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EU alert

AG opines on Dutch tax treatment of interest expense deductions/currency losses in context of fiscal unity

On 25 October 2017, AG Campos Sánchez-Bordona of the Court of Justice of the European Union (CJEU) issued his opinion in two cases relating to the Dutch fiscal unity regime in situations involving the interest deduction limitation rule and the rule on the deduction for currency losses on a participation. The fiscal unity regime allows members of a Dutch group to be treated as a single entity for tax purposes. However, a fiscal unity may be formed only by Dutch-resident companies.

The Dutch Supreme Court had referred the cases to the CJEU on 16 July 2016, and the CJEU consolidated the cases.

Both cases involve situations where the Dutch national rules apply equally to domestic and cross-border situations. However, restrictive legislative provisions can be avoided by forming a fiscal unity in a domestic situation. Since a fiscal unity can be formed only between Dutch companies, the combined application of the restrictive legislative provisions and the fiscal unity rules could constitute a violation of EU law. Notably, the CJEU held in 2015 in the *Groupe Steria* case that the French tax consolidation rules violate the freedom of establishment principle in the Treaty on the Functioning of the European Union because a domestic tax group of French companies was able to obtain certain tax benefits for dividends that were not available to French parent companies with subsidiaries established in other EU member states (for prior coverage, see tax alert **dated 3 September 2015**).

The AG now has opined that the relevant Dutch rules may violate the freedom of establishment because the rules treat Dutch companies with subsidiaries in other EU member states differently, as compared to Dutch companies with Dutch subsidiaries. Under EU law, the Netherlands is not permitted to favor domestic groups by allowing the neutralization of restrictive tax provisions following the creation of a fiscal unity.

Facts of the cases before the CJEU

Interest deductions: One case concerns the restriction on the deduction of interest expense under article 10a of the Corporate Income Tax Act (CITA), which is designed to prevent erosion of the tax base. Under article 10a, interest paid to a shareholder that holds at least 33 1/3% of the shares of the payer company is nondeductible if the loan on which the interest is paid relates to a "tainted transaction," such as a dividend distribution, a capital contribution or the acquisition of a 33 1/3% subsidiary.

Under the facts of the case, a Dutch company obtained a loan from a related EU company to make an investment in an Italian subsidiary. When the Dutch company claimed a deduction for the interest expense on the loan, the Dutch tax authorities disallowed the deduction based on article 10a.

The article 10a rules do not distinguish between domestic and cross-border situations. However, in a purely domestic situation, a taxpayer can avoid the application of article 10a by creating a fiscal unity with another Dutch group company. By forming a fiscal unity, intragroup loans or the potentially tainted transactions become disregarded for tax purposes. As such, the formal requirements for the application of article 10a are not met, and any limit on the deduction of the interest can be avoided.

The taxpayer argued that because it was unable to form a fiscal unity with its Italian subsidiary, whereas this would be possible if the subsidiary was a Dutch company, the rules resulted in discriminatory treatment in violation of EU law.

Case involving currency losses: The other case involved currency losses of a Dutch parent on its participation in a subsidiary located in another EU member state. Under the Dutch participation exemption rules, currency gains from a participation are tax exempt and exchange rate losses are nondeductible. In the case, due to exchange rate fluctuations, the Dutch parent suffered losses on its participation in a UK company during a group restructuring. The Dutch tax authorities disallowed the deduction of the currency losses based on the participation exemption. However, had the Dutch parent and the UK subsidiary been able to form a fiscal unity, the UK subsidiary would have been treated as a UK permanent establishment, and the currency losses would have been deductible. However, since a non-Dutch company was involved, no fiscal unity was possible and the currency losses could not be deducted.

The taxpayer argued that the freedom of establishment principle was violated because it was unable to form a fiscal unity with its Dutch parent company and thus it was unable to obtain the full benefit of the deduction of currency losses.

Opinion of the AG

AG Campos Sánchez-Bordona opined that the Dutch rules essentially constitute a violation of EU law, particularly in the case of the interest deduction limitation where all of the interest would be deductible in a purely domestic situation, since no tainted transaction is considered to exist within a fiscal unity. Cross-border situations do not qualify for this benefit and the interest deduction potentially remains limited because a fiscal unity may be formed only by Dutch-based companies. The AG rejected the Dutch government's argument that the interest deduction limitation could be justified because article 10a is an anti-abuse rule designed to prevent tax evasion. He acknowledged that the prevention of abuse could justify an infringement of EU law; however, because the Netherlands allows a full interest deduction where a fiscal unity is present, the anti-abuse nature of the rule equally does not allow it to be applied in nonfiscal unity situations.

In the currency loss case, AG Campos Sánchez-Bordona noted that there is a difference in treatment between domestic and cross-border transactions. That is, in a cross-border situation, a Dutch parent company cannot take currency losses suffered on a subsidiary from another EU member state into account, while the Dutch parent would be able to do so had the subsidiary been a member of a fiscal unity. However, the AG concluded (citing a 2013 decision of the CJEU in a Swedish case), that the deduction of currency losses may be disallowed because in a Dutch domestic situation, the presence of a fiscal unity does not directly result in different treatment, i.e. to the extent currency gains are not taken into account, currency losses also may not be taken into account. In this respect, the AG appears to conclude that the existence of a fiscal unity cannot render a rule that, in and of itself, is not contrary to EU law (i.e. the fact that currency losses are nondeductible) contrary to EU law. As a result, there is no direct link between the rules on currency losses and the fiscal unity rules.

It is unclear whether the CJEU will follow the AG's opinion. If the court concludes that the Dutch rules violate EU law, the potential impact of creating a fiscal unity should be assessed separately for each statutory provision (the interest deduction and the currency loss rules, in this case), i.e. using a "per element" approach.

Dutch government response

Almost immediately after publication of AG Campos Sanchez-Bordona's opinion, the Dutch State Secretary of Finance announced that emergency remedial legislative measures would be taken if the CJEU agrees with the AG, and that these would become effective retroactively as from 25 October 2017. Depending on the CJEU's decision, the remedial measures could affect interest deductions, currency losses, or both.

The state secretary indicated that the current rules would be revised so that the advantages of forming a fiscal unity in domestic situations would be eliminated to equalize the treatment of domestic and cross-border situations. This would have the effect that some corporate income tax and dividend withholding tax rules would have to be applied as if no fiscal unity existed, which would prevent certain aspects of a fiscal unity in domestic situations from translating into more favorable treatment than in comparable cross-border EU situations. The emergency remedial measures would be formulated in such a way that they also could affect existing fiscal unities.

The state secretary also announced that a new group regime would be introduced to replace the emergency remedial measures. Although the parameters of such a regime currently are unclear, the possibilities range from a regime permitting a fully cross-border fiscal unity (excluding cross-border loss setoffs) to replacing the current regime with a more profit-focused regime (such as a group relief system). Another, less obvious option would be to abolish the fiscal unity regime altogether.

Contacts

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