Sweden:
Government proposes restrictions on participation exemption

A memorandum issued by the Swedish Ministry of Finance on 22 April 2015 includes proposals to introduce restrictions on the application of the domestic participation exemption to prevent companies from using structures that do not reflect economic reality; it also would extend the Tax Avoidance Act to cover the Swedish withholding tax regime. The proposal relating to the participation exemption would implement the recently amended EU parent-subsidiary directive (PSD) into Swedish law.

If enacted, the proposed rules would apply as from 1 January 2016.

Participation exemption and PSD

Under the domestic participation exemption, dividends paid to a Swedish (or nonresident) company on “business-related shares” generally are tax-exempt. Shares are deemed to be business related if they are unlisted or, if listed, the shares held by the company receiving the dividends represent 10% or more of the total number of votes of the payer company. In the case of listed shares, the recipient company must hold the shares for at least 12 months.

The PSD, which is designed to prevent the double taxation of dividends and profit distributions between members of a corporate group in different EU member states, provides for a tax exemption for such payments made by qualifying EU subsidiaries to EU parent companies.

The PSD was amended in 2014 to address hybrid financial mismatches due to the interaction of different national tax systems within the EU, specifically where hybrid loan structures are used to achieve nontaxation of payments between affiliated entities in two EU member states because a loan is treated as debt in the member state of the debtor (subsidiary) and as equity in the member state of the lender (parent company). An anti-abuse clause inserted in the revised PSD provides that the withholding tax exemption will not apply to dividends paid to an EU parent company to the extent the payment is deductible by the payer subsidiary located in another member state. Accordingly, a cross-border group of parent and subsidiary companies using hybrid financing arrangements will be denied a tax exemption for payments received in the member state in which the parent company is resident if the payments are deductible in the member state in which the subsidiary is resident. According to the PSD, the member state of the parent company must tax such profits where they are deductible by the subsidiary and refrain from taxing the profits if they are not deductible by the subsidiary. Member states are required to implement the anti-hybrid rule into their domestic legislation by 31 December 2015.

Proposed changes

The minister has proposed that neither the Swedish participation exemption nor the PSD would apply to dividends paid to a Swedish company in cases where the dividends may be deducted as interest by the payer company. The proposal goes further than the PSD because the participation exemption would be denied even if the payer is resident outside the EU.
Also as part of implementing the amended PSD, the minister has proposed to include certain Romanian and Polish entities as entities whose shares should be deemed to be held for business purposes under Sweden’s participation exemption.

Currently, the Tax Avoidance Act does not apply to withholding tax and the anti-avoidance in the withholding tax regime is not compliant with the PSD. The minister now has proposed to eliminate the latter anti-avoidance rule and include it in the Tax Avoidance Act to comply with the amended PSD. In essence, the act deems tax avoidance to occur when a legally valid transaction is used to avoid or circumvent the tax rules to gain a substantial tax benefit unintended by the legislature.

Comments

The anti-abuse rule in the PSD is not intended to be applied if there is no double nontaxation or if double taxation arises. EU member states do have the option to impose more stringent anti-abuse rules, but the minimum standards in the revised PSD must be applied. According to the proposed Swedish rules, dividends treated as deductible interest in the payer country would be taxable in Sweden even if the nonresident payer company is unable to utilize the interest deduction.

Although the proposed amendment to Sweden’s participation exemption is designed to comply with the amended PSD, the new restriction would apply irrespective of the extent of the Swedish company’s participation in the payer company, and irrespective of where the company is resident (i.e. even if the payer subsidiary is an entity resident outside the EU). It also should be noted that hybrid mismatch arrangements are one of the action plan items for the OECD under the base erosion and profit shifting (BEPS) project.

The Swedish government’s “preparatory work” to the above proposal refers to the general anti-abuse rule in the revised PSD. (The general anti-abuse provision adopted by the European Council on 27 January 2015 aims to prevent misuses of the directive and ensure more consistency in its application; the clause requires governments to refrain from granting the benefits of the directive where there is an arrangement, or a series of arrangements, that are not “genuine” and have been put in place to obtain a tax advantage.) This reference makes genuine substance of the recipient company an important factor from a Swedish perspective when considering whether the Tax Avoidance Act could apply to dividends distributed from Sweden. It therefore is necessary to determine whether an arrangement is put into place for valid commercial reasons that reflect economic reality. According to the amended PSD, the tax authorities should undertake an objective analysis of all relevant facts and circumstances to determine if valid substance exists.

If the proposal is enacted as currently drafted, there may be an increase in the number of challenges by the tax authorities against structures, including challenges where a foreign holding company owns shares in a Swedish limited liability company; however, the proposal may be revised before it is adopted, so it will be necessary to wait for the final legislation to understand the full scope of the rules.
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