ANTI-ABUSE DEVELOPMENTS: A NEW NORMAL IN THE NETHERLANDS

Author
Michael Bennett

Tags
Article 10a
Conduit Financing
Danish Cases
Economic Substance
Fraus Legis
G.A.A.R.
Hunkemöller
The Netherlands
Withholding Taxes

INTRODUCTION[1]

"*Doe normaal*" is practical advice in the Netherlands encouraging one to *act normal*. In the past, that phrase would describe commonly used plans to reduce tax. Today, if the old normal is followed by a group effecting an acquisition, it could end up facing unintended consequences. Legislators and tax authorities are increasingly examining traditionally "normal" acquisition structures and financing arrangements in a quest to combat deemed abusive tax arrangements. Like its fellow E.U. Member States, the Netherlands has shifted its tax policy agenda in recent years in line with international and E.U. initiatives to target abuse.

The U.S. has targeted abusive arrangements for several decades via common law doctrines and codified anti-abuse rules, including the economic substance doctrine and conduit financing regulations. Consistent with these U.S. provisions, the E.U. is imposing its own anti-abuse rules, scrutinizing transactions lacking a business motive and structures with interposed entities deemed to be artificial.[2] Member States are now charged with enforcing these policies, and often do so without clear guidance. The result is an ever-evolving landscape that is detrimental to taxpayers following previously accepted methods.

This article highlights the features of anti-abuse provisions originated in the U.S. and their latest counterparts in the E.U. It then analyzes how the new normal established by E.U. developments pose tax risks to existing acquisition structures and intercompany financing arrangements within the E.U., specifically through the lens of the Netherlands. Among the latest possible tax risks, this article considers the effects of recent case law challenging the deductibility of interest on intercompany loans used to finance acquisitions and the risk of potential withholding taxes on outbound payments. In certain situations, a group can face both consequences if it adheres to the traditional way of doing business.

1 The author acknowledges Thomas de Booij, a tax adviser in the Amsterdam office of Dentons, who assisted in the review of this Article.

2 See Council Directive (EU) 2016/1164 of 12 July 2016, Article 6 General anti-abuse rule and the *Danish Cases* (joined dividend cases C-116/16 and C-117/16; joined interest cases C-115/16, C-118/16, C-119/16, and C-299/16).

© Ruchelman P.L.L.C., 2023. All rights reserved.

DEVELOPMENT OF ANTI-ABUSE RULES AND CURRENT EFFECTS

Economic Substance Doctrine

Seemingly in line with tax authorities around the world, the I.R.S. announced it could "bring up the economic substance doctrine to a greater extent than in the past."[3] Look no further than the complaint filed in October against Liberty Global, Inc. alleging the company employed a series of transactions lacking economic substance with the goal to avoid G.I.L.T.I. and capital gain taxes.[4] Additionally, the I.R.S. issued interim guidance in April 2022 making it simpler for examiners to raise the economic substance doctrine and assert penalties by eliminating the prerequisite of first receiving executive level approval.[5]

The economic substance doctrine ("E.S.D.") is a common law doctrine now codified under §7701(o). A transaction or series of transactions will be treated as having economic substance only if (i) the transaction changes the taxpayer's economic position in a meaningful non-tax way and (ii) the taxpayer has a substantial non-tax business purpose for entering into the transaction.

The I.R.S. can employ the economic substance doctrine when the tax results of a transaction are inconsistent with congressional intent. In such cases, the I.R.S. will recharacterize a transaction to reflect the true economic reality and assess taxes accordingly.

G.A.A.R.

A foreign, younger relative of the U.S.'s economic substance doctrine is the E.U.'s general anti-abuse rule ("G.A.A.R.") articulated in Article 6 of the A.T.A.D. According to the G.A.A.R., a Member State shall ignore an arrangement or series of arrangements if (i) the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the law and (ii) the arrangement is deemed to be non-genuine to the extent it is not put into place for valid commercial reasons that reflect economic reality.

The uses of "transaction" in the E.S.D. and "arrangement" in the G.A.A.R are virtually interchangeable. An arrangement is a broader term meant to include not just a transaction, but also any agreement, understanding, or scheme. The E.U. will generally refer to arrangements in its anti-abuse initiatives.

While both the E.S.D. and the G.A.A.R target abusive arrangements, based on a plain reading, the E.S.D. concentrates on business motives whereas the G.A.A.R. primarily focuses on tax motives underlying an arrangement, even if valid business considerations exist. In this sense, the G.A.A.R. can be a more difficult and less defined test, blurring the line on how far tax authorities may go.

---

3 Andrew Velarde, "Government's Use of Economic Substance Doctrine May Increase," Tax Notes, Oct. 17, 2022.

4 *United States v. Liberty Global*, No. 22-cv-02622 (D.CO).

5 LB&I-04-0422-0014.

© Ruchelman P.L.L.C., 2023. All rights reserved.

Fraus Legis

The Netherlands chose not to implement the E.U. G.A.A.R. Instead, it relies on the Dutch common law doctrine *fraus legis*, which effectively works in the same manner. Like the G.A.A.R., *fraus legis* allows tax consequences of certain arrangements to be ignored if (i) the decisive purpose for entering into an arrangement was to realize a tax benefit (considering the artificiality of an arrangement lacking a business motive) and (ii) the arrangement is contrary to the object and purpose of the law. *Fraus legis* can be applied only if no specific anti-abuse rule is applicable to challenge the *bona fide*s of a transaction.

As will be demonstrated in the following section, *fraus legis* has been applied as a backstop to anti-abuse legislation, making for a win-win situation for the Dutch Tax Authority ("D.T.A.").

Interest Expense Deductions – to Permit or Deny?

The Netherlands applies many specific anti-abuse rules of Dutch tax law, including Article 10a of the Corporate Income Tax Act 1969. The D.T.A. has successfully applied Article 10a in combination with *fraus legis* to deny interest expense deductions on intercompany loans within typical acquisition structures. However, an open question remains as to whether interest expense deductions can be denied when the intercompany loan is constructed under arm's length terms and conditions.

Article 10a denies a taxpayer interest expense deductions in respect of debts insofar as these debts are related to the acquisition or increase of an interest in an entity that is or becomes affiliated with the taxpayer.[6] An acquired entity is considered affiliated with a taxpayer when (i) the taxpayer holds at least a one-third interest in the entity, (ii) the entity holds at least a one-third interest in the taxpayer, or (iii) a third-party holds at least a one-third interest in both the taxpayer and the acquired entity.[7] As of 2017, the affiliated entity definition extends to a cooperating group, whereby the cooperating group's total interest taken together is at least one-third.[8]

Two exceptions exist to this rule. A deduction of interest is still permitted where (i) the taxpayer demonstrates that the loan and transaction are based predominantly on business considerations or (ii) the interest income is taxed at a rate of at least 10% in the hands of the direct recipient or a direct or indirect shareholder of the recipient.[9]

A presumption exists that a loan and transaction entered into for the acquisition or expansion of an interest in an entity that only becomes associated with the taxpayer after the acquisition or expansion are predominantly based on business considerations. The presumption does not apply if the loan is deemed to be a wholly artificial arrangement. Regrettably, if equity capital of the group is diverted into debt capital for no commercial purpose other than the generation of a tax benefit the arrangement is deemed to be wholly artificial.[10]

---

6 Article 10a(1)(c) C.I.T.A.

7 Article 10a(4) C.I.T.A.

8 Article 10a(6) C.I.T.A.

9 Article 10a(3) C.I.T.A.

10 Supreme Court 2 September 2022, nr. 20/03948, ECLI:NL:HR:2022:1121.

© Ruchelman P.L.L.C., 2023. All rights reserved.

In cases where Article 10a is inapplicable due to the entities involved not meeting the affiliation threshold (generally for arrangements preceding the 2017 cooperating group provision), the D.T.A. has applied *fraus legis* to sidestep the issue and deny interest expense deductions.

Over the years, it has been typical to finance acquisitions through intercompany loans originally stemming from contributed equity, as it is explicit in Dutch case law that a taxpayer is free to choose the most beneficial form of financing of a company in which it participates.[11] As evidenced by recent court decisions in the Netherlands, this principle may have its limitations.

Recent Challenges in the Courts

Limitations on the choice of financing gained momentum following the July 2021 landmark Dutch Supreme Court case, *Hunkemöller*.[12] The case involved a private equity structure that acquired a retail business headquartered in the Netherlands. Four French investment entities (transparent under French law and opaque under Dutch law) wholly owned a Dutch HoldCo, which acquired all the shares of the Dutch retail group using a combination of equity and shareholder loans. The shareholder loans were financed through equity of the investment group. After the acquisition, the Dutch HoldCo formed a fiscal unity with the retail group and used the interest from the shareholder loans to offset income.

The D.T.A. initially denied the interest expense deductions arguing Article 10a. However, the court deemed the provision inapplicable since none of the French entities held a one-third interest in the Dutch HoldCo. Nonetheless, the D.T.A. successfully argued that if Article 10a was inapplicable, then *fraus legis* should cause the interest expense deduction to be disallowed – the overall transaction involved the diversion of equity into a shareholder loan, which was wholly artificial and lacked business considerations aside from the realization of tax benefits. Further, the interest income went untaxed due to the hybrid mismatch of the French entities. The Court found the arrangement to be against the object and purpose of the law (of Article10a) and disallowed the deduction of interest associated with the loan. The decision informed the business community that limits exist to a taxpayer's discretion on the choice of financing.

"The decision informed the business community that limits exist to a taxpayer's discretion on the choice of financing."

The diversion of equity into debt is not automatic grounds for abuse. In a case involving a comparable fact pattern that was decided one week prior to *Hunkemöller*, the Dutch Supreme Court ruled that no abuse of law existed where the funds used by a shareholder to finance the loan were acquired initially by way of a third-party bank loan.[13] The Court concluded that the two-step arrangement did not lose the link with the external loan and is therefore not abusive.

Throughout 2022, the D.T.A. continued to find success in the courts challenging interest expense deductions in the spirit of Article 10a.[14] That was until the Dutch

---

[11] Supreme Court 9 July 2021, nr. 19/05112, ECLI:NL:HR:2021:1102.

[12] Supreme Court 16 July 2021, nr. 19/02596, ECLI:NL:HR:2021:1152.

[13] Supreme Court 9 July 2021, nr. 19/05112, ECLI:NL:HR:2021:1102.

[14] See Supreme Court 15 July 202, nr. 20/03946, ECLI: NL: HR: 2022:1085. and nr. 20/02096, ECLI:NL:HR:2022:1086 (cases remanded to rule on applicability of *fraus legis* to deny interest deductions); District Court of North Holland 12 August 2022, nr. AWB-18_2897, ECLI:NL:RBNHO:2022:6584 (interest deduction disallowed on shareholder loans used to acquire Dutch company).

© Ruchelman P.L.L.C., 2023. All rights reserved.

Supreme Court paused to reconcile the issue with recent holdings of the C.J.E.U. and the European Free Trade Association ("E.F.T.A.") Court.[15]

Taxpayers may still have room to finance an acquisition of a Dutch target with an intercompany loan if the conditions, including interest rate, are consistent with arm's length terms. The Dutch Supreme Court raised the issue in its September 2, 2022, opinion in which it asked the C.J.E.U. for guidance on whether Article 10a can be applied to loan interest where the agreed loan conditions are arm's length.[16]

The case involved a Dutch HoldCo that acquired all the shares in a Dutch Target Co. The acquisition was financed via intercompany loans from a Belgian coordination center, which obtained the funds shortly before through a capital contribution. The lower courts disallowed the interest expense deduction based on Article 10a because the funds used for the acquisition diverted equity into debt. For that reason, the arrangement was deemed to be wholly artificial and lacking a business purpose. *Fraus legis* was not at stake since the affiliated entity threshold was met.

The Dutch Supreme Court expressed the opinion that the interest expense deduction should be completely denied even if the loan contains arm's length terms and conditions. The key factor was the artificial reduction in the Dutch tax base inherent in the transaction. The Court acknowledged, though, that this line of reasoning might run contrary to the C.J.E.U. decision in *Lexel*, which involved a cross-border internal acquisition financed through an intercompany loan. The C.J.E.U. assessed the validity of Swedish law similar to Article 10a and held that intercompany loans containing arm's length terms and conditions cannot be considered wholly artificial.[17] The C.J.E.U. concluded that only the non-arm's length portion of the interest rate could be denied due to the E.U. principle of proportionality. Denying anything more would go beyond what is necessary to prevent wholly artificial arrangements. In 2022, the E.F.T.A. Court came to a similar conclusion in *PRA Group Europe AS v. Norway*.[18] According to the E.F.T.A. Court, a domestic tax law denying interest expense deductions for anti-abuse purposes must focus on the portion of interest expense that exceeds an arm's length amount.

Lexel involved an internal acquisition, whereas the Dutch case involved an external acquisition. The Supreme Court asked the C.J.E.U. if this distinction has any bearing on the principle laid down in *Lexel*. Further, the Court asked whether the application of Article 10a is a breach of E.U. law in situations where a loan is concluded under arm's length terms and conditions.

The decision is expected within the next two years and will provide much needed clarity for the choice of acquisition financing. If the C.J.E.U. interprets Article 10a in line with *Lexel* and *PRA Group Europe AS*, the decision will effectively create an arm's length safe harbor permitting the deductibility of interest associated with intercompany loans funded by group equity. In this light, it will be imperative to document not only the arm's length interest rate, but also additional arm's length terms and conditions, including the debt-to-equity ratio, payment schedule for interest and principal, and creditor rights.

---

15 The E.F.T.A. Court is the equivalent of the C.J.E.U. in matters relating to E.E.A. E.F.T.A. states (Iceland, Liechtenstein and Norway).

16 Supreme Court 2 September 2022, nr. 20/03948, ECLI: NL: HR: 2022:1121.

17 Court of Justice of 20 January 2021, Lexel AB, C-484/19, ECLI:EU:C:2021:34.

18 E.F.T.A. Court, 1 June 2022, E-3/21.

© Ruchelman P.L.L.C., 2023. All rights reserved.

Despite the potential arm's length safe harbor for interest expense deductions, the same arrangement could subject the interest payment to Dutch withholding tax. If the arm's length safe harbor does not prevail, debt financing could potentially take a double hit – a denial of interest expense deduction and subject to withholding tax. Financing an acquisition with 100% equity won't resolve these concerns, since a deduction is not available, and dividend payments could similarly be subject to withholding tax. Prudence suggests that taxpayers review their structures and financing arrangements to adjust terms and conditions, if any, that run afoul of *fraus legis* and Article10a and a withholding tax regime that is described in the following section.

WITHHOLDING TAXES – TO COLLECT OR NOT TO COLLECT?

Like the use of intercompany loans to finance acquisitions, the use of interposed entities in acquisition structures has been market standard for years. Multinational groups typically establish layers of interposed entities to hold an acquisition vehicle established in the jurisdiction of the target in order to facilitate an investment or series of investments. Today, however, tax authorities are scrutinizing the economic reality of the interposed entities and asserting that some act as conduits permitting related-party income streams to avoid withholding taxes while the income goes untaxed at the level of the ultimate beneficial owner.

U.S. Conduit Financing

While scrutiny applied to conduit financing arrangements is relatively new in the E.U., the U.S. has long combatted the use of these arrangements initially highlighted in the 1971 Tax Court case *Aiken Industries*.[19] The court held that the interest paid to an interposed company was not exempt from U.S. withholding taxes, as the interposed company was deemed a conduit established for the sole purpose of avoiding withholding taxes.

In *Aiken Industries*, a U.S. subsidiary intended to pay interest to its foreign parent domiciled in the Bahamas, which did not have an income tax treaty in effect with the U.S. It was advised that a 30% withholding tax would be imposed on the payment of interest. To address the issue, the Bahamian parent sold the note to a second-tier Honduran subsidiary. At the time, an income tax treaty existed between the U.S. and Honduras that provided full tax exemption for the payment of interest. The I.R.S. challenged the arrangement and the U.S. Tax Court ruled in its favor. According to the court, the Honduran entity was merely a conduit for the passage of interest payments from the U.S. subsidiary to the Bahamian parent and denied access to treaty benefits. The Honduran entity had no actual beneficial interest in the interest it received because it was committed to pay out exactly what it collected and had no opportunity to realize a profit. Withholding tax was levied on the interest payment because the economic owner of the payment was the Bahamas corporation.

The primary holding of *Aiken Industries* has since been codified in Code §7701(l), which authorizes the conduit financing regulations found in Treas. Reg. §1.881-3. The conduit financing regulations allow the I.R.S. to disregard intermediate conduit entities in a financing arrangement and assess withholding taxes by looking only at the U.S. payer and the ultimate foreign recipient. An intermediate entity is generally

---

19 *Aiken Industries v. Commr.*, 56 T.C. 925 (1971).

© Ruchelman P.L.L.C., 2023. All rights reserved.

regarded as a conduit if its participation reduces withholding tax owed pursuant to a tax avoidance plan.

The Danish Cases

While *Aiken Industries* was decided over half a century ago, it was not until 2019 when the E.U. reached similar landmark decisions in what are known as the *Danish Cases*.[20] The *Danish Cases* confirmed the ability of Member States to enforce anti-abuse rules in E.U. directives in the absence of domestic legislation if appropriate to deny withholding tax benefits in artificial conduit arrangements.

> ***"Dutch tax policy has traditionally focused on promoting the Netherlands as a center for global trade. Key to this policy was the absence of withholding taxes on payments of interest, royalties, and direct investment dividends to recipients outside the Netherlands."***

Each case generally involved the use of common international private equity structures whereby dividend or interest payments were made from a Danish entity to an E.U. resident entity and then eventually paid forward to an ultimate parent entity in a third country. In order to benefit from withholding tax exemptions under E.U. law, the C.J.E.U. held the recipient must be the beneficial owner of the income. The court articulated that the beneficial owner is an entity that benefits economically from the income received and has the power to freely determine its use. A conduit company is the opposite of a beneficial owner because the entity lacks substance and is not put in place for valid business reasons reflecting economic reality. Conduit indicators identified by the court include the following:

- The existence of a legal or contractual obligation to pass the income to another person, so that the payee has no right to use or enjoy the proceeds of the income
- The fact that income is passed on shortly after receipt to other entities which do not qualify for benefits
- The fact that the entity makes an insignificant profit from the income it receives because it is obligated to pass the funds on to other entities
- The entity's sole activity is the receipt of passive income and the payment of that income to another party

The impact of the C.J.E.U. judgments can be felt throughout the E.U. as tax authorities have since placed greater emphasis on combatting entities without substance and an apparent economic purpose.

What Do the Dutch Have to Say About It?

Domestic Law

Dutch tax policy has traditionally focused on promoting the Netherlands as a center for global trade. Key to this policy was the absence of withholding taxes on payments of interest, royalties, and direct investment dividends to recipients outside the Netherlands. That policy has changed significantly in recent years following international and E.U. developments.

---

20 Joined dividend cases C-116/16 and C-117/16; joined interest cases C-115/16, C-118/16, C-119/16, and C-299/16.

© Ruchelman P.L.L.C., 2023. All rights reserved.

In accordance with the *Danish Cases* and to distance itself as a conduit facilitator, the Netherlands amended its minimum substance requirements for foreign entities claiming an exemption from withholding tax. Minimum Dutch substance requirements include the following factors:

- At least half the board members reside in the jurisdiction of the recipient.
- The board members have qualified knowledge to complete tasks that are required for the position.
- The recipient employs qualified personnel.
- Board meetings and key board decisions take place in the jurisdiction of the recipient.
- Main bank accounts are managed and held in the jurisdiction of the recipient.
- Books and records are kept in the jurisdiction of the recipient.
- Wage costs exceed €100,000.
- For a period of at least two years, the recipient has equipped office space in the jurisdiction where activities are actually performed.

While no longer functioning as a safe harbor, entities who satisfy the minimum substance requirements can shift the burden to the D.T.A. to prove that the arrangement is abusive.

In cases where abuse is deemed to be present, the Netherlands can levy withholding taxes on dividend, interest, and royalty payments made to foreign entities. The Netherlands has historically applied a dividend withholding tax under certain conditions. Currently, the rate is 15%. As of January 1, 2021, the Netherlands applies a conditional withholding tax on interest and royalties if, *inter alia*, an arrangement is deemed abusive. The tax is assessed at the highest corporate rate, currently 25.8%. A conditional dividend withholding tax in line with the conditional interest and royalty withholding tax will take effect January 1, 2024.

Both the dividend withholding tax and conditional withholding tax on interest and royalties contain similar anti-abuse rules to prevent interposed conduit entities from enjoying an exemption from withholding tax.[21] A withholding tax generally will be imposed on dividend, interest, or royalty payments if (i) the recipient is included in the structure mainly to avoid withholding tax and (ii) the payment is part of an artificial arrangement that has not been put in place for valid business reasons that reflect economic reality.

If the recipient entity is considered the beneficial owner of the income and satisfies the minimum substance requirements, the entity and transaction are presumed to have been put in place for valid business reasons that reflect economic reality. Consequently, the income will likely avoid Dutch withholding tax.

In situations where the D.T.A. believes the entities were put in place for the avoidance of tax and not valid business reasons that reflect economic reality, a withholding tax

[21] Article 2.2(1)(c) Withholding Tax Act 2021 and Article 4(3)(c) Dividend Withholding Tax 1965.

© Ruchelman P.L.L.C., 2023. All rights reserved.

can be levied on interest and dividends paid up the structure. In conjunction with a denial of interest expense deductions, these highlighted tax risks can have a significant impact on the rate of return of an investment or a group's operating profit.

Treaty Considerations

Withholding taxes assessed in abusive situations can nevertheless be mitigated if the recipient is resident in a jurisdiction that has concluded an income tax treaty with the Netherlands that permits the reduction or exemption from withholding taxes on dividends, interest, or royalties. The Netherlands, though, has ratified the M.L.I. and elected to include the Principal Purpose Test ("P.P.T."). The P.P.T. will apply to deny treaty benefits if, having regard to all relevant facts and circumstances, it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly results in that benefit. If granting the benefit would be in accordance with the object and purpose of the relevant provisions, the treaty benefit will not be denied.

The P.P.T. will apply in tax treaties concluded with Netherlands if the treaty partner has also ratified the M.L.I. and adopted the P.P.T. If there is no P.P.T. or alternative anti-abuse provision in the treaty between the Netherlands and recipient jurisdiction, successfully combating the undesired use of the tax treaty becomes difficult.

CONCLUSION

The E.U. is catching up to the U.S. in combatting deemed abusive tax practices, with new initiatives, directives, and landmark cases challenging the status quo. Traditional acquisition and financing methods are under scrutiny, and those that do not reflect economic reality may lead to undesired tax consequences. International taxpayers should review their structures and take action where necessary to remain compliant in this evolving landscape. This is especially true in the Netherlands, as the legislature and the D.T.A. continue to redefine what are acceptable arrangements. Perhaps taxpayers could heed the advice of the Dutch adage "*doe normaal*" after all, so long as they are conforming to the "*nieuw normaal*."

Disclaimer: *This article has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*