KPMG Meijburg & Co Tax Lawyers

**Court of Justice of the European Union also applies per element approach to the Netherlands**

## 1. Introduction

On February 22, 2018, the Court of Justice of the European Union (CJEU) rendered judgment in two interesting corporate income tax cases for which the Dutch Supreme Court had requested preliminary rulings (see our previous memorandum). The CJEU joined both cases as they have a common key issue, i.e. whether taxpayers, despite being unable to enter into a fiscal unity with subsidiaries established elsewhere in the EU, are nevertheless eligible for benefits from separate elements of the fiscal unity regime as if a fiscal unity with foreign subsidiaries can be entered into (the 'per element' approach).

In one of the cases, which concerned an interest deduction limitation (profit shifting, Section 10a Corporate Income Tax Act 1969), the CJEU ruled – in accordance with Advocate General Campos Sánchez-Bordona (see our previous memorandum) – that this is contrary to the freedom of establishment. In response to the Advocate General's Opinion, the Dutch Cabinet had already announced emergency remedial measures that would have to be implemented with retroactive effect to 11:00 a.m. on October 25, 2017, should the CJEU follow the Advocate General's Opinion. The measures mean that some corporate income tax and dividend withholding tax rules – even in domestic relationships – will have to be applied as if there is *no* fiscal unity. From a letter by the Deputy Minister of Finance that was also published on February 22, 2018, it appears that the aim is to present the bill to the Lower House in the second quarter of 2018.

With regard to the other case, which involves the deduction of foreign exchange losses on EU participations, the CJEU ruled that there is no violation of EU law.

Both cases and the Cabinet's response are addressed below.

## 2. Profit shifting (Section 10a Corporate Income Tax Act 1969)

As stated above, this case concerns a provision to limit the deduction of interest. In simplified form, the case involved a Dutch company that borrowed from the Swedish top holding company of a group of which it was a member and then used the borrowed funds to make a share contribution in an Italian subsidiary, which, in turn, used these funds to delist another Italian group company. In dispute was the application of Section 10a Corporate Income Tax Act 1969 (CITA), given that this involved a loan from a related entity for the purposes of making a contribution in a related entity. One of the questions that arose was whether Section 10a CITA is contrary to EU law.

According to the Supreme Court, that is in principle not the case, but this could be different due to the overlap with the fiscal unity regime (the 'per element' approach). If the Italian subsidiary had been established in the Netherlands, then it could have been included in a fiscal unity with the Dutch company, in which case the contribution would not be a tainted transaction. The Supreme Court therefore requested a preliminary ruling from the CJEU in this case. The question posed to the CJEU was, in short, whether Section 10a CITA is contrary to the freedom of establishment in those cases where the application of that provision in national situations would be avoided by setting up a fiscal unity.

*CJEU judgment*
The CJEU firstly reiterated its conclusion from the Groupe Steria judgment that each separate tax benefit obtained by the fiscal unity, other than the tax benefit of the transfer of losses, must be assessed as to whether a Member State can exclude this particular tax benefit in cross-border situations. According to the CJEU, the per element approach must thus also be applied to the Dutch fiscal unity regime.

The CJEU further ruled that objectively comparable cases are being treated differently due to the combined application of Section 10a CITA and the fiscal unity regime. According to the CJEU, Section 10a CITA does not however distinguish between internal and cross-border situations and comparability must therefore be exclusively assessed on the basis of the purpose of the fiscal unity regime.

The CJEU subsequently rules that there is no valid justification for this. Of importance here is, among other things, the fact that although the purpose of Section 10a CITA is to combat abuse, the different treatment that exists here arises from the combined application of the fiscal unity regime, which has another purpose. Moreover, the CJEU points out that the risk that a loan is unrelated to economic reality and is only intended to artificially create an interest expense in an internal situation with a subsidiary that is a member of a fiscal unity is not less serious than in the situation with a foreign EU subsidiary.

The CJEU concluded that the refusal to grant an interest deduction for a loan taken out by a related entity to finance a capital contribution in an EU subsidiary is contrary to the freedom of establishment, given that this would be permissible if the capital contribution was made to a resident subsidiary that is a member of a fiscal unity.

### 3. Foreign exchange losses on a UK participation

The other case concerned a Dutch parent company of a fiscal unity, which held direct and indirect participations, some of which were established in the UK. An interest in the Dutch company was held via this UK branch. Internal reorganizations took place in 2008 and 2009, which also involved intercompany debt. After the reorganizations, the Dutch company was held directly by the fiscal unity, while the UK branch was held indirectly via a Luxembourg company. As a result of the reorganizations a foreign exchange loss was incurred on the capital invested in the UK branch. The application of the participation exemption means that such foreign exchange losses are, in principle, non-deductible. The question that arose was whether EU law would nevertheless require their deduction.

The Supreme Court concluded that it is not beyond reasonable doubt whether the taxpayer is justified in invoking the Groupe Steria. One of the questions it therefore asked the CJEU was – broadly speaking – whether the EU freedom of establishment requires that foreign exchange losses incurred on the capital invested in an EU subsidiary be deducted if this is also permitted in domestic situations?

*CJEU judgment*
According to the CJEU, internal and cross-border situations are not objectively comparable in this context. A Dutch company cannot incur any foreign exchange losses on its Dutch participation, other than in the very exceptional event that this participation is denominated in another currency that the one in which the result of the parent company is denominated. But even in that case it can be disputed whether there is a difference in treatment, because for a resident subsidiary that is *a member of a fiscal unity* the participation relationship is not visible, so that even then no deductible exchange loss on the participation can be recognized. Lastly, the CJEU reiterated its conclusion in the X judgment that a Member State does not have to deduct losses if positive results are not taxable. This is the case under the Dutch participation exemption.

The CJEU concluded that not allowing the deduction of foreign exchange losses incurred on EU subsidiaries is not contrary to the freedom of establishment.

## 4. Practical consequences: Cabinet response

### 4.1 Emergency remedial measures
In response to the concurring Opinion issued by the Advocate General on October 25, 2017, the Dutch Cabinet announced emergency remedial measures on the same day that would have to be implemented with retroactive effect to 11:00 a.m. on October 25, 2017, should the CJEU (partly) follow the - for the Netherlands - negative Advocate General's Opinion. The announced measures mean that some corporate income tax and dividend withholding tax rules will have to be applied as if there is *no* fiscal unity, see our previous memorandum. Consider Section 10a CITA in particular. Applying Section 10a CITA as if there is no fiscal unity means, for example, that the interest on loans to related entities, which loans are used to finance a capital contribution in a subsidiary that is a member of a fiscal unity, is non-deductible in certain circumstances. This can arise in many acquisition structures.

In his letter dated December 20, 2017, the Deputy Minister of Finance provided some clarification of certain aspects of the emergency remedial measures. Nevertheless, in practice there is still considerable uncertainty about the precise effects of these measures. On February 22, 2018, the Deputy Minister again sent a letter to the Lower House, which indicates that the aim is to present the bill to implement the emergency remedial measures (including the announced retroactive effect) in the second quarter of 2018.

### 4.2 Future group regime
The Deputy Minister reiterates that the emergency remedial measures will have to be followed in the near future by group rules that are future-proof. To ensure a good tax

business climate, these rules will also be discussed with the business sector, interest groups and academics. Practical developments may mean that further (remedial) measures will be taken prematurely. As a final remark he notes that the consolidation element will probably not be part of a future group regime. This remark suggests that a new group regime will fundamentally differ from the current fiscal unity regime.

We will, of course, keep you informed of developments. Please feel free to contact you Meijburg advisor if you have questions or wish to discuss, for example, whether as a result of the emergency remedial measures an existing fiscal unity, acquisition or financing structure should be left in place.

Meijburg & Co
February 2018