Euro Tax Flash from KPMG's EU Tax Centre

CJEU decision in the *X* cases on the Dutch fiscal unity regime

Tax groups – Interest expenses – Foreign exchange losses – Freedom of establishment – The "per element" approach

On February 22, 2018, the Court of Justice of the European Union (CJEU) decided that certain elements of the Dutch fiscal unity regime are – and certain are not – contrary to the freedom of establishment. The dispute related to interest deduction limitation and rules on deduction of foreign exchange losses on EU participations.

In essence, the CJEU concluded that taxpayers should be eligible for benefits from separate elements of the fiscal unity regime (also referred to as the 'per element' approach).

The interest deduction case

Background

Case C-398/16 concerns a Dutch company that borrowed funds from the Swedish top holding company of a group of which it was a member and then used those funds to make a share contribution in an Italian subsidiary. The subsidiary, in turn, used these funds to purchase shares in another Italian company.

In dispute was the application of Sections 10a and 15 of the Netherlands Corporate Income Tax Act 1969 ("CITA"), based on which the Dutch tax authorities denied the deductibility of the interest cost paid by the Dutch entity to the Swedish lending company. The Dutch borrower argued that its freedom of establishment has been limited as the interest would have been deductible if it had been allowed to form a fiscal unity with its Italian subsidiary.

The CJEU decision

Citing its judgment in the *X-Holding* case (C-686/13), the Court held that the situation of a parent company wishing to form a fiscal unity with a non-resident subsidiary is objectively comparable to that of a parent company wishing to form a single entity with a domestic subsidiary. The difference in treatment therefore constitutes an infringement of the freedom of establishment. The question then arises as to whether there is a justification for the difference in treatment.

The Dutch government argued that this difference can be justified by the need to preserve the division of taxing rights between Member States. The Court rejected this argument, noting that the rules at issue do not appear to depend on where the income corresponding to the deduction claimed is taxed.

Regarding the need to safeguard the coherence of the Dutch tax system, the Dutch government failed to prove that there is a direct link between the disputed tax deduction and a corresponding tax benefit. The CJEU therefore rejected this justification. The Dutch government also noted the use of the interest deduction limitation as a tool to fight against tax evasion. However, the Court noted that the likelihood of tax evasion is the same in a purely internal case as it is in a cross-border situation. Therefore, the same checks can be carried out in both situations.

The Court therefore concluded that the disputed Dutch legislation is contrary to the EU freedom of establishment.

The currency losses case

Background

The second case (C-399/16), concerns a Dutch parent company of a fiscal unity wishing to deduct a foreign exchange loss on a UK shareholding resulting from a group reorganization. The application of the Netherlands participation exemption rules means that such foreign exchange losses are, in principle, non-deductible. The Dutch parent company argued that the losses would have been deductible if it had been allowed to form a fiscal unity with the UK subsidiary.

The CJEU decision

The Court departed slightly from the AG’s analysis on comparability between the situation of a Dutch parent company investing in a resident subsidiary and that of a Dutch parent company investing in a non-resident subsidiary. The CJEU held that the two situations are not comparable as foreign exchange losses would not arise in a purely domestic situation. The Court further noted that, even if the situations were indeed comparable, the difference in treatment remains questionable. This is because the Dutch parent would not be able to deduct any losses resulting from the impairment of its interest in a resident subsidiary with which it forms a tax group.

In the Court’s view, Member States cannot be required to exercise their fiscal powers asymmetrically, i.e. to allow the deductibility of losses when the corresponding gains would not be taxed in their jurisdiction. In this particular case, any foreign exchange gains from an interest in a non-resident subsidiary would not be taxed in the Netherlands. The Court therefore concluded that the disputed Dutch rules are not in breach of the freedom of establishment.

EU Tax Centre comment

Following the AG's opinion of October 25, 2017 (see ETF 341), the Dutch government immediately announced emergency remedial measures, to be implemented with retroactive effect until October 25, 2017. As the CJEU's judgment largely follows the opinion, the government confirmed immediately after the publication of the CJEU's ruling on February 22, 2018 the previous announcement. It aims to submit the bill to Parliament in the second quarter of 2018. The government reiterated that the emergency remedial measures will have to be followed in the near future by group rules that are future-proof. To ensure a good tax business climate, these rules will also be discussed with, for example, the business sector.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, or, as appropriate, your local KPMG tax advisor.

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