

CJEU Rules That Arm's Length Interest to Related Party Is Not Deductible If Debt Is Regarded As (Part Of) A Wholly Artificial arrangement

According to the Court of Justice of the EU (CJEU) in *X BV* ([C-585/22](#)), Article 10a Dutch Corporate Income Tax (CITA), an interest deduction limitation rule, is compatible with EU law. Although this Article introduces a difference in treatment between a domestic and a cross-border situation, such a difference is justified based on the need to combat tax fraud and tax evasion. In addition, the Court considered that Article 10a Dutch CITA is proportionate to this objective and took a position regarding its previously decided *Lexel AB* ([C-484/19](#)) case. Furthermore, as per Court,

- where the artificial nature of a given transaction results from an exceptionally high rate of interest on such a loan which reflects economic reality, the principle of proportionality requires that an adjustment be made for the part of the interest paid on that loan which exceeds the usual market rate. The refusal of any interest deduction would go beyond what is necessary for the purpose of preventing wholly artificial arrangements.
- by contrast, where the loan is, in itself, devoid of economic justification and, but for the relationship between the companies and the tax advantage sought, would never have been contracted, it is consistent with the principle of proportionality to refuse the deduction of the whole interest.

Background and facts

Article 10a Dutch CITA aims to prevent the Dutch tax base from being eroded by artificially creation of interest charges within a group of taxpayers. Transactions that are in scope of this Article are an internal or external acquisition, a dividend payment (distribution of profit), or a capital contribution into an affiliated company (i.e. an interest in the company of at least 1/3). Interest that relates to the financing of such transactions is only deductible if the loan and the underlying transaction are based predominantly on sound business considerations or if the interest received is effectively and sufficiently taxed by Dutch standards (Article 10a, paragraph 3, under (a) or (b), of the Dutch CITA).

The case concerned X, a company incorporated under Dutch law which belongs to a multinational group of companies. That group includes, inter alia, companies A and C, both established in Belgium. A is the sole shareholder of X and the majority shareholder of C. In 2000, X acquired the majority of the shares in F, a company incorporated under Dutch laws, in which A acquired the remaining shares. X financed that acquisition by means of loans contracted with C, which used for that purpose own funds obtained through a capital contribution made by A. In 2007, Dutch authorities refused to allow X to deduct interest paid to C. X challenged this, and in 2020, the Dutch Court of Appeal upheld the interest deduction limitation under Article 10a CITA as EU-law compliant. X appealed to the Dutch Supreme Court, which referred questions to the CJEU, seeking clarification based on the *Lexel AB* case, where the CJEU ruled that transactions at arm's length are not abusive/artificial.

Judgment of the CJEU

The case was decided based on the freedom of establishment. The CJEU ruled that although Article 10a of the Dutch CITA applies without distinction, it creates a difference in treatment that could affect the exercise of the freedom of establishment. This difference in treatment concerns objectively comparable situations, as the position of the Dutch debtor is the same regardless of whether the interest is paid to a Dutch or foreign creditor. However, the difference in treatment can be justified by the need to combat abuse. The CJEU referred to the Danish beneficial ownership cases (*N Luxembourg 1 and Others*) and the Dutch Groupe Steria cases (*X and X* ([C-398/16](#) and [C-399/16](#))). This justification applies even when the entity becomes affiliated with the taxpayer only after the acquisition or extension.

The Court considered Article 10a Dutch CITA to be proportionate to the objective pursued. Although this Article introduces a presumption of a wholly artificial arrangement, this presumption may be rebutted by the taxpayer by demonstrating that the conditions of Article 10a, paragraph 3, under (a) or (b), of the Dutch CITA have been met. In that regard, the CJEU ruled that

Article 10a(3)(a) of the Dutch CITA concerns evidence regarding the reason for contracting loan and the related legal transaction and the objective elements characterising that loan and that legal transaction, with the taxpayer having to demonstrate that they are justified by commercial considerations and that they could have been agreed in the absence of those specific relationships between entities. In that regard, as per the CJEU, it cannot be inferred from paragraph 56 of the judgment of *Lexel AB*, that, where a loan and the related transactions are not justified by commercial considerations, the mere fact that the terms of that loan correspond to those which would have been agreed between independent undertakings, thus at arm's length, implies that that loan and those transactions do not, by definition, constitute wholly artificial arrangements. Besides, according to the CJEU, the purpose of the Swedish provision in the *Lexel AB* case, which is to counter aggressive tax planning through the deduction of interest expenses, differs from that of Article 10a of the Dutch CITA, which is aimed at combating wholly artificial arrangements.

Moreover, as per the CJEU, the principle of proportionality requires that the refusal of the right to deduct be limited to the part of the interest paid on that loan which exceeds the amount that would have been agreed if there had been no special relationship between the parties. However, where the loan itself lacks any economic justification and would never have been entered into if there had been no special relationship between the undertakings concerned and no tax advantage was sought, it is compatible with the principle of proportionality to refuse the deduction of interest in its entirety, since the tax authorities must disregard such a wholly artificial arrangement.

Finally, as per the CJEU, the use of abstract concepts in Article 10a CITA does not imply that the application of this Article is left entirely to the discretion of the tax authorities.

Takeaway

In the X BV case, the CJEU clarified the concept of abuse concerning inter-group loans and ruled that the mere fact that the terms of such a loan are at arm's length does not necessarily imply that the loan and related transactions do not constitute wholly artificial arrangements. Building on its previous *Lexel AB* case, the Court has now introduced an economic logic test, in addition to the formally agreed terms of the loan, for assessing whether a loan can be considered a wholly artificial arrangement.

Let's talk

For a deeper discussion, please contact:

Hein Vermeulen
PwC Netherlands
+31 6 20941031
hein.vermeulen@pwc.com

Maarten de Wilde
PwC Netherlands
+31 6 34196789
maarten.floris.de.wilde@pwc.com

Vassilis Dafnomilis
PwC Netherlands
+31 6 13998729
vassilis.dafnomilis@pwc.com

or contact any other member of PwC's [EU Direct Tax Group](#)

EU DIRECT TAX GROUP

The EU Direct Tax Group (EUDTG) is PwC's pan-European network of EU law experts. We specialise in all areas of direct tax, including the fundamental freedoms, EU directives and State aid rules. You will be only too well aware that EU direct tax law is moving quickly, and it's difficult to keep up. But it is crucial that taxpayers with an EU or EEA presence understand the impact as they explore their activities, opportunities and investment decisions. Find out more on: www.pwc.com/eudtg

Interested in receiving our free EU tax news? Send an e-mail to eudtg@nl.pwc.com with "subscription EU Tax News".

© 2024 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details. This content is for general information purposes only and should not be used as a substitute for consultation with professional advisors. PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com