

Summaries of the proposal from the Swedish Committee on Corporate Taxation

This document contains a two-page executive summary and a six-page full summary of the main proposal from the Swedish Committee on Corporate Taxation. The Committee has also delivered a somewhat different alternative proposal and a number of proposals for financing the reform. These are not covered here. The proposals were delivered on 12 June 2014..

Executive Summary

The Committee proposes the introduction of a new system for corporate taxation. The model consists of two parts. Firstly, deductions for interest expenditure and other financial costs will be limited by only allowing deductions for financial costs for which there is corresponding financial income. No other financial costs will be deductible. This proposal therefore means deductions for net financial costs will be discontinued. Secondly, a standard deduction will be introduced for all financing costs – a ‘financing allowance’ – at a rate of 25 per cent of the company’s entire taxable profit. This financing allowance will be allowed regardless of whether or not the company has financial costs and, in terms of the financial effects for companies, will be equivalent to reducing the corporate tax rate by 5.5 percentage points (from 22 per cent to 16.5 per cent).

In principle, the limitation of deductions will apply to all costs that are interest expenditure in financial terms. To avoid problems of definition, it will also apply to other financial costs. The Committee proposes a new definition of financial costs for tax purposes. This definition will be very similar to the definition of financial costs used in accounting.

The great majority of companies that conduct non-financial activities have net financial costs. Prohibiting deductions for net financial costs will mean that equity and debt are treated in the same way, for tax purposes, in companies that have net financial costs. The proposal therefore means that equity and debt will be taxed equally for the great majority of non-financial companies.

As stated, financial costs will be deductible against financial income. One consequence of this is that the rules will not influence

the source of financing chosen by companies that have net financial income. In principle, banks always have net financial income. The model is therefore not particularly suitable for banks. Nevertheless, the Committee proposes that financial enterprises should receive financing allowance, but that to compensate for this, the banks should report taxable standard income based on their liabilities. This will mean that the source of financing chosen by banks will also be influenced. Even if full neutrality between equity and debt will not be achieved in the financial sector, the choice of financing will be treated more neutrally than is now the case.

Discontinuing the deduction for net financial costs removes the tax incentive to report large interest costs in Sweden. This makes it possible to abolish the rules to prevent tax planning by means of intra loans between associated enterprises that Sweden introduced in 2009 and 2013.

The proposal will result in higher interest costs for companies with net financial costs. However, no very striking increase in costs is involved. At the current lending rate of around 3 per cent, the discontinuation of deductions for net financial costs will mean after-tax interest costs will be 0.50 percentage points higher than under present tax regulations. With a more normal lending rate of 5 per cent, after-tax interest costs would be 0.82 percentage points higher than under present tax regulations.

The proposal means a redistribution of corporate tax payments in the business sector. The change in taxation for a company will depend partly on the leverage of the company's and partly on the rate of returns on the company's investments. High interest costs will mean higher taxes. High returns will mean large financing allowance and therefore lower taxes. The overall effect will depend on which effect is greatest. The proposal means that companies with large debts and investments that yield low returns will have to pay more in corporate tax than under present tax regulations. Companies with a small debts and investments that yield high returns, in contrast, will pay less in tax.

This proposal is expected to lead to companies having increased equity ratios, which will reduce the sensitivity of the business sector to business cycle fluctuations. The proposal is also expected to lead to a pattern of investments by the business sector that is more beneficial to the economy. In the longer run, this is expected to lead to higher productivity and hence higher wages and higher GDP.

Summary

In 2011, the Swedish Government appointed a committee to deliver proposals on an improved system for corporate taxation. The Committee's main task is to propose a system for corporate taxation that leads to greater neutrality between the taxation of equity and debt .

Principle of neutrality

A tax system characterised by neutrality has good prospects of minimising the costs to the economy of any given tax levy. In the area of corporate taxation, neutrality means, among other things, that the tax system should not distort companies' investment and financing decisions.

Equity and debt are treated differently for the purposes of taxation, which contravenes the principle of neutrality. As a result of the difference in treatment, the cost of equity is considerably higher than that of debt. Equity and debt differ in their suitability for different types of companies, in different sectors, in different stages of development, and so on. In consequence of the more favourable treatment of debt, the tax system favours investments and activities for which debt is suitable and is less favourable to investments in assets that cannot be used as collateral (often intangible assets) and in newly started companies that do not have a long credit history. Another consequence of the difference in treatment is that the financing structure that is economically optimal for businesses differs from the financing structure that is economically optimal for society. The cost of such over-indebtedness is linked to the fact that a higher level of indebtedness entails a higher risk of financial distress.

A tax system that discriminates against investments in certain assets and in certain companies, while also encouraging over-indebtedness, risks leading to a misallocation of economic resources, in that labour and capital will be employed where the least amount of tax is levied, not where they create most value. The consequence of such misallocation is lower economic growth and a smaller surplus to distribute.

Backdrop to the proposed changes

In most countries – not just Sweden – investments financed by equity are taxed more severely than investments financed by debt. The impact of this differing tax treatment on the economy has been discussed extensively in the economic research literature. Based on this discussion, the Committee has not found any grounds that motivate a difference in the tax treatment of equity and debt. For a long time, the academic discussion on reducing or abolishing the differing tax treatment of equity and debt had little impact on the political debate. The distortions to which the research had drawn attention were probably previously not perceived to be sufficiently serious to lead decision-makers to consider there was any call for reform. However, in recent decades the situation has changed. The financial market has been deregulated and exchange rate regulation abolished both in Sweden and in other countries. This has opened the way for the large-scale conversion of equity into debt and the moving of capital to low tax jurisdictions. Standardised methods have emerged for artificially achieving large interest deductions so as to reduce corporate tax payments. In this way, the differing tax treatment of equity and debt, apart from having a distorting effect on the economy, has also become a factor undermining the corporate tax base. This is problematic from a fiscal perspective and also threatens the legitimacy of the corporate tax system. The Riksdag (the Swedish Parliament) has on two previous occasions (in 2009 and 2013) limited the right to deduct interest costs, with a view to checking abuse. The limitations in the right to deduct interest were designed to prevent tax planning by means of interest deductions for loans between associated enterprises. In both cases, the limitation of the right to deduct interest was accompanied by reductions in corporate tax rates.

Sweden is not the only country to have introduced regulations to prevent certain interest deductions. The Netherlands has regulations that resemble the Swedish regulations in that they seek to distinguish between ‘legitimate’ and ‘non-legitimate’ interest deductions. Other countries, including Germany and Finland, have introduced more general regulations that do not make this distinction but instead impose a ceiling on the amount of interest costs that may be deducted. The Committee considers this type of general model interesting, since it has not been thought meaningful

to once again formulate rules that aim to distinguish certain ‘non-legitimate’ interest costs from others.

Alongside the increased international existence of regulations that restrict the possibility of deducting interest costs, a good deal of economic research has been published on various methods of evening out the difference, in tax terms, between equity and debt . The most discussed models are generally referred to as ACE (Allowance for Corporate Equity) and CBIT (Comprehensive Business Income Tax). In both models, the tax treatment of equity and debt is made equal. In the ACE model this is done by granting an allowance for corporate equity), in the CBIT model by not allowing deductions for interest costs or dividends. These models therefore, taking different approaches, seek to even out the tax difference between equity and debt . In its pure form, the ACE model results in reduced tax revenue for the government. If such a reform is to be financed within the parameters of the corporate tax system, this means the corporate tax rate has to be raised. A CBIT model, in contrast, increases corporate tax revenues and so makes it possible to lower the corporate tax rate. Both models have their adherents, though primarily in the academic world. In the political discussion, these models are more rarely advocated. Some countries have introduced regulations that can be likened to an ACE model. This applies for example to Italy and Belgium. No country, however, has introduced regulations that can be likened to a CBIT model.

Limitation of deductions for interest costs

The Committee’s work on developing a proposal on a corporate tax system has been shaped by the tendencies mentioned above, to formulate general rules for interest deductions that prevent erosion of the Swedish corporate tax base and to design a system that is more neutral in its treatment of equity and debt . Inspiration and ideas have been drawn from the economic research literature and from tax systems in other countries.

The proposal limits the right to deduct interest payments and other financial costs. In a corporate tax system in which all income and expenditure is treated equally, it matters little whether a certain cost is called interest or something else. If the right to deductions is only limited for certain costs, however, the costs that are to be covered by this limitation must be carefully defined. The proposal

uses the concept of 'financial costs', and it is deductions for such expenses that are limited. The starting point is that deductions will be limited for all costs that are interest costs in a financial sense.

It is relatively easy in certain situations to convert interest into other types of financial income and costs, such as exchange rate effects, capital gains and capital losses, and rental income and costs. A broader concept than the current concept of interest must therefore be used. The scope of the concept that will apply under our proposal comes close to the concept of 'financial costs' used in accounting. The Committee therefore proposes that the term 'financial cost' should be used in the new legislation as a common special name for tax purposes for the costs for which the right to deductions is limited. What is referred to as a financial cost will thus acquire a special meaning for tax purposes. Apart from interest, the concept in the proposal also includes exchange rate effects, taxable profits and losses on financial instruments, taxable dividends and the interest component of some rents. For simplicity, certain types of interest payments, such as imputed interest in accounts payable and accounts receivable, will normally not be included. The interest component in rents for real property and non-residential premises and short-term rents of various kinds will not normally be included either.

Deductions will not be denied for all financial costs, only net financial costs. The thinking behind this is that companies commonly have large financial income and large financial costs at the same time. For example, the parent company in a group may take out a large loan that is then loaned on to a number of subsidiaries. If deductions were denied for financial costs in both parent company and subsidiary while the corresponding financial income were taxable, a series of charges to tax would arise in the group.

The economic analysis made by the Committee has not revealed any grounds to treat debt financing more favourably than equity financing. The Committee therefore considers that the complete abolition of the right to deductions for financial costs in excess of financial income has the advantages both of being economically correct and effectively protecting the corporate tax base. The broad formulation of the concept of interest will also result in rules characterised by a high degree of predictability for taxpayers.

One important principle in the Swedish corporate tax system is that an activity conducted in a group and an activity conducted in a single company are to be taxed equally. To uphold this principle,

companies with net financial income will be allowed to set this off against net financial costs reported by companies in the same group.

Financing allowance

According to the Committee's terms of reference, the proposals must not lead to an increase in total tax payments from the corporate sector on a static analysis of the budgetary impact. The Committee therefore considers that the possibility of deducting interest – which is only linked to the cost of financing using debt – should not only be limited; it would also be appropriate to supplement this with a form of tax relief that will increase after-tax returns on all investments, irrespective of the source of financing.

The discontinued deduction should, in the Committee's view, be replaced with a new form of deduction tied to returns on all capital (both own and borrowed). This can be done in a number of different ways. One option the Committee has considered is to link the financing allowance to the size of actual investments. However, the Committee has found that, in practice, it is virtually impossible to design such a system so as to lead to neutral taxation of different investments. In addition, measuring companies' actual investments is highly problematic in practice. Companies make investments with the intention of generating returns. Consequently, linking the financing allowance directly to the returns on investments is another way of reducing the tax on the returns on investments. The Committee finds that this link is both practicable and more stable with regard to circumvention than models that build on the size of investments made. The financing allowance is designed so as to be exactly equivalent to a reduction of the corporate tax rate; the proposed 25 per cent financing allowance corresponds to a reduction of 5.5 percentage points in the corporate tax rate. Since the proposal involves such a substantial limitation on the right to deductions for interest and other financial costs, the Committee considers it appropriate to propose a general deduction in the form of a financing allowance rather than a reduction of the corporate tax rate.

The proposed rules for limiting deductions and financing allowances are intended for legal entities. Special rules are proposed for partnerships. The rules will not apply to sole proprietorships.

Special treatment of banks

In companies that have net financial income, however, debt retains its advantage from a tax perspective. The business idea at the heart of banking is to accept deposits in order to lend the money at a higher rate of interest. Consequently, they normally have net financial income and will therefore not be affected by the limitation on deductions. The model is therefore not as suitable for financial enterprises. Despite this, there is a point in the same model applying to all companies. Accordingly, it is proposed to allow financial enterprises to make financing allowances as well, but to compensate for this, banks will be required to report standard income based on their liabilities. This notional income will increase banks' taxable profits. For the financial sector, the standard income and the financing allowance in combination will result in no change in the corporate tax levied. Debt financing will still be treated favourably in tax terms in the financial sector, but the proposal will reduce the difference in taxation in this sector as well.

Proposal improves economic efficiency

The proposal leads to increased neutrality between investments financed by equity and those financed by debt. This will enhance the economic efficiency of the tax system. Firstly, distortions in the financing choices made by companies will decrease, as a result of which a greater proportion of investments will be financed by equity. A stronger equity ratio in companies will reduce the risk of their getting into financial distress and will increase their resilience in the face of macroeconomic shocks. Secondly, distortions in the investment choices made by companies will decrease. Investments that, in the absence of deductions for interest costs, do not meet the required returns will not receive financing and will therefore not be made. On the other hand, other investments will be made that are financed by equity and that fail to meet required returns under current tax regulations. The change in the composition of investments is expected to lead to an increase in average returns. For this reason, the increased neutrality is expected to further enhance the economic efficiency of the tax system.