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ARTICLE

Changes in the Application of Tax Treaties in Sweden*

Maria Hilling**

In 2008, the Swedish Supreme Administrative Court[1] gave precedence to controlled foreign corporation (CFC)[2] legislation over a tax treaty without consulting the tax treaty. Since then, the relationship between domestic law and tax treaties has been a highly debated issue in Sweden.[3] The Court's reasoning was based on an identified conflict between domestic law and a tax treaty, which was solved through reference to general principles on derogation. In a recent judgment in a similar situation, the same Court deviated in principle from the 2008 judgment by giving priority to the tax treaty over domestic law,[4] thereby creating a welcome return to established principles of tax treaty application. Because the Court introduced a rule of exception from the rule that Swedish tax treaties prevail over domestic law*, however, this recent decision introduces changes for the application of tax treaties in Sweden. In such situations, the main rule of tax treaty precedence over domestic law is set aside, and the principles of derogation will be applied.*

This article is divided into four sections, in which I examine and analyse the recent case and its implications for tax treaty application in Sweden. As the 2008 decision is of central importance, I briefly present this case in section 1. In section 2, I turn to the 2010 decision. Conclusions on the effects of the Court's adjudication on tax treaty application in Sweden are presented in section 3, in which I analyse the situations to which the rule of exception is applicable. A significant legal issue following the aftermath of the 2010 decision is presented in section 4.

1. The 2008 decision

In the 2008 decision, the Swedish Supreme Administrative Court found that CFC taxation of the profits of a Swiss subsidiary of a Swedish company was possible despite the tax treaty.[5] The Court unexpectedly held that tax treaties ratified through Swedish laws had no special position in relation to other laws enacted by the Swedish parliament. If there is a conflict between domestic legislation and a tax treaty, the Court stated, derogation principles such as *lex specialis* and *lex posterior* should apply. The Court solved this conflict, therefore, by giving precedence to the 2004 CFC legislation over the 1965 tax treaty without interpreting the tax treaty itself.

The Court's reasoning in the 2008 decision has been heavily criticized because it contradicts the logic of tax treaty application. If tax treaties are not given a limiting effect on national taxing regimes, they are unable to fulfil their aims. Moreover, as the Court's reasoning represented a deviation from earlier case law and its controversial approach to tax treaty application was expressed generally, it resulted in a decrease in legal predictability. Even though the language used by the Court indicated a new approach to tax treaty application in general, I consider it of focal importance that the aim of the domestic law in question was to counter abuse.[6]

Notes

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1 RÅ 2008 Ref. 24 (see also RÅ 2008 n. 61).

2 CFC stands for controlled foreign corporation or controlled foreign company.

3 See, for example, M. Dahlberg, Skattenytt (2008): 482–489; L. Mutén, Svensk Skattetidning (2008): 353–357; D. Kleist, Skattenytt (2008): 708–714; M. Hilling, Intertax (2008): 455–461; K.-J. Grundström, Skattenytt (2010): 159–166; S.-E. Holmdahl & M. Barenfeld, Skattenytt (2009): 627–634; A.-S. Sallander, Svensk Skattetidning (2010): 177–204; and A. Hultqvist, Svensk Skattetidning (2010): 520–534.

4 RÅ 2010 Ref. 112, decided 14 Dec. 2010. The case is hereinafter referred to as the 2010 decision. For literature, see, for example, K.-J. Grundström, Skattenytt (2011): 68–75; M. Dahlberg, Skattenytt (2011): 126–130; D. Kleist, Skattenytt (2011): 208–213; and B. Wiman, Svensk Skattetidning (2011): 174–186.

5 For a detailed analysis, see M. Hilling, 'The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment', *Intertax* (2008): 455–461.

6 *Ibid.*, 460.

2. A RETURN TO ESTABLISHED PRINCIPLES: BUT EXCEPTIONS ARE POSSIBLE

In a case on domestic exit taxation and the 1961 tax treaty between Sweden and Greece, the Swedish Supreme Administrative Court dealt with the question of the relationship between domestic law and tax treaties once again.[7] The exit taxation rules state that individuals who were previously residents of Sweden are subject to capital gains tax on the alienation of shares and similar instruments issued by Swedish corporations for a period of ten years. Swedish tax treaties generally allow such exit taxation but often limit the taxing period to three to five years. In 2007, the domestic legislation was expanded in order to cover shares and similar instruments issued by foreign corporations. The question was whether the Court would once again apply the derogation principles and give precedence to the domestic legislation over the tax treaty.

In contradiction to the 2008 decision, the Court allowed the tax treaty to prevail over domestic law. The result was that no exit taxation was possible. The Court's reasoning is noteworthy. It initially held that Swedish tax treaties generally take precedence over domestic law regardless of when the domestic law was introduced. Nevertheless, this rule will be set aside when the Swedish legislator has clearly stated that an income is to be taxed in Sweden or that a new rule of domestic law takes precedence over tax treaty law.[8] If the intention of the legislator is not 'entirely clear' in this respect, the general rule will apply. With the intention of distinguishing the 2008 decision from the general rule of tax treaty application, the Court explained its reasoning by referring to the specific circumstances applicable in that situation. What was special according to the Court was the fact that the CFC legislation actually targeted the specific type of income and its source: income of insurance activities from Swiss subsidiaries. These specific circumstances were apparently enough for the Court to conclude that it was 'entirely clear' that the income was supposed to be taxed in Sweden. This indicates that the 'entirely clear test' is easily fulfilled.

3. A RULE OF EXCEPTION

What are the implications of the 2010 decision? Significantly, it confirms the traditional understanding of tax treaty application in Sweden: that tax treaties have a limiting effect on domestic taxing regimes regardless of the date the latter legislation was introduced. It is certainly satisfactory that the argumentation in the 2008 decision is, in the general case, not allowed to set the standard for tax treaty application in Sweden. Besides this general rule, however, the Court is introducing a rule of exception when stating that domestic law will take precedence over tax treaties when that is the intention of the legislator. The Court is thereby introducing a new way of dealing with the challenge of protecting the Swedish tax base. This means that the Court is accepting tax treaty override, which is usually defined as an enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.[9]

Tax treaty override is an obvious breach of international law. The Vienna Convention on the Law of Treaties clearly states that every treaty in force is binding upon the parties to it and must be performed in good faith.[10] According to the Convention, a state may not invoke the provisions of its domestic law as justification for not acting in accordance with treaty obligations.[11] That the Court is willing to accept tax treaty override is unfortunate for the Swedish tax treaty network, for Sweden will be considered an unreliable tax treaty partner if the possibility of tax treaty override is used repeatedly. It is surprising that the Court does not hesitate to override whenever the legislator so instructs. From a domestic perspective, override is unproblematic, considering that no constitutional aspect of Swedish law hinders tax treaty override, but it is inconsistent with established rules of international law.

Aside from the remedies for breach of international law,[12] it is essential to consider the fact that tax levied pursuant to overriding domestic legislation is not levied in accordance with the tax treaty.[13] The other contracting state will not be required to give credit, therefore, or

Notes

7 See n. 5.

8 My translation of '*{o}m lagstiftaren emellertid gett klart uttryck för att avsikten är att en viss typ av inkomst ska beskattas i Sverige eller att en viss ny bestämmelse ska tillämpas oberoende av innehållet i ett skatteavtal så ska den nya regeln ges företräde*'.

9 See, for example, K. Vogel, *Klaus Vogel on Double Taxation Conventions, Introduction*, 3rd edn, Marginal Number 128.

10 Article 26.

11 Article 27.

12 Article 60 in the Vienna Convention on the Law of Treaties provides specific sanctions in response to treaty violations. These include the possibility of terminating the treaty.

13 J. Schwarz, *Schwarz on Tax Treaties* (2009): 23.

otherwise to relieve double taxation that arises due to the override. A taxpayer who is negatively affected by the override may invoke a mutual agreement procedure.[14]

The rule of exception appears to apply in two situations: (1) when it is possible to ascertain that it is the intention of the legislator that the income is to be taxed in Sweden, notwithstanding the content of a tax treaty; and (2) when the legislator has explicitly stated that a rule of domestic law prevails over tax treaties. In terms of legal certainty, the first situation is most problematic. For the Court's reasoning to make sense, it must consider the CFC legislation in the 2008 decision to belong to this category. In that decision, ambiguous writings[15] in the preparatory works, together with the design of the legislation, were enough for the Court to decide that the intention of the legislator was to let the CFC legislation take precedence over tax treaties. The Court's statement that the legislator's intention must be entirely clear appears, therefore, to be too easily fulfilled.

As it is not possible to reconcile fully the Court's statements in the 2010 decision with its statements in the 2008 decision, the principles of derogation mentioned in the 2008 decision will still be used in the context of tax treaty application in Sweden. Had the 2010 decision been decided in full court, this situation would have been avoided. There will still be recourse to the principles of derogation, therefore, in situations in which the main rule of tax treaty precedence over domestic law is set aside.

4. The general anti-avoidance provision and Swedish tax treaties

As should be clear from my reasoning in this article, I find that the Court's introduction of the rule of exception decreases the predictability of tax treaty application in Sweden. The main problem is to establish the situations in which this rule is applicable. Consequently, new legal questions occur. For instance: Can the general anti-avoidance provision in the domestic tax legislation be considered to breach the presumption of tax treaty precedence over domestic law? In other words, can taxation according to the general anti-avoidance provision be invoked regardless of a tax treaty provision stating that Sweden has no right to tax?[16] Lower court decisions are divided on this issue.[17] It is expected that the Supreme Administrative Court will have to deal with this question in the near future.

Notes

[14] See Art. 25 OECD Model Tax Convention.

[15] As Kleist is pointing out, the fact that the government considered that CFC taxation was possible despite Sweden's tax treaties is not the same as concluding that the intention was that the CFC legislation should *prevail* over tax treaties. See D. Kleist, 'Nya domar rörande förhållandet mellan skatteavtal och intern rätt – ordningen återställd?', *Skattenytt* (2011): 212.

[16] For more on the subject of the general anti-avoidance provision and Swedish tax treaties, see A.-S. Sallander, 'I kölvattnet av RÅ 2008 ref. 24', Svensk Skattetidning (2010): 198–199.

[17] See, for example, Cases 3855-09 and 3856-09, which were decided by the Administrative Court of Appeal in Jönköping. An application of the general anti-avoidance provision was possible in these cases, despite a tax treaty. In contrast, an application of the general anti-avoidance provision was not accepted in similar situations – for instance, in Cases 3348-10 and 3856-09, which were decided by the Administrative Court of Appeal in Stockholm.