tenement buildings can be depreciated 2% annually for tax purposes. In order to reflect the actual decrease in value more accurately, the proposal includes a 12% primary deduction on new construction tenement buildings, as well as for reconstructions of and additions to existing tenement buildings. The primary deduction will be deductible during a period of six years from the completion of the building, the reconstruction or the addition.

Increased standardized income on tax allocation reserves

Legal entities currently enjoy the possibility to allocate a portion of its profits to tax allocation reserves. Such reserves are charged with a standard income amount calculated on 72% of the government borrowing rate by the end of November during the previous fiscal year multiplied by the value of the tax allocation reserve. The borrowing rate shall always be considered to be at least 0.5%.

The Government proposes that the standardized income should be calculated on 100% of the borrowing rate multiplied by the value of the tax allocation reserve. The proposal also includes a raised return rate when the fund is returned for taxation. The rate will be increased to 103% in 2019 and to 106% in 2021.

Standardized income on contingency reserves

It is proposed that non-life insurance companies would have to recognize a standardized income amount on contingency reserves. The income would be the government borrowing rate at the end of November during the previous fiscal year multiplied by the value of the contingency reserve. However, the Government proposes that the government borrowing rate should be in all circumstances at least 0.5%.

Implications

The calculation of the allowed deduction for the net interest expense requires thorough analysis, and companies may be affected differently depending on the industry.

It has proven challenging to apply the existing interest limitation rules, which are now proposed to be narrowed. The proposal indicates, however, that the existing guidance will still be relevant to the interpretation of the rules. Therefore, the fundamental challenges associated with the application of the rules may remain.

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