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In this installment of In Step With Stibbe, Tolman and Molenaars review the Court of Justice of the European Union’s *Lexel* judgment for its potential effect on the Dutch anti-base-erosion rule, and more broadly, if it signals a change in the Court’s approach to evaluating whether a transaction is abusive.

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On September 2 the Dutch Supreme Court referred preliminary questions to the Court of Justice of the European Union on whether the application of the Dutch anti-base-erosion rule of article 10a of the Dutch Corporate Income Tax Act 1969 (CITA) is compatible with EU law. The questions followed the CJEU’s 2021 judgment in *Lexel*¹ and the Court of the European Free Trade Association’s recent decision in *PRA Group Europe*

AS,² from which it may be derived that loans that are based on arm’s-length terms cannot be considered wholly artificial and thus are not abusive.

The effect of the *Lexel* judgment may be broad. It may affect the antiabuse interpretation of the European parent-subsidiary directive (90/435/EEC) and anti-tax-avoidance directives 2016/1164/EU (ATAD 1) and 2017/952/EU (ATAD 2), and the proposed Council Directive 2021/0434 (ATAD 3). It may also affect the domestic abuse doctrines and even the OECD’s proposed pillar 2 blueprint. The responses to the preliminary questions are expected to provide much-needed clarity on the interpretation of not only the Dutch anti-base-erosion rule, but also other member states’ interest deduction limitations.

Lexel and PRA Group Europe AS

Lexel

On January 20, 2021, the CJEU concluded in *Lexel* that a Swedish interest deduction limitation was discriminatory and incompatible with EU law. The case concerned a Swedish company within the Schneider Electric group that acquired an intragroup interest in a Belgian company. The acquisition was funded with a loan from a French affiliated company. Interest paid by the Swedish company was included in the French tax base but did not result in taxation because it was offset against available tax losses.

The deduction of interest was denied by the Swedish tax authorities on the basis that the “substantial benefit exception” was met. Under

¹ See *Lexel AB v. Skatteverket*, C-484/19 (CJEU 2021).

² See *PRA Group Europe AS v. Norway*, E-3/21 (EFTA 2022).

Swedish tax law, interest payments to an affiliated party are in principle deductible if the income is subject to a tax rate of at least 10 percent, unless the main reason for entering into the loan agreement is to capture a substantial tax benefit. In a domestic situation, the exception would not have been applicable, because Swedish companies would then have been covered by the provisions on intragroup financial transfers.

The CJEU concluded that the Swedish interest deduction limitation provision was not compatible with the freedom of establishment as laid down in article 49 of the Treaty of the Functioning of the European Union. The Swedish regime was also not justified by the argument of fighting tax avoidance, because the rule did not only target wholly artificial arrangements, but also transactions between companies in accordance with the arm's-length principle. This follows from paragraph 56 of the CJEU ruling:

56. It must be held that the exception may include within its scope transactions which are carried out at arm's length and which, consequently, are not purely artificial or fictitious arrangements created with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

The ruling can be read to suggest that an interest deduction limitation rule that aims to counteract wholly artificial transactions (such as intragroup loans) may be incompatible with EU law if it applies to transactions carried out at arm's length. If in that situation there are no commercial reasons for a structure, the deduction of interest should only be limited to the extent that it is not at arm's length, based on the proportionality principle. It could therefore be concluded from *Lexel* that arm's-length transactions could never be wholly artificial or fictitiously created with a view to escaping taxes normally due and could thus not be abusive.³

The CJEU ruling was received with mixed feelings. Some welcomed the CJEU's new approach of reaffirming the arm's-length

³ See, e.g., Maarten van der Weijden, "ECJ Lexel AB Decision Casts a Shadow Over Dutch Interest Limitation Provision," European Tax Blog, June 21, 2021.

standard as a safe harbor for taxpayers,⁴ while others were more skeptical and argued that the arm's-length reference should not be interpreted as a new arm's-length safe harbor, remembering that the case was handled by one of the smaller EU courts and that the conclusion would be undesirable for the CJEU's antiabuse explanation.⁵

PRA Group Europe AS

After *Lexel*, the EFTA Court embraced the CJEU's approach in its judgment in *PRA Groupe Europe AS*. The case concerned the compatibility of a Norwegian interest deduction limitation with the freedom of establishment as provided in article 31 of the Agreement on the European Economic Area.

A deduction of interest paid to a Luxembourg group company was denied at the level of a Norwegian group company, while it would not have been denied if it had been paid to a Norwegian group company because of Norwegian group transfer rules. The EFTA Court concluded that the Norwegian interest deduction limitation was a restriction on the freedom of establishment. The Court said that a regime could be justified if it serves to prevent wholly artificial arrangements leading to tax avoidance. But the Norwegian regime did not provide an opportunity for taxpayers to show that the transaction is commercially justified. By referring to the *Lexel* judgment, the EFTA Court continued, because of this absence, the deduction refused may not necessarily be limited to the proportion of interest that exceeds what would have been agreed to had the relationship between the parties been arm's length.

The EFTA Court applied the same *Lexel* approach of comparing a restrictive domestic antiabuse provision with the proportionality requirement of EEA law by using the arm's-length standard as a benchmark. This approach seems to confirm the transfer pricing safe harbor in EEA

⁴ See, e.g., CFE ECJ Task Force, "Opinion Statement ECJ-TF 1/2021 on the CJEU Decision of January 20, 2021, in Case C-484/19, *Lexel AB*, Concerning the Application of Swedish Interest Deductibility Rules" (Apr. 9, 2021); and *Lexel*, C-484/19, with note from O.C.R. Marres.

⁵ See, e.g., Maarten de Wilde and Ciska Wisman, "After CJEU Now EFTA Court Too Embraces Arm's-Length Standard as a Beacon; What's Next?" Kluwer Tax Blog, June 10, 2022; and Peter Wattel, "Marktconforme Profit Shifting," NJB 2021/175 (Mar. 9, 2021) (in Dutch).

law as introduced by the CJEU in *Lexel* and could mean that domestic antiabuse rules within the EU/EEA cannot be justified if arm's-length transactions are targeted.

Potential Impact

The impact of the approach chosen by the CJEU and later by the EFTA Court may be significant and may put pressure on antiabuse and anti-mismatch regimes in scope of EU/EEA law that apply beyond the arm's-length principle. Thus, one could think of the interplay of the conclusions with antiabuse rules following, for example, the EU parent-subsidiary directive, the (pending) anti-tax-avoidance directives (ATAD 1, ATAD 2, and ATAD 3) and the proposed source state rules in the OECD's pillar 2 blueprint. Also, the conclusions may affect the approach taken in national and international case law on antiabuse matters, such as the CJEU's Danish cases on beneficial ownership in relation to withholding taxes⁶ or Dutch Supreme Court rulings on the applicability of *fraus legis*.⁷ As a result of the judgments in *Lexel* and *PRA Group Europe AS*, it is expected that member states will refer questions to the CJEU to confirm the compatibility of domestic antiabuse rules with EU law.

Preliminary Dutch Supreme Court Questions

The Dutch Anti-Base-Erosion Rule

Dutch tax law contains several interest deduction limitations. One is the anti-base-erosion rule under article 10a of the CITA. This rule looks like the interest deduction limitation in Sweden that was assessed in *Lexel*, with an important difference in that it applies to both internal and external acquisitions. The Swedish rule targeted only internal acquisitions. Under the Dutch rule, an interest deduction is denied for

loans from related group companies⁸ to the extent that these loans relate legally or de facto effectively, directly or indirectly, to so-called tainted transactions. Tainted transactions include capital contributions, repayments of capital, dividend distributions, and acquisitions of an interest in a company that is or becomes related to the taxpayer after the acquisition.

The antiabuse provision does not apply if the taxpayer is able to demonstrate that either one of the following rebuttal rules is met:

- The transactions and related intragroup debt financing are predominantly motivated by business reasons (the double business motive test). For third-party acquisitions, this is generally the case if the funds have not been artificially rerouted within the group.
- The interest on the loan is taxed in the hands of the recipient at a level that is sufficiently determined under Dutch tax rules — that is, at least against a 10 percent rate (the sufficient compensating tax test).

In 2018 the CJEU considered two cases concerning the Dutch fiscal unity regime, and whether the Dutch anti-base-erosion rule is compatible with EU law. The rule had been considered justified by the fact that it seeks to prevent Dutch tax base erosion because of a deduction without a reasonable levy in another jurisdiction (that is, to combat tax evasion and tax avoidance).⁹

The Case That Led to Preliminary Questions

The Dutch Supreme Court's September 2 decision¹⁰ concerned a Dutch company that acquired an interest in another Dutch company from a third party. After the transaction, the Dutch companies became related to one another.

⁸ For purposes of article 10a CITA, a "related entity" is: (1) an entity in which the taxpayer owns at least a one-third interest; (2) an entity that owns at least a one-third interest in the taxpayer; or (3) an entity in which a third party owns at least a one-third interest while this third party owns at least a one-third interest in the taxpayer. The term "interest" refers both to paid-in capital (financial interest) and issued capital (voting interest) and includes direct and indirect relations. Entities can also be related if they form part of a cooperating group.

⁹ See *X BV v. Netherlands*, joined cases C-398/16 and C-399/16 (CJEU 2018).

¹⁰ Tax Chamber of the Dutch Supreme Court (Hoge Raad der Nederlanden), ECLI:NL:HR:2022:1121 (2022).

⁶ See *N Luxembourg 1 v. Skatteministeriet*, joined cases C-115/16, C-118/16, C-119/16, and C-299/16 (CJEU 2019); and *Denmark v. T Danmark*, joined cases C-116/16 and C-117/16 (CJEU 2019).

⁷ See, e.g., de Wilde and Wisman, *supra* note 5.

The funds (three loans) to acquire the interest were borrowed from a Belgian finance group company. The Belgian finance company benefited from the Belgian so-called coordination center regime and was taxed at a low effective tax rate. The Belgian finance company made the funds available from funds received through capital contributions from its Belgian parent company, which was also the parent company of the Dutch company. The Dutch tax authorities denied the deduction of interest based on the anti-base-erosion rule of article 10a of the CITA because the funds were considered artificially rerouted because of the capital contribution by the Belgian parent company immediately before making the loan available.

The lower courts agreed with the tax inspector that tax saving was the main reason for rerouting the funds via the Belgian finance company and that the double business motive test was not met. The courts dismissed any concerns that the interest deduction limitation could be in breach of EU law.¹¹ The case was appealed to the Supreme Court.

Supreme Court Preliminary Questions

The Supreme Court considered the Dutch anti-base-erosion rule to be generally compatible with EU law. However, it acknowledged that after *Lexel*, there is some level of uncertainty as to whether interest deduction limitation rules counteracting wholly artificial transactions (such as intragroup loans) could be in breach of EU law in situations in which the loans are concluded on

¹¹The lower court decisions consist of the District Court of Gelderland, ECLI:NL:RBGEL:2018:4220 (2018); and the Court of Appeal of Arnhem-Leeuwarden, ECLI:NL:GHARL:2020:8628 (2020).

arm's-length terms. The Supreme Court therefore preliminarily asked the CJEU for clarification on how to interpret *Lexel* in relation to whether the Dutch anti-base-erosion rule could be in breach of EU law. The Court also asked whether it is in breach of EU freedoms to limit interest deduction in the case of a loan that is part of a wholly artificial construction, regardless of whether the loan is considered to be at arm's length. The Court also asked whether the outcome would be different if the intercompany loan were used for an external or internal acquisition.

The CJEU's answers to the preliminary questions are expected in the next 18 months to two years, after which the case will be referred back to the Dutch Supreme Court for a final ruling. To this point, Dutch taxpayers facing consequences from the interest deduction limitation rule based on article 10a of the CITA may want to preserve their rights of objection to, for example, tax assessments disallowing the interest deduction.

Final Remarks

Based on the *Lexel* judgment, one may conclude that the CJEU seems to have shifted its focus for determining whether a transaction is abusive from reviewing the motive and artificial creation of the structure as a whole to determining the arm's-length nature of the interest expenses. Whether this is indeed the case remains to be seen. The answers to the preliminary questions raised by the Dutch Supreme Court are expected to provide much-needed clarity for the interpretation of not only the Dutch anti-base-erosion rule, but also the interest deduction limitations of other member states. ■