

Supreme Court considers that Box 3 taxation is still contrary to the ECHR and drafts compensation scheme

The Supreme Court ruled on June 6, 2024 that the current Box 3 tax is also contrary to certain provisions/rights contained in the European Convention for the Protection of Human Rights and Fundamental Freedoms (hereinafter: ECHR) because the deemed (flat-rate) returns are still being used, which means that the deemed (flat-rate) return may be higher than the actual return. The Supreme Court concluded that tax assessments must be reduced so that only the actual return is taxed in Box 3, and it also provides rules for determining the actual return. It is the responsibility of the taxpayer to demonstrate that their actual return is lower than the deemed (flat-rate) return. This judgment is likely to provide a tax advantage for many taxpayers. In practice, however, it can be difficult to convincingly establish what the actual return is. Below, we elaborate on the judgment and its possible implications.

The background

Since 2001, income from savings and investments (Box 3) has been determined on a flat-rate basis. From January 1, 2017, various flat-rate returns were recognized and differentiated according to the amount of the assets (hereinafter: 2017 regime). The Supreme Court ruled on December 24, 2021 (the Christmas judgment) that this 2017 regime was in contravention of the ECHR's discrimination prohibition and the right to peaceful enjoyment of property for cases where the flat-rate return was higher than the actual return. Legal redress was therefore necessary, according to the Supreme Court, and this should be achieved by means of a tax on the actual return. The Supreme Court did not say at the time what a tax on the actual return entailed. That was left to the legislature.

The legislature subsequently drafted a scheme for the restoration of rights: for the years 2017 through 2022 by means of the Box 3 Legal Redress Act (*Wet rechtsherstel box 3*; hereinafter: Legal Redress Act) and for the years from 2023 by means of the Box 3 Bridging Act (*Overbruggingswet box 3*; hereinafter: Bridging Act). These two pieces of legislation also employ flat-rate returns. However, they more closely align with the actual asset composition and also make a distinction between the fixed return on savings, other investments, and debts. The Legal Redress Act for the years 2017-2022 only applies to taxpayers whose assessments were not yet irrevocable on December 24, 2021 or thereafter. Taxpayers whose assessments were already irrevocable on Christmas Eve 2021 (2017-2020 assessments) were *not* granted legal redress under the Legal Redress Act. These non-litigants took legal action in this regard, but came away empty-handed. This issue is currently being revisited in several (test) cases (*massaal bezwaarplus-procedures*; "mass objection plus cases").

However, many taxpayers who *did* qualify for the restoration of rights under the Legal Redress Act considered that the new flat-rate tax still did not provide sufficient restoration of rights, and either appealed or automatically joined a mass objection case. They wanted a tax on an actual return if that was lower.

The aforementioned Bridging Act, which broadly entails the same Box 3 taxation as the Legal Redress Act, applies with effect from January 1, 2023. Taxpayers also opposed

this Bridging Act, logically for the same reasons (the actual return is lower than the flat-rate return). Pending the Supreme Court's judgment as to whether the Legal Redress Act and/or the Bridging Act were lawful, no final assessments that included Box 3 assets were imposed for 2021 through 2023, except in situations which only involved savings.

The five judgments on June 6, 2024

On June 6, 2024, the Supreme Court ruled in five cases. The main question that needed to be answered was whether the Legal Redress Act and the Bridging Act are in accordance with the discrimination prohibition and the right to peaceful enjoyment of property under the ECHR. If the answer was in the negative, the question was then what a tax on the actual return would entail. Finally, there was still the question of whether interest (on tax due) had to be reimbursed by the Dutch tax authorities if the restoration of rights resulted in a refund.

Legal Redress Act and Bridging Act contrary to the ECHR

The Supreme Court considers that the flat-rate scheme for savers as included in the Legal Redress Act/Bridging Act does represent an improvement over the 2017 regime. This is because the flat-rate return for savings generally approximates the actual return on those savings. For the 'other assets' category, this does not apply. The flat-rate returns are still insufficiently an approximation of the actual return. The conflict with the ECHR's discrimination prohibition and right to peaceful enjoyment of property as identified in the Christmas judgment therefore also plays a role in the Legal Redress Act/Bridging Act. There are insufficient arguments to justify such a violation of fundamental rights. The fixed return regime under the Legal Redress Act/Bridging Act is therefore not permitted in all cases where the ensuing tax is higher than a tax on the actual return. Compensation must be paid even if the difference is small. The assessment must be reduced to the amount that would have been payable if the actual return had been taxed.

Actual return

The Supreme Court subsequently formulates rules to determine the actual return. In doing so, it aims to align as closely as possible with the principles underlying the fixed return regime of Box 3. In summary, these principles are:

- The return on all assets in Box 3 should be taken into account.
- The actual return includes not only the benefits derived from assets, such as interest, dividends and rental income, but also realized and unrealized movements in the value of such assets.
- This concerns the return on assets and debts (as referred to in Section 5.3 Personal Income Tax Act 2001), without taking the tax-free amount into account.
- It includes the actual return on all assets in Box 3 that the taxpayer has held throughout the year, not just the assets that were present on the reference date of January 1.
- This concerns the nominal return with no account being taken of inflation.

- The actual return is calculated on an annual basis. No account is taken of positive or negative returns in other years (no loss set-off). The Supreme Court recognizes that the restoration of rights to be offered may lead to overcompensation. After all, in situations where the actual return in any year is higher than the flat-rate return, the taxpayer may opt for the lower flat-rate return ensuing from the statutory provision. The highest Dutch judicial body accepts this consequence.
- No costs can be taken into account, with the exception of interest on debts.

The taxpayer must state the facts, and if these are disputed, make them plausible, in order to demonstrate the amount of the actual return on the entire Box 3 assets.

If there are foreign assets and any related debts, the calculation of the double tax relief must also take account of the actual return and the tax on that actual return, if the taxpayer invokes the actual return scheme.

Interest on tax due

The Supreme Court rules that, in principle, no interest needs to be paid if the assessment is reduced. However, if and to the extent that the amount of statutory interest exceeds the tax reduction in Box 3, the difference must be paid.

KPMG Meijburg & Co comments

The Supreme Court once again rendered landmark judgments on June 6, 2024. As with the 2017 regime in the Christmas judgment, it concluded that the Legal Redress Act and the Bridging Act are inconsistent with certain rights in the ECHR. And that compensation – referred to as restoration of rights – must be given for the difference between the (higher) flat-rate tax and the (lower) tax on the actual return convincingly demonstrated by the taxpayer. What is new is that the highest Dutch judicial body substantiates the compensation measure by defining the actual return.

It is important to recognize that the Supreme Court only creates a compensation measure and is not proposing an alternative Box 3 tax. The measure is not perfect since it can both overcompensate and undercompensate: overcompensate by granting a refund for a higher tax and not for a lower one (*cherry picking*) and undercompensate by, for example, taking no account of costs other than interest or loss set-off in the case of a negative return over a year. It also fails to consider the relationship with the other income Boxes and with formal aspects. The Supreme Court cannot be blamed for that, however. Incidentally, the question is whether and to what extent the Supreme Court's interpretation of the concept of actual return will be followed by the legislator in the design of the new Box 3 regime.

Zooming in on the compensation scheme created by the Supreme Court, we note that there are many questions. We mention a few of these:

- In a response to the judgment, the Deputy Minister of Finance made it be known that taxpayers with only bank and savings deposits are not entitled to any restoration of rights. Restoration of rights is only possible for taxpayers with

other assets in Box 3 such as securities, receivables and real estate. We have doubts as to whether this interpretation is correct.

- The Supreme Court makes reference to the assets and liabilities referred to in Section 5.3 Personal Income Tax Act 2001. We assume that the actual return on exempted assets, such as NSW estates, art, tax-exempt debts due to the receipt of more than a rightful share/receivables due to the receipt of less than a rightful share, etc. are not included.
- Actual return refers to income received, such as interest or rental income, or the interest paid. A second home that is not rented out does not produce a direct positive actual return, but does possibly provide a relevant unrealized increase in value (convincingly demonstrated by means of, for example, the WOZ valuation) that should be regarded and included as actual return. A negative actual return may arise in relation to interest on debts incurred for a second home. There may also be a return due to realized capital gains or losses.
- Will adjustments be made if the interest or rental income is not on arm's-length terms, such as in respect of favorable family loans?
- The Supreme Court has said nothing about the moment when income is deemed to have been received. Should interest on a savings deposit in 2024 be reported in 2024 (payable) or in 2025 (credited)?
- To determine the amount of realized capital gains, the cost and a selling price must be determined. Sales of securities (securities portfolio withdrawals) and purchases of securities (securities portfolio deposits) must also be identified. It is therefore not enough to take the value of the securities portfolio at the beginning and end of the year. The crediting of dividend, for which securities have again been purchased, will also have to be determined. Demonstrating this could present significant practical challenges. For example, bank statements may not always show the result of each transaction. Furthermore, transaction costs might be implicitly included in the statements or in the costs of the investment fund. For this reason, it is wise to start collecting this information now, especially because, in certain cases, this information may eventually become unavailable or 'disappear'.
- The same applies to (implicit) costs in the statement from the organization that rents out your holiday home. These costs need to be eliminated.
- And what is the cost of a property in which investments were made during the year? This cost would then be higher. However, if maintenance has been performed, such costs are not deductible. Therefore, the difference between maintenance and improvements seems to become relevant.
- Unrealized capital gains are also included. In this context, the question arises as to what the cost is and what value should be taken into account at the end of the calendar year. Can the value of properties at the end of 2022 be based on the 2024 WOZ value (which, after all, has January 1, 2023 as reference date)? And if the property was sold during the year, does the actual selling price or the WOZ value in that year apply as income? And if this is the WOZ value, what value applies if the property is sold during the year? After all, WOZ values are only known on January 1 of each year.

- There is no loss set-off over the years, but if a loss is incurred during the year itself, does the taxpayer receive a refund? This does not seem to be the case, as the compensation only consists of the reduction of the assessment (par. 5.5.2), which cannot be reduced below zero.
- In the returns of tax partners, common income components (to which Box 3 income belongs) can be divided between both partners. An adjustment of the optimal distribution is possible up to six weeks after the final tax assessment. Since the Dutch tax authorities, following the Christmas judgment, have in most cases no longer imposed assessments for the tax years 2021 and beyond, it must also be examined whether a lower actual return provides grounds for a new distribution of income between the partners. The Dutch tax authorities will also have to consider this and, furthermore, implementation challenges will arise.

The above shows that determining the actual return as formulated by the Supreme Court can be quite a complicated exercise. Hopefully, the Dutch tax authorities will come up with clear guidelines/standard forms. We are also curious as to how the Dutch tax authorities will settle outstanding assessments. The Dutch tax authorities have indicated that they will issue a response to the judgment within eight weeks.

As a final point, please note that the Supreme Court has not yet rendered judgment in the mass objection plus cases. Briefly, these cases concern the question whether taxpayers whose assessments were already irrevocable on Christmas Eve 2021 (2017-2020 assessments) also qualify for restoration of rights. That group of taxpayers will therefore have to wait and see whether they are entitled to restoration of rights under the Legal Redress Act or via the Supreme Court's compensation scheme.

Please do not hesitate to contact us should you have any further questions or comments regarding the above.

KPMG Meijburg & Co
June 7, 2024

The information contained in this memorandum is of a general nature and does not address the specific circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.