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Tax & Legal

Court of Justice of the European Union rules on Section 10a CITA 1969 and EU law

On Friday, October 4, 2024 the Court of Justice of the European Union (CJEU) rendered a preliminary ruling on the questions posed by the Dutch Supreme Court in 2022 regarding the interpretation of the CJEU judgment in the Lexel AB case concerning the Dutch anti-profit shifting provision of Section 10a Corporate Income Tax Act 1969 ('CITA 1969'). In essence, the CJEU ruled that Section 10a CITA 1969 is not contrary to the freedom of establishment. The CJEU also explicitly noted that a debt to an affiliated party with an arm's length interest rate can indeed be (part of) a wholly artificial arrangement, and that in that case EU law allows the arm's length interest to be fully excluded from deduction.

Why a preliminary ruling was requested

Section 10a CITA 1969 aims to prevent the erosion of the tax base in group relationships (anti-profit shifting). This is done by, in principle, not allowing the deduction of interest paid on debts to related entities, if the funds are used to finance a dividend distribution, capital contribution or the acquisition of or increase in shares in an entity that is or has since become a related company. On the other hand, interest deduction is permitted if it is convincingly demonstrated that both the debt and the legal transaction was primarily business-motivated (the double business motivation test). In the year to which the case related (2007), interest deduction was also permitted if the interest income was taxed at a rate of at least 10% (fair tax test).

In its judgment of September 2, 2022 the Dutch Supreme Court noted that Section 10a CITA 1969 in principle restricts the EU freedoms, because the rebuttal provision for the fair tax is almost always met in domestic relationships, while that is less so in cross-border cases. The Dutch Supreme Court subsequently ruled that, in its opinion, Section 10a CITA 1969 could be justified by the specific objective of the provision, i.e. combating tax fraud and tax avoidance. It follows from settled case law of the CJEU that a national measure that is in principle contrary to one of the EU freedoms is nevertheless permitted if that measure is specifically intended to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, and which are intended to avoid tax normally payable on profits from activities performed on national territory.

The Dutch Supreme Court nevertheless requested a preliminary ruling from the CJEU, the body that interprets EU law. The reason for the request was the Lexel AB case. In that judgment the CJEU ruled "(...) that transactions which are carried out at arm's length (...) are not purely artificial or fictitious arrangements created with a view to escaping the tax normally due on the profits generated by activities carried out on national territory." According to the Dutch Supreme Court in 2022, it could perhaps be concluded from this that if an arm's length interest rate is charged, there is, by definition, no question of a wholly artificial, tax-evading arrangement. In that case, Section 10a CITA 1969 might not be justified on the grounds of combating tax fraud and tax avoidance.

CJEU judgment
In its judgment of October 4, 2024, the CJEU ruled that only the freedom of establishment is important here, because Section 10a CITA 1969 is limited to group relationships. The CJEU went on to state that Section 10a CITA 1969 restricts the freedom of establishment if the interest income in domestic relationships cannot be taxed at a rate of less than 10% or – although theoretically possible – if that never happens in practice. It is up to the Dutch Supreme Court to look into this.

After having addressed the objective comparability, the CJEU concluded – with reference to previous EU case law on Section 10a CITA 1969 – that Section 10a CITA 1969 is clearly aimed at combating tax fraud and tax avoidance. The CJEU examined whether Section 10a CITA 1969 is suitable for achieving this – as an end in itself – legitimate objective and whether this is done in a coherent and systematic manner. The CJEU concluded that this is indeed the case, because Section 10a CITA 1969 makes it possible to neutralize the tax consequences of wholly artificial, economically unrealistic, tax-evading transactions between related entities, because it excludes artificially generated interest expenses from deduction, or in any case ensures that the interest is taxed at a fair rate at the creditor and that profit tax is not completely avoided.

The CJEU then addressed the question whether Section 10a CITA 1969 does not go beyond what is necessary to achieve the objective of combating tax fraud and tax evasion. It noted that a national tax anti-abuse provision such as 10a CITA 1969 does not go beyond what is necessary, if the question whether a transaction concerns a wholly artificial arrangement solely set up for tax purposes, is based on an examination of the objective and verifiable elements. The CJEU noted that what is also of importance here is that if such an arrangement cannot be ruled out, the legal rules must offer the relevant taxpayer the opportunity to provide, without undue administrative effort, evidence of any commercial reasons why the transaction took place.

The CJEU went on to state that the circumstance of there being a situation as referred to in Section 10a(1)(c) CITA 1969 is a sufficient indication that there is a wholly artificial arrangement set up for tax purposes. The taxpayer can however refute this presumption via the rebuttal provision, including the double business-motivation test. According to the CJEU, this means that interest deduction pursuant to Section 10a CITA 1969 is limited to cases where the loan within a group of related companies is motivated by tax considerations to such an extent that the loan is not essential for realizing business-based objectives and would not have been taken out at all by entities between which there are no special relationships. The CJEU also noted that the double business-motivation test relates to both the reason for the loan and the associated legal transaction and the objective elements that characterize the loan and the transaction, which means that only loan debt that has been entered into arbitrarily and without commercial reasons falls within the scope of Section 10a CITA 1969.

The CJEU then addressed the question whether it can be inferred from Lexel AB that transactions whereby debts are entered into with an entity related to the taxpayer, do not by definition constitute wholly artificial arrangements, if they were entered into 'at

arm's length'. With reference to other case law, the CJEU explains that the examination of (compliance with) being at arm's length not only relates to the conditions of the loan agreement that mainly relate to the amount or the interest rate, but also to the economic logic of the relevant loan and the associated legal transactions. After all, this boils down to an examination of the economic reality of the transaction(s), and the absence therefore is one of the decisive elements for qualifying a transaction as a wholly artificial arrangement. To paraphrase the CJEU, it therefore cannot be inferred from Lexel AB that if there is an arm's length interest rate this, by definition, means there is no wholly artificial arrangement.

Lastly, the CJEU addressed the question whether it is proportionate that the entire interest deduction is refused when applying Section 10a CITA 1969. The CJEU considered in this respect that if the relevant loan lacks any economic justification and the loan would never have been taken out if there had not been special relationships between the companies involved and no tax benefit had been pursued, it is compatible with the principle of proportionality to refuse the entire interest deduction, given that the Dutch tax authorities have to ignore such a wholly artificial arrangement when determining the corporate income tax payable. If only part of the interest deduction would be refused, then that would moreover enable the taxpayer to obtain part of even the entire tax benefit pursued by means of abuse, which would undermine the coherence of the relevant rules.

KPMG Meijburg & Co comments
In our view, this judgment brings the CJEU to the most logical conclusion: loans with an arm's length interest rate may also be (part of) a wholly artificial tax avoidance structure. That is logical because the arm's length nature of the interest rate does not necessarily guarantee the economic or commercial reality of the transaction as such. Certainly, it must be acknowledged that it could indeed be inferred from the Lexel AB judgment that transactions which are carried out at arm's length – in the sense of: at an arm's length interest rate – are not by definition wholly artificial or fictitious arrangements that were only set up to avoid the tax normally due on profits generated by activities carried out on national territory. It is now clear that the CJEU does not deem those considerations to apply to rules that specifically combat wholly artificial arrangements, and that can also be the case if there is debt that would never have been entered into in third party relationships.

More generally, Section 10a CITA 1969 can count on the approval of the CJEU. Although Section 10a may perhaps restrict the EU freedom of establishment – it is up to the Dutch Supreme Court to examine that based on the criteria the CJEU has formulated for this –, the Section does pursue the legitimate objective of combating of tax fraud and tax avoidance in a coherent and systematic manner, and it also does not go beyond what is necessary. If Section 10a restricts the freedom of establishment, then that restriction is in any case justified under EU law.

If you would like to know more about this, feel free to contact us or your usual Meijburg tax advisor.

KPMG Meijburg & Co
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