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Supreme Court judgment on interest deduction on group loan

On Friday, July 9, 2021 the Supreme Court rendered judgment on the deduction of interest on a loan to finance an acquisition, in a case in which interest costs were also deductible in other countries due to hybrid elements in the group structure (ECLI:NL:HR:2021:1102). The Supreme Court dismissed the appeal in cassation by the Deputy Minister of Finance.

The Deputy Minister firstly contested the judgment by the Court of Appeals that the interest costs were arm's length interest costs and therefore in principle deductible. The Supreme Court upheld this conclusion. It can be deduced from the considerations by the Supreme Court that financing the acquisition of participations by means of loans is an arm's length event. Therefore, the interest that is payable is an arm's length expense, also if this concerns group loans, provided the conditions for the group loans were determined in accordance with the arm's length principle.

The Deputy Minister also contested the conclusion by the Court of Appeals that the interest deduction was not prohibited by Section 10a Corporate Income Tax Act 1969. The Court of Appeals had ruled that the taxpayer could invoke the rebuttal provision, because the interest was, in substance, payable to a third party. According to the Court of Appeals, there was sufficient parallelism between the group loan and the third party loans. This was not altered by the fact that an entity involved with the financing structure was a hybrid entity, i.e. an entity that is regarded as a transparent entity by one country and as a non-transparent entity by another.

Lastly, the argument that the Court of Appeals had wrongly rejected the tax inspector's appeal on the basis of abuse of law (*fraus legis*) was also dismissed. In accordance with previous case law, the Supreme Court concluded that using the asymmetrical treatment of benefits from a foreign participation (exempt under the participation exemption) and of costs related to that participation (deductible since the judgment, known as the 'Bosal judgment', by the Court of Justice of the European Union of September 18, 2003, ECLI:EU:C:2003:479) is not contrary to the spirit and intent of the law. This is only otherwise if the interest costs are set off against acquired profits or against benefits created in another artificial manner.

Comments by KPMG Meijburg & Co

Of this judgment, the conclusions about Section 10a Corporate Income Tax Act 1969 are particularly relevant. According to published policy by the Dutch tax authorities, the rebuttal provision due to indirect borrowing from third parties cannot be invoked, if there are hybrid elements leading to a double deduction. That policy can no longer be fully enforced. The rebuttal provision can still be invoked even if an entity involved with the financing structure is a hybrid entity. It remains to be seen whether the Supreme Court will also reach the same conclusion if hybrid financing is used (rather than a hybrid entity). It also remains to be seen whether the Supreme Court will also rule that a hybrid element is not important when assessing the arm's length nature of the financing in situations where funds are not indirectly borrowed from third parties. In its

judgment of June 5, 2015, ECLI:NL:HR:2015:1460, the Supreme Court concluded that "there is, in principle, a loan that is primarily based on arm's length principles if there is no diversion of the funds used for the acquisition." The question here is whether a hybrid element can be grounds for making an exception to the principle postulated by the Supreme Court. For the time being, it is difficult to see why in this context a different conclusion would be reached than in the context of the rebuttal provision for indirect borrowing from third parties.

There are two developments that necessitate a nuancing of the importance of this judgment. Firstly, since 2020 hybrid mismatches have become much less common, because legal measures have been taken against arrangements with a double deduction, or deduction without taxation, due to hybrid elements (legislation to implement the ATAD2 Directive). Secondly, since 2018 the fact that borrowing takes place from third parties only substantiates the arm's length nature of the debt, and that in such a case the arm's length nature of the 'tainted' transaction in Section 10a Corporate Income Tax Act 1969 must still be demonstrated. Incidentally, in the case of external acquisitions, it can be assumed that this is an arm's length transaction.

Several other proceedings about comparable cases are still pending before the Supreme Court. It is expected that one or more judgments about interest deduction will follow in the course of 2021.

Please feel free to contact your KPMG Meijburg & Co advisor if you have any questions or would like to discuss the above matters.

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