EU Court Advocate General concludes that Dutch interest deduction limitation anti-profit shifting rule is compatible with EU law and urges CJEU to revisit previous judgment

CJEU – Netherlands – Interest deductibility – Anti-abuse provisions – Artificial arrangements – Freedom of establishment – Arm's length principle

On March 14, 2024, Advocate General (AG) Nicholas Emiliou of the Court of Justice of the European Union (the CJEU) rendered his opinion in case C-585/22. The case concerned the compatibility of the Dutch interest deduction limitation anti-profit shifting rule[1] with EU law.

The AG recommends that the CJEU finds the rule under dispute as permissible under EU law. On the question of whether loans contracted at arm's length could still be considered purely artificial or fictitious arrangements, the AG recommends that the CJEU revisits its previous case-law on this topic.

Background

The plaintiff, a Dutch subsidiary (Company X) of a Belgian entity (Company A), acquired shares of an unrelated Dutch entity (Company F), thereby becoming its majority shareholder. The acquisition was financed by a loan granted by another group company (Company C), which was tax resident in Belgium and had received the funds shortly before through a capital injection from Company A. Following the acquisition, the two Dutch companies established a fiscal unity. A dispute arose between Company X and the Dutch tax authorities over the deductibility, for Dutch corporate income tax purposes, of interest expenses related to the intra-group loan.

[1] Section 10a of the Dutch Corporate Income Tax Act

Under the provisions of the Dutch Tax Code applicable at that time, the deductibility of interest expenses incurred with respect to loans contracted from related parties – for the purposes of internal reorganizations or external acquisitions, was restricted (subject to certain conditions). Two exceptions applied:

- a rebuttal provision allowed taxpayers to deduct the intra-group interest if they could demonstrate that both the loan and the associated legal transaction were predominantly contracted based on commercial considerations; or
- in cases where the interest was taxed at a rate of at least 10 percent.

Under settled case-law in the Netherlands, the interest deductibility restriction applied regardless of whether the interest rate was set at a level which would have been agreed between independent parties on an arm's length basis.

The dispute reached the Dutch Supreme Court (Supreme Court), which tentatively agreed with the position of the Court of Appeal that the rule under dispute was justified and proportionate in light of the aim of combating tax avoidance and preserving the Dutch tax base. However, the Supreme Court expressed doubts about whether this conclusion was in line with the CJEU's decision in case C-484/19, concerning the Swedish interest deduction limitation rules. In that judgment, the CJEU held that the exception to the 10 percent rule in the interest deduction limitation rules, applicable between 2013 and 2018, was contrary to the freedom of establishment[2]. In the justification assessment, the CJEU placed particular emphasis on the fact that the exception to the 10 percent rule may cover transactions carried out on market terms and which consequently, in the CJEU's view, do not constitute wholly artificial or fictitious arrangements. For more details, please refer to E-News Issue 124).

Consequently, the Supreme Court referred the case to the CJEU to clarify whether the rule under dispute was compatible with the freedom of establishment, the freedom to provide services and / or the free movement of capital enshrined in the Treaty on the Functioning of the European Union (TFEU).

The AG's opinion

The AG started by analyzing the freedom applicable in the disputed case[3]. The AG noted that the provision under dispute concerned only relationships within a group of companies, as its scope was limited to intra-group loans. On these grounds, the AG concluded that the Dutch interest deduction limitation rule had to be assessed based on the freedom of establishment.

Is there a restriction on the freedom of establishment?

The AG continued by analyzing whether the rule under dispute constituted a restriction on the freedom of establishment.

The AG acknowledged that the Dutch rules do not entail a direct discrimination based on the residence of the parent and went on to analyze whether the rules represent instead a de facto restriction.

The AG took the view that national laws do not necessarily need to employ criteria tailored to a national market or solely favor domestic companies in order to de facto disadvantage cross-border scenarios. The AG argued that

[2] The exception to the 10 percent rule stated that interest expenses relating to intra-group debt may not be deducted if the main reason for the debt relationship was to create a significant tax benefit for the group.

[3] Under settled case-law, where more than one freedom could be relevant, the prevailing freedom is determined by taking into consideration the purpose of the disputed legislation. For example, national legislation intended to apply only to those shareholdings which enable the holder to exert a definite influence over a company's decisions and to determine its activities falls within the scope of the EU freedom of establishment (Article 49 TFEU), whereas national provisions which apply to shareholdings acquired solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking will be examined exclusively in light of the free movement of capital.

the crucial factor was whether the criteria used in these laws disproportionately affect cross-border situations. For this purpose, the restriction assessment should include a comparison between the impact on groups of companies with internal banks in the Netherlands versus those with banks in other Member States. Whilst it is up to the referring court to perform this check, the AG suggested that the latter group was more significantly disadvantaged as a result of applying the minimum taxation criterion. As such, whilst the proportion of groups with internal banks established in the Netherlands that would not meet the criteria was negligible[4], groups with internal banks established in other Member States could fail the minimum taxation requirement due to preferential tax regimes applicable in those jurisdictions, or due to lower effective tax rates. In practice, groups with internal banks established in other Member States would therefore be subject to the additional burden of having to justify the commercial considerations of the arrangement – thus reinforcing the different treatment between domestic and foreign internal banks.

Based on the above, the AG concluded that the Dutch interest limitation rule represents a de facto restriction on the freedom of establishment.

Is the restriction justified?

The AG recalled that restrictions on fundamental freedoms may nevertheless be compliant with EU law when they are justified by an overriding reason in the general interest. In this context, the AG noted that the purpose of the rule under dispute was to combat tax avoidance by preventing the deduction of interest on funds that were artificially borrowed (i.e., not economically justified) by a Dutch entity in cases where the related revenue was not being (reasonably) taxed elsewhere. Recalling settled case-law under which the fight against tax avoidance constitutes an overriding reason in the public interest in the field of taxation, the AG held that the restriction under dispute was justified.

Is the restriction appropriate?

The AG continued by assessing whether the restriction is 'appropriate' and recalls the relevant criteria, namely:

> i) suitable to achieve the objective pursued, and ii) genuinely reflecting a concern to attain the objective, while being consistently and systematically implemented.

According to the appellant, the disputed rule does not combat artificial intra-group loans in a consistent and systematic manner as it allows the deduction if the interest is taxed at a reasonable rate in the Member State of the lending company, even where the loan and/or the associated transaction have no economic justification.

The AG accepted that allowing the deduction in the case described by the appellant may mean that taxable profits are shifted from the Netherlands to the Member State where the lending company is established. The AG noted, however, that a rule that tests whether that interest is taxed at a reasonable rate in the other State ensures that taxation is not avoided altogether and therefore is consistent with the objective of fighting against tax avoidance.

Is the restriction necessary?

The AG further held that the restriction did not go beyond what was necessary to achieve its purpose, on the grounds that: i) it was only targeted at wholly artificial arrangements, and ii) the consequences of a transaction being characterized as such were not excessive.

[4] The Dutch Government had confirmed that in a purely domestic scenario the interest derived by internal banks would be taxed at a rate higher than 10 percent, thus meeting the minimum taxation criterion.

On the first point, the AG rejected the plaintiff's plea that the rule under dispute also targeted legitimate transactions, insofar as it also applied to interest set in line with the arm's length principle. The AG took the view that intra-group loans could be considered as artificial arrangements in two situations:

(i) where the loan was concluded for valid economic and commercial reasons, but based on certain terms which are not in line with the market, and
(ii) where the loan lacks valid economic and commercial reasons, even if its terms are at arm's length.

The AG noted that this view departs from the CJEU's ruling in case C-484/19, where the Court considered that the purpose for which the loan was concluded is not relevant and distinguished between loans contracted on an arm's length basis (deemed genuine) and those which are not contracted on such basis (which the Court regarded as artificial).

In this context, the AG also highlighted that the intervening governments and the European Commission are of the view that the present case should be distinguished from case C-484/19, which would allow for the analysis to be based on the purpose for which a loan was contracted, rather than on its terms – as was the case in that judgement. Whilst the AG does not agree with such a distinction between the two cases, he is of the view that the purpose, rather than the terms of the loan, are relevant to the analysis.

The AG recalled settled CJEU case-law according to which groups of companies that operate cross-border within the EU can legitimately rely on the freedom of establishment when structuring their operations in Member States in a manner that allows them to benefit from a favorable tax regime. With specific application to the present case, the AG raised no objections to situations where cross-border intra-group loans may lead to a reduction of the corporate tax base of the borrowing company, effectively shifting its profits (through interest charges) from the Member State where it is established to the Member State where the lender company is resident. This flexibility can, however, not be relied on for abusive ends. In line with settled EU jurisprudence, the AG recalled that it is abusive for operators established in different Member States to carry out artificial transactions devoid of economic and commercial justification (i.e., arrangements that do not reflect economic reality), which allows them to fulfil the conditions to benefit from a tax advantage only formally, with the essential aim of benefiting from that advantage.

The AG is of the view that, in order to determine whether an intra-group loan is abusive, i.e., constitutes a 'wholly artificial arrangement', the objective pursued by the economic operators in question is decisive. Whether that transaction was carried out for the sole (or main) purpose of benefiting from a tax advantage (as demonstrated by the fact that it is otherwise devoid of economic and/or commercial justification) requires an overall assessment of the relevant facts and circumstances of the case. The AG acknowledged that the arm's length principle serves as an objective benchmark to determine whether an intra-group loan reflects economic reality. However, the AG notes that related companies may also conclude a loan, which is overall devoid of economic and/or commercial justification, for the sole (or main) purpose of generating interest payments in the seat of the borrowing company. In such a case, i.e., where the loan is 'wholly artificial', whether the terms applicable to that loan correspond to those that would have been agreed by unrelated entities in similar circumstances is irrelevant. The AG, therefore, urges the CJEU to revisit its ruling in case C-484/19.

The AG then went on to consider the plaintiff's plea that the rule under dispute was in breach of the principle of legal certainty – specifically, assessment of the condition of whether the loan and the associated legal transaction 'are predominantly based on commercial considerations', and that it introduced a general presumption of abuse.

In the context of the first point, the AG referred to the formulation of the 'general anti-abuse rule' under Article 6 of the Anti-Tax Avoidance Directive (ATAD), which similarly depends on whether that transaction was made 'for valid commercial reasons which reflect economic reality' and not 'for the main purpose […] of obtaining a tax advantage'. According to the AG, an undesirable, yet acceptable side effect of anti-abuse provisions is that they must be broad enough to cover the greatest number of arrangements aiming at tax avoidance possible. In the AG's view, the fact that there are 'grey areas' in the operation of an anti-abuse clause does not make that rule incompatible with the principle of legal certainty. Furthermore, the AG notes that it is sufficient that the practice of the tax authorities and the courts will progressively clarify the disputed provisions. Whilst not providing further detailed guidance on the issue, the AG does note that "when evaluating whether an arrangement should be regarded as artificial or economically justified, tax authorities and courts should consider all valid economic reasons, including financial ones".

On the second point, the AG recalled settled CJEU case-law based on which, where national tax authorities seek to refuse a tax advantage to a taxpayer on grounds of abuse, they are required to provide prima facie evidence of abuse. Nevertheless, in the AG's view, such requirement does not entail a prohibition for Member States from enacting legal presumptions in their national law, provided that they are specific and rest on sufficient grounds. With reference to the disputed legislation, the AG is of the view that circumstances where an intra-group loan has been concluded with a related entity established in another Member, in which the interest charges collected by the latter are not taxed, or not taxed at a reasonable rate, can legitimately be regarded as indications of conduct that might amount to abusive 'tax evasion', therefore justifying a reversal of the burden of proof.

Lastly, the AG argued that denying the interest deduction in full was a proportional measure, in so far as the loan lacked any economic and/or commercial rationale and was motivated solely by the relationship between the parties and the obtaining of a tax advantage.

The AG therefore concludes that the EU freedom of establishment must be interpreted as meaning that it does not preclude national legislation under which the interest on a loan contracted with an entity related to the taxable person is not deductible when determining the profits of that person, where the conclusion of that loan was predominantly motivated not by commercial considerations, but by the objective of creating a deductible debt, even where the interest rate stipulated therein does not exceed that that would have been agreed upon between companies which are independent of one another. In the AG's view, in such a situation, it is proportionate for the interest deduction to be disallowed in full.

ETC Comment

The AG's opinion is striking insofar as it suggests to the CJEU that it reconsider its judgement in a previous case. Specifically, the AG warns against the risk that the arm's length principle becomes a 'safe harbour' for taxpayers. According to the AG, in a scenario where the purpose of a transaction is not taken into consideration, "astute tax advisers would be free to conjure up all sorts of convoluted arrangements designed for the sole purpose of eroding a company's corporate tax liability in a Member State and transferring its profits to another State with a lower tax rate", as long as those terms reflect market conditions. The AG furthermore makes the point that under the general principle of prohibition of abuse of EU law national tax authorities have the duty, not just the right, to prevent tax advantages being obtained through 'wholly artificial arrangements'.

The AG does note that tax 'optimisation' is not prevented by the EU freedom of establishment, which is a principle that the Member States must accept in light of the EU single market. Such strategies must, however, be pursued within the limits of EU law, i.e., in alignment with the economic and commercial purpose of the relevant transactions. It is perhaps noteworthy that the AG does not appear to make a clear distinction between tax evasion and tax avoidance.

In line with the mechanics proposed by the European Commission in the context of the Unshell Directive proposal, the AG notes that, once conditions have been met to establish that an arrangement might have been concluded for tax avoidance purposes, it is not excessive for tax authorities to require taxpayers to rebut that assumption by producing evidence of the economic and/or commercial character of the arrangement. According to the AG, the taxpayer is best placed to provide explanations and evidence of the motives of the transactions it carries out.

It should be noted that AG opinions are not binding on the CJEU. It remains to be seen if the CJEU follows the AG's recommendation to revisit case C-484/19. It is important to note that, on the basis of that decision, the

Swedish Supreme Administrative Court (SAC) ruled in the corresponding domestic case that the plaintiff was allowed to deduct the disputed interest expenses.

Should you have any queries, please do not hesitate to contact KPMG's EU Tax Centre, KPMG in the Netherlands (Otto Marres) or, as appropriate, your local KPMG tax advisor.

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