DEVELOPMENTS IN ANTI-ABUSE MEASURES AND ACQUISITION FINANCING IN THE NETHERLANDS

Author
Michael Bennett

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INTRODUCTION

The financing of acquisitions involving Dutch companies has come under increased scrutiny in the Netherlands in recent years. The Dutch Tax Authority ("D.T.A.") has challenged the ability of Dutch acquisition companies to deduct interest on intercompany loans deemed to be abusive. Article 10a of the Dutch Corporate Income Tax Act ("C.I.T.A.") denies interest expense deductions if the financing structure artificially erodes the Dutch tax base. If organizations circumvent the direct application of Article 10a, the D.T.A. has successfully invoked the principle of *fraus legis* to deny interest expense deductions. *Fraus legis* may be applied if an arrangement is contrary to the intent of the law and its decisive purpose is to obtain a tax benefit.

A 2023 Insights article discussed cases in which the D.T.A. challenged the deductibility of interest under Article 10a and *fraus legis*.[1] However, many grey areas and interpretative issues remained. In the period since the article was published, new developments regarding the denial of interest expense deductions on intercompany acquisition loans have emerged. This year, the Dutch Supreme Court, the Advocate General for the C.J.E.U., and the Advocate General of the Netherlands have issued opinions on three separate cases. This article reviews the opinions and their potential impact on Dutch acquisition financing. While the saga of Article 10a and *fraus legis* continues to unfold, taxpayers welcome the recent guidance as it provides further insight into this evolving area and the extent to which *fraus legis* may be applied.

ARTICLE 10A AND FRAUS LEGIS

The Netherlands applies many specific anti-abuse rules of Dutch tax law, including Article 10a of the Corporate Income Tax Act 1969. 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.[2] 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.[3] As of 2017, the affiliated entity

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1. M. Bennett, "Anti-Abuse Developments: A New Normal in the Netherlands," *Insights*, Volume 10, No. 1, (January, 2023), page 52.
2. Article 10a(1)(c) C.I.T.A.
3. Article 10a(4) C.I.T.A.

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definition extends to a cooperating group, whereby the cooperating group's total interest taken together is at least one-third.[4]

Two exceptions exist to this rule. A deduction of interest is 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.[5]

A presumption exists that a loan and transaction entered into for the acquisition or expansion of an interest in an entity are predominantly based on business considerations when the target first becomes associated with the taxpayer after the acquisition or expansion. Nonetheless, the presumption does not apply if the loan is deemed to be a wholly artificial arrangement.

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. The Netherlands applies the common law doctrine *fraus legis*, which is akin to the E.U. 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.

Fraus legis has been applied as a backstop to anti-abuse legislation, making for a win-win situation for the D.T.A. More specifically, 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.

The extent to which *fraus legis* may be applied to deny interest expense deductions remains unsettled, as evidenced by the numerous cases litigated in Dutch courts over the years. However, new guidance has emerged in 2024, helping to clarify some of the blurred lines that define what is and is not considered abusive.

DUTCH SUPREME COURT OPINION

On March 22, 2024, the Dutch Supreme Court ruled on a case involving interest expense deductions and financing costs in a private equity acquisition.[6] In this case, a Swedish private equity firm used a Dutch acquisition vehicle ("X B.V.") to purchase a Dutch company.

The investment fund initially consisted of four limited partnerships ("L.P.'s"), which were non-transparent for Dutch tax purposes. Each L.P. established a sub-fund in Guernsey. The sub-funds were subject to a 0% tax rate in Guernsey. Sub-fund 1 was the only sub-fund with an interest in X B.V. that exceeded the one-third affiliate threshold of Article 10a. A fifth L.P. and Gurnsey sub-fund were established one

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

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

6 Supreme Court, 21/01534, ECLI:NL:HR:2024:469 (March 22, 2024).

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month before the acquisition was finalized in order to reduce L.P 1's interest in X B.V. to a level below the affiliate threshold. The limited partners in L.P. 1 were the same as those in L.P. 5. During the takeover, 15% of X B.V. shares were transferred to a family company of the sellers ("FamBV"). The acquisition was financed with a combination of debt and equity from the sub-funds and FamBV. The sub-fund financing originated from equity contributed to the L.P.'s by the limited partners.

On its tax return, X B.V. deducted only interest paid on the FamBV loan, designating the remaining interest expense as nondeductible on the basis of Article 10a. Following an audit, the D.T.A. challenged the deductibility of interest paid on the FamBV loan. X B.V. objected and took the position that the full amount of interest may be deducted, including the interest paid on the sub-fund loans that had originally been excluded on the tax return.

Both the district court and the appellate court allowed the deduction for interest paid on the FamBV loan since the lender did not belong to the private equity group, but disallowed the deduction for interest paid on the sub-fund loans. The courts acknowledged that Article 10a was not directly applicable since the affiliate threshold was not met between the sub-funds and X B.V. Nonetheless, they held that *fraus legis* applied to deny the interest expense deductions because the structure was set up to artificially circumvent Article 10a and pay zero tax on the interest income in Gurnsey. The loans were deemed to be an unbusinesslike diversion of equity.

X B.V. appealed to the Supreme Court. Advocate General Wattel concurred with the lower courts. However, the Supreme Court partially overturned the lower courts' decisions. The Supreme Court held that only the interest expense deduction paid on the loan from sub-fund 5 could be denied since the sub-fund was solely created to bypass the affiliate threshold of Article 10a.

The interest paid on the loans from the other sub-funds and FamBV was deductible since the entities were not one-third affiliated with X B.V., and there was no series of transactions between affiliated entities aimed at circumventing the Article 10a affiliate threshold. The Supreme Court referred to the legislative history of Article 10a, which provides that although *fraus legis* may still apply if Article 10a does not directly apply, it must concern exceptional cases, which are rare in practice given the extensive codification of such cases.

The Supreme Court also clarified a consideration from its March 3, 2023, decision. In the 2023 decision, the Court noted that if a taxpayer can convincingly demonstrate that the debt and associated transaction were primarily business motivated, then *fraus legis* is not applicable. The Court explained in the 2024 decision that this is the case only if the lender associated with the taxpayer fulfills a pivotal financial function and does not act as a conduit. The Court noted this was not the case for the relevant entities in the 2024 decision; thus, the application of *fraus legis* was properly assessed.

In an interesting turn of events, the D.T.A. ultimately ended up in a worse position after challenging the FamBV loan interest expense deduction. Not only was the taxpayer allowed to deduct that interest as a result of the Supreme Court decision, but it could also deduct interest on the majority of the sub-fund loans.

While the Article 10a story continues to play out, this decision at least demonstrates there are limits to *fraus legis* when challenging acquisition financing. A case must

represent an exceptional circumstance clearly crossing the boundary of permissible tax savings. The Court also made it clear that if a structure attempts to artificially evade the one-third affiliate threshold, there may be a limitation on interest expense deductions under *fraus legis*.

C.J.E.U. ADVOCATE GENERAL OPINION

"In 2022, the Dutch Supreme Court considered a case where the primary issue was whether Article 10a can be applied to interest arising und a loan where the agreed loan conditions are arm's length."

In 2022, the Dutch Supreme Court considered a case where the primary issue was whether Article 10a can be applied to interest arising under a loan where the agreed loan conditions are arm's length.[7] The Supreme Court sought clarification from the C.J.E.U. on this issue, particularly in regard to the *Lexel* decision and the treatment of intragroup loans under anti-abuse provisions. The Dutch Supreme Court acknowledged that the country's anti-base erosion rules generally align with E.U. law. However, post-*Lexel*, there is uncertainty about whether limiting interest expense deductions for deemed artificial transactions conducted at arm's length violates E.U. law.

The C.J.E.U. in *Lexel* ruled that transactions between affiliated entities conducted at arm's length are not purely artificial. Additionally, the C.J.E.U. emphasized that under E.U. law, if a particular legal structure lacks a commercial reason, the proportionality principle mandates limiting an interest deduction to the extent that it is not considered at arm's length.

The *Lexel* decision has sparked mixed reactions in the Netherlands. Some practitioners view the C.J.E.U.'s decision as an affirmation of the arm's length standard as a safe harbor for taxpayers. Others exercise caution, arguing that the decision, rendered by a lower E.U. court, does not align with the C.J.E.U.'s general anti-abuse stance, which tends to apply a principal purpose test.

On March 14, 2024, Advocate General Emiliou of the C.J.E.U. delivered his opinion in response to the request by the Dutch Supreme Court.[8] A.G. Emiliou first identified the freedom of establishment under Article 49 T.F.E.U. as the relevant fundamental freedom affected by the case. A.G. Emiliou found that Article 10a C.I.T.A., in principle, restricts that freedom by potentially treating intragroup loans differently based on the location of the lender within the group. This may disadvantage cross-border situations, creating a *de facto* restriction. However, he concluded that the restriction is justified by an overriding public interest in the fight against tax avoidance.

A.G. Emiliou reasoned that the arm's length nature of a loan is irrelevant in determining its business justification. A.G. Emiliou recommended disregarding the emphasis on arm's length conditions in the *Lexel* decision, suggesting that a loan's economic and commercial justifications are paramount. He contended that artificial debts targeted by Dutch rules should not be shielded by arm's length compliance, noting that national provisions targeting such loans are necessary to prevent artificial profit transfers to low-tax jurisdictions.

The forthcoming decision from the C.J.E.U. is expected to provide clarity on the application of Dutch anti-base erosion rules within the framework of E.U. law. The

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[7] Supreme Court, 20/03948, ECLI:NL:HR:2022:1121 (September 2, 2022).

[8] Opinion of Advocate General Emiliou in *X B.V. v. Staatssecretaris van Financiën*, C585/22, ECLI:EU:C:2024:238 (March 14, 2024).

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judgment should also address whether an arm's length safe harbor applies. The outcome of this case could hold considerable implications for Dutch taxpayers.

NETHERLANDS ADVOCATE GENERAL OPINION

On January 26, 2024, Advocate General Wattel of the Netherlands issued an opinion in a case that was submitted to the Dutch Supreme Court.[9] The primary issue is whether *fraus legis* applies to disallow interest expense deductions paid on an intercompany loan if the interest deduction falls outside the scope of Article 10a.

The case concerns a private equity takeover structure where a Dutch BidCo financed the acquisition of a Dutch target with a loan from its parent company in Luxembourg. The funds were obtained through preferred equity certificates ("P.E.C.'s") issued to six sub-funds and two partnerships of private equity funds, where each holds less than a one-third interest in the Dutch BidCo. Following the acquisition, the target was included in a fiscal unity with the Dutch BidCo, enabling interest on the shareholder loan to be charged against the target's profits. The D.T.A. disallowed this interest deduction.

This District Court of The Hague found that the shareholder loans fell under Article 10a, rendering the interest nondeductible. The district court regarded the P.E.C.'s as a contribution of capital, considering their yields to be profit distributions rather than interest. The district court did not find it relevant that the P.E.C.'s were considered debt in Luxembourg. Moreover, the interest income was not subject to a minimum 10% tax since it could be deducted against profits in Luxembourg. The district court held that the P.E.C.'s were an unbusinesslike diversion of equity.

The Amsterdam Court of Appeals found that the group entities were not affiliated for the purposes of Article 10a since they did not meet the one-third affiliate threshold. Nonetheless, the Court of Appeals held that the shareholder loan was an unbusinesslike diversion and denied the interest expense deduction by way of *fraus legis*.

In his opinion, A.G. Wattel highlighted that the legislative history of Article 10a indicates that interest deduction can be denied due to *fraus legis* in situations where Article 10a does not apply directly due to the failure to meet the one-third affiliate threshold. This is especially true if the tax savings clearly exceed permissible limits. A.G. Wattel stated that there is a presumption that the parties are acting in good faith when they are not affiliated but clarified that this does not preclude the application of *fraus legis* when there is a clear motive for tax avoidance.

A.G. Wattel noted that the *Hunkemöller* ruling established broader grounds for applying *fraus legis* than those that exist under Article 10a. A.G. Wattel also compared the case to the pre-Article 10a case, *Bovag*, where a restructuring was financed in such a way that deductible interest flowed to a nontaxable entity and was deemed artificial. He stated that while a lack of one-third affiliation under Article 10a leads to the inapplicability of Article 10a, one-third affiliation is not a requirement for *fraus legis*, as demonstrated in *Hunkemöller* and pre-Article 10a case law.

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[9] Opinion of Advocate General Wattel, 23/02746, ECLI:NL:PHR:2024:85 (January 26, 2024).

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A.G. Wattel recommended confirming the decision of the appellate court, but also urged the Supreme Court to provide further clarity on the application of *fraus legis* to the anti-abuse rules. The matter now lies with the Supreme Court for resolution.

CONCLUSION

The recent ruling by the Dutch Supreme Court and the opinions of the advocate generals highlight the ongoing uncertainty surrounding the precise scope of Article 10a and its interaction with *fraus legis*. As the saga continues to unfold in the courts, only time will reveal the full extent to which these rules will apply. In the interim, international taxpayers should carefully evaluate their structures and acquisition financing arrangements when targeting a Dutch entity, taking into account the potential implications of the Dutch anti-base erosion rules.

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