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Netherlands Overhauls Fiscal Unity Regime Following X BV and X NV Judgment

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Netherlands Overhauls Fiscal Unity Regime to Address 'Per Element' Approach

by Gerbrand Hidding and Kristel Tijsterman

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In this article, the authors discuss a recent ruling from the Court of Justice of the European Union that found an element of the Dutch fiscal unity regime violates EU law and examine the impact of the emergency measures enacted in response to the decision.

On February 22 the Court of Justice of the European Union issued its judgment in *X BV* and *X NV*, joined cases C-398/16 and C-399/16 (CJEU 2017). The judgment addresses the compatibility of some aspects of the Dutch fiscal unity regime with EU law.

The fiscal unity regime allows Dutch parent companies to file a consolidated tax return with their Dutch subsidiaries. The advantages include that the profits and losses of the companies within the fiscal unity are offset against each other, that assets can be transferred within the fiscal unity without triggering taxation, and that payments can be made between fiscal unity companies without the need to recognize any taxable income.

In *X BV*, the CJEU ruled that a beneficial element of Dutch fiscal unity (specifically, the nonapplication of an anti-base-erosion rule) does not comply with EU law. This judgment has a major impact on other statutory tax provisions in the Netherlands that, applying the same reasoning, may also be incompatible with EU law. Anticipating this judgment, the Dutch government had announced emergency measures on October 25, 2017, the day the CJEU's advocate general issued his own negative opinion. Based on the CJEU's judgment, which was in line with the advocate general's opinion, these emergency measures became retroactively effective as of October 25, 2017. These emergency response measures have a major impact on the Dutch tax consolidation regime.

In this article we address the impact and scope of the CJEU's judgment and the emergency response measures.

Background — *Groupe Steria*

The joined cases *X BV* and *X NV* involve the "per element" approach established by the CJEU in *Groupe Steria*, C-386/14 (CJEU 2015).

The *Groupe Steria* case concerned a French company with shareholding interests in France and other EU member states. At that time, 5 percent of the dividends received by a French company from its subsidiaries were subject to French corporate income tax and a full exemption of dividends could apply upon forming a tax group. However, the French group tax regime legislation did not allow cross-border tax groups, meaning a full exemption could only be obtained in purely domestic situations.

The CJEU ruled that disadvantaging a company that had a non-French subsidiary versus a French subsidiary — that is, the differing treatment of comparable situations — infringed the freedom of establishment and could not be justified.

The CJEU applied a per element approach to determine whether limiting specific tax advantages (namely, a given element of a tax consolidation group) constituted a violation of EU law. The per element approach did not mean that a cross-border fiscal unity must be allowed, but rather that a specific element (5 percent taxation of the dividends from the foreign subsidiary) could not be applied.

It was clear that *Groupe Steria* could have consequences in the Netherlands because a Dutch

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fiscal unity — which could only be formed by Dutch companies — could offer beneficial outcomes upon the application of several different Dutch tax provisions.

The CJEU's *X BV* Judgment

In the joined cases *X BV* and *X NV*, the CJEU ruled on the application of the per element approach to the Dutch fiscal unity regime. This article will focus on *X BV*. The CJEU found that the Dutch legislation challenged in *X NV* is compatible with EU law.

X BV addresses whether the interest deduction limitation included in article 10a of the Dutch Corporate Income Tax Act (CITA) to combat Dutch base erosion is compatible with EU law. Under that provision, interest charges paid to a related party on a loan used for some "tainted" transactions may not be deducted for tax purposes. Tainted transactions are typically dividend distributions, acquisitions, and capital contributions. There are two exceptions to this anti-base-erosion rule: (1) the business reasons exception, and (2) the reasonable taxation exception. We provide a more detailed outline of article 10a of the CITA later in this article.

X BV obtained a loan from its Swedish shareholder and used the loan to make a capital contribution to an Italian subsidiary. In principle, article 10a of the CITA would apply and limit the interest deduction since it concerns a related-party debt and a tainted transaction. This outcome would only be different if one of the exceptions applied.

If X BV had made a capital contribution to a Dutch subsidiary included in its fiscal unity (instead of a subsidiary in another member state), then the equity contribution itself would not be visible as a result of the fiscal unity regime. The transaction would, therefore, fall outside the scope of article 10a of the CITA. X BV could not achieve this result, however, since the fiscal unity regime is restricted to Dutch resident companies.

The difference between a domestic situation and the situation of X BV is illustrated in Figure 1.

X BV argued that if Dutch law permitted it to form a fiscal unity with its nonresident EU subsidiary, it could have deducted the interest on the loan. Because the option to enter into a fiscal unity is reserved for Dutch resident companies (and PEs of nonresidents), X BV argued that article 10a of the CITA infringed the freedom of establishment since investing in a nonresident subsidiary was less attractive than investing in a Dutch subsidiary.

In line with the *Groupe Steria* ruling, the CJEU ruled that the two situations were objectively comparable because both dealt with the financial costs borne by a parent company involving its shareholding in a subsidiary (EU or domestic). Further, agreeing with the advocate general's opinion, the CJEU concluded that the different treatment of two comparable situations was a restriction on the EU's fundamental freedoms. The CJEU did not accept the Netherlands' attempt to justify the distinction by pointing to the need to maintain the coherence of the fiscal unity regime. Likewise, the Court did not accept the Dutch government's argument that the interest deduction limitation could be justified because article 10a of the CITA is an antiabuse rule designed to prevent tax evasion.

The CJEU ruled in favor of the taxpayer and found that this element of the Dutch tax consolidation regime is in breach of EU law. Therefore, taxpayers can successfully argue that (in EU situations) article 10a of the CITA's interest limitation rule should not apply if a fiscal unity could have been formed in a similar domestic situation.

The per element approach may, based on the same reasoning, also apply to other statutory provisions that provide different results (that is, are more beneficial) when a fiscal unity is in place — provisions that may also be in breach of EU law. The CJEU's ruling is far-reaching and, in response, emergency response measures immediately took effect in the Netherlands to limit its negative impact.

The Government's (Planned) Response

The CJEU's judgment in *X BV* is in line with the advocate general's opinion of October 25, 2017. Following the advocate general's opinion, the Dutch government immediately announced emergency response measures intended to prevent substantial budgetary leakage. If the CJEU ruled in accordance with the advocate general's submission, the measures would enter into effect from October 25, 2017.

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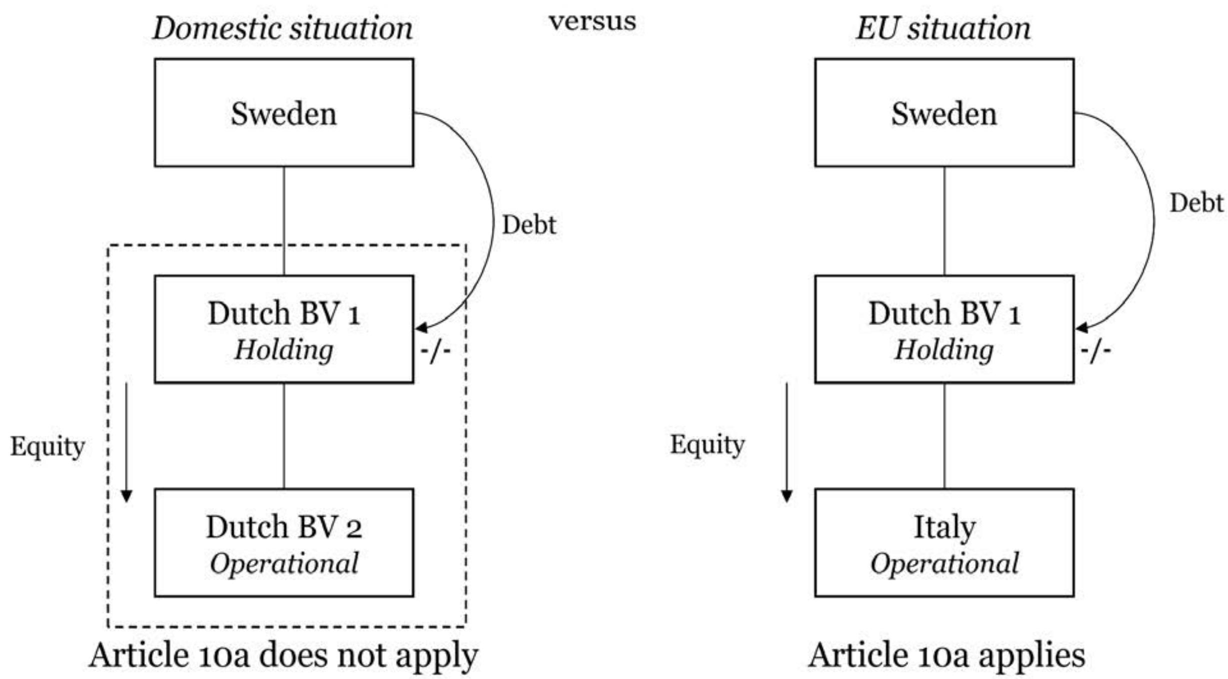
Figure 1. X BV's Capital Contribution: Domestic vs. EU Comp



The emergency response measures essentially eliminated some favorable elements of the fiscal unity to ensure that domestic situations are treated equally to comparable EU situations. Hence, the government did not achieve equal treatment by extending these benefits to EU situations, but by excluding these benefits in domestic situations as well.

The measures mean that when applying several provisions, the existence of the fiscal unity must be ignored: The provisions must apply as if there were no fiscal unity in place. This will affect the application of article 10a of the CITA (the anti-base-erosion rule), the participation exemption, the excessive participation debt clause, tax loss forfeiture rules (article 20a of the CITA), and a specific clause in the Dutch dividend tax.

Based on the CJEU's ruling, these emergency response measures took effect retroactively. Their scope, impact, and uncertainties are addressed in the next section, which focuses on article 10a of the CITA and the loss forfeiture rules. Also, it is not fully clear how tax provisions outside the scope of the emergency measures may be affected.

The Emergency Response Measures

Interest Limitation Anti-Base-Erosion Rule

Article 10a of the CITA disallows the deduction of interest paid on loans (directly or indirectly) to an affiliated entity to the extent the loan is (directly or indirectly) connected to one of the following tainted transactions:

- a profit distribution or repayment of paid-in capital by the taxpayer to an affiliated party;
- a capital contribution by the taxpayer into an affiliated entity; or
- an acquisition of shares or the expansion of an existing shareholding by the taxpayer, in an entity that is affiliated after the acquisition or expansion.

Rebuttal rules may apply if a taxpayer can demonstrate that:

- the tainted transaction and the debt financing of the tainted transaction are for sound business reasons (business reasons exception); or
- the interest income is sufficiently subject to taxation (that is, a minimum 10 percent rate) at the level of the creditor, and the creditor is not entitled to a carryforward of losses (or

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similar set-offs) for years preceding the year in which the loan is granted (reasonable taxation exception).

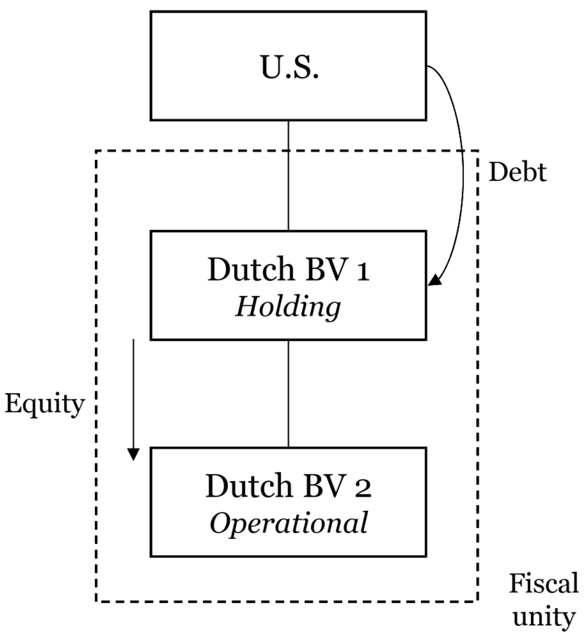
The reasonable taxation exception is not a complete safe harbor. If the taxpayer relies on the reasonable taxation exception, the interest may still be considered nondeductible if the tax authorities can make a reasonable argument that:

- the debt has been incurred to set off the interest income against (anticipated) losses or against similar provisions (incurred in the same year of granting the loan or soon thereafter) at the level of the creditor; or
- the debt or the tainted transaction has not been made mainly for sound business reasons.

Example 1

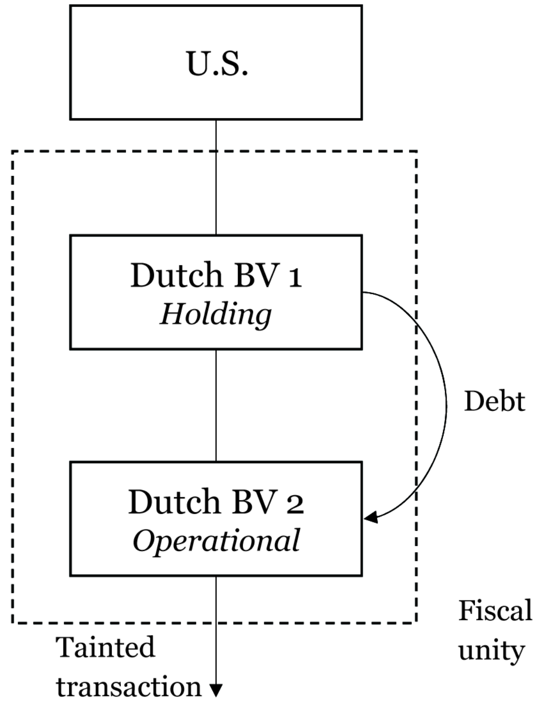
A very common structure involving article 10a of the CITA that could be affected by the emergency response measures is shown in Figure 2.

Figure 2. Tainted Equity Contribution Made Visible (Example 1)



In this structure, BV 1 obtains a loan from its U.S. parent company (an affiliated entity). BV 1 uses the funds to contribute equity into BV 2 (a tainted transaction), which is within the fiscal unity of BV 1.

Figure 3. Tainted Debt Made Visibile (Example 2)



Before the emergency response measures took effect, the equity contribution by BV 1 would have been disregarded because of the fiscal unity. Therefore, no tainted transaction would have been recognized and article 10a of the CITA would not have applied.

As a result of the emergency response measures, the fiscal unity must be disregarded. Therefore, the equity contribution becomes visible and the transaction falls within article 10a CITA's scope.

If the taxpayer can rely on one of the exceptions (that is, sufficient taxation at the level of the U.S. parent or business reasons for both the debt and the transaction), then the practical impact of the emergency response measures may be limited.

Example 2

Our next example considers how the reasonable taxation exception could apply under the emergency response measures when the creditor company is a Dutch entity.

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In Example 2 (illustrated in Figure 3), the effect of the emergency response measures is that the tainted debt becomes visible (versus the tainted transaction made visible in Example 1).

In this structure, BV 2 obtains a loan from BV 1 (the parent company in the fiscal unity). The funds are used by BV 2 for a tainted transaction (that is, an acquisition, capital contribution, dividend payment, or so forth).

As a result of the fiscal unity, the group loan between BV 1 and BV 2 is invisible. Therefore, before the application of the emergency response measures, the loan would have fallen outside the scope of article 10a of the CITA.

Under the emergency response measures, however, the fiscal unity must be disregarded. Therefore, the group loan becomes visible and the transaction falls within article 10a of the CITA's scope. If the loan is used for a third-party acquisition — a business-driven transaction — then it is likely that the connected debt could also be substantiated by business reasons.

However, if the business reasons exception cannot be applied — that is, if the tainted transaction itself or the connected debt cannot be justified by business reasons — the issue becomes how the reasonable taxation exception applies to this case.

The exception requires that the interest income on the loan is taxed at a minimum rate of 10 percent, and the creditor is not entitled to carry the losses forward for the years preceding the year that the loan is made. The statutory corporate income tax rate in the Netherlands is well above 10 percent so, assuming the fiscal unity, as a whole, is not loss-making, one might jump to the conclusion that the reasonable taxation exception applies. If so, the burden of proof would shift to the Dutch tax authorities to show that the loan or transaction is not business-driven or that the debt has been incurred to offset interest income against (anticipated) losses at the level of the creditor.

The emergency response measures, however, dictate that the fiscal unity must be disregarded for the purpose of article 10a of the CITA. Although unclear, this could mean that the reasonable taxation exception should be applied to the stand-alone position of BV 1, disregarding the tax position of the fiscal unity as a whole. As a holding company, BV 1 would most likely only incur costs and therefore would be in a loss-making position if judged as a stand-alone entity. If that is indeed the interpretation of the emergency response measures, then the taxpayer could only rely on the business reasons exception.

No further guidance exists on this point.

The impact of the emergency response measures related to article 10a of the CITA for the period up to January 2019 may be limited because on April 20 a temporary grandfathering rule involving the application of the emergency response measures to article 10a of the CITA was announced. According to this grandfathering rule, the reasonable taxation exception of article 10a is deemed to be met if the total interest expenses on article 10a loans do not exceed €100,000 (an all-or-nothing approach applies). This rule only applies when the debt and tainted transaction were effectuated before October 25, 2017. This grandfathering rule applies until January 1, 2019. Companies, particularly small and medium-size enterprises, have the opportunity to ensure that group debt disappears within this transitional period and to prevent the consequences of the emergency repair measures, if applicable.

Loss Forfeiture Upon Change in Shareholders

Article 20a of the CITA provides loss forfeiture rules that apply following a substantial change in ultimate ownership; that is, they apply when there is a change in the ultimate ownership of 30 percent (or more) of the shares when compared with the earliest year from which tax losses are carried forward. Tax losses incurred by the entity before the change cannot be offset against profits realized after the change in ownership.

However, this rule does not apply if, among other things:

- for at least nine months in both the loss-making year and the profit year (against which the loss would be offset), less than 50 percent of the taxpayer's assets were passive portfolio investments; and
- directly before the change in ultimate ownership, the taxpayer's volume of activities was neither less than 30 percent of its volume of activities in the oldest loss year, nor was it the taxpayer's intention to so reduce it within the next three years.

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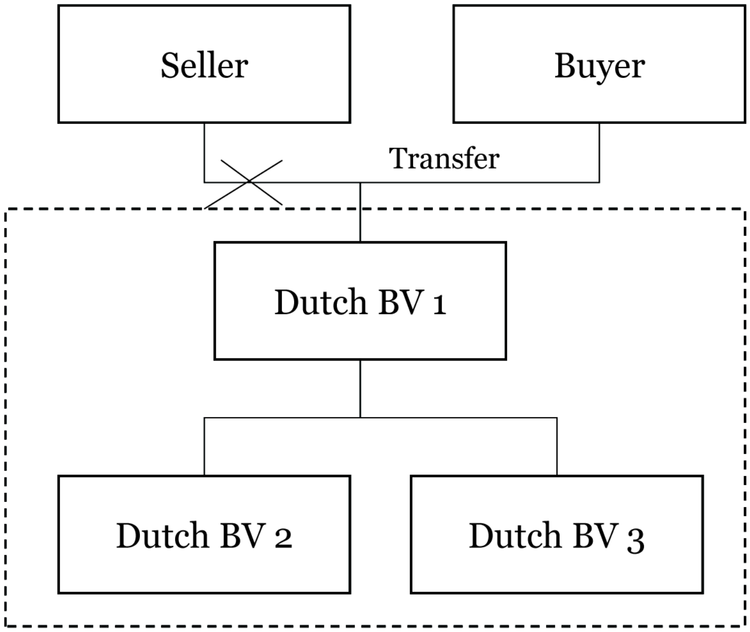
Figure 4. Assessing Change of Ownership for Loss Forfeiture Rules (Example 3)



Example 3

Example 3 illustrates the impact of the emergency response measures on article 20a of the CITA (see Figure 4).

Before the emergency response measures, the application of the loss forfeiture rules would have been assessed at the consolidated level of BV 1. This made it easier to qualify for the exception in cases involving a fiscal unity.

As a result of the emergency response measures, the fiscal unity must be disregarded for the purposes of article 20a of the CITA. Therefore, the assessment about whether the loss forfeiture rules apply must be made for each entity in the fiscal unity.

It is not clear whether losses incurred during the fiscal unity's existence should be attributed in full to the parent company or attributed to the different entities within the fiscal unity.

Ring-Fencing Holding and Financing Losses

As noted above, the goal of the emergency response measures is to eliminate specific favorable elements of the fiscal unity scheme for domestic situations in order to ensure equal treatment for comparable EU situations.

However, the emergency response measures do not include all provisions to which the per element approach might apply. An example is the limitation for offsetting holding or financing losses in article 20, paragraph 4 of the CITA.

A tax loss can be classified as a holding or financing loss if the taxpayer's activities for almost the entire year consisted almost entirely of holding or group financing activities. These losses may only be compensated against years in which the taxpayer qualifies as a holding or financing company. Additional requirements may also apply.

Example 4

The assessment of whether a company is treated as a holding or financing company is made at the fiscal unity level. If an operational company is included in the fiscal unity, these operations are considered when determining whether the taxpayer's activities consisted almost entirely of holding or group financing activities for almost the entire year. Thus, the fiscal unity may prevent qualifying the losses as those of a holding or financing company.

In a comparable situation in which the subsidiary is a resident of another EU member state, only BV 1's activities would be considered when assessing the loss as a holding or financing loss because no cross-border fiscal unity can be formed. Thus, the loss may qualify as a loss of a

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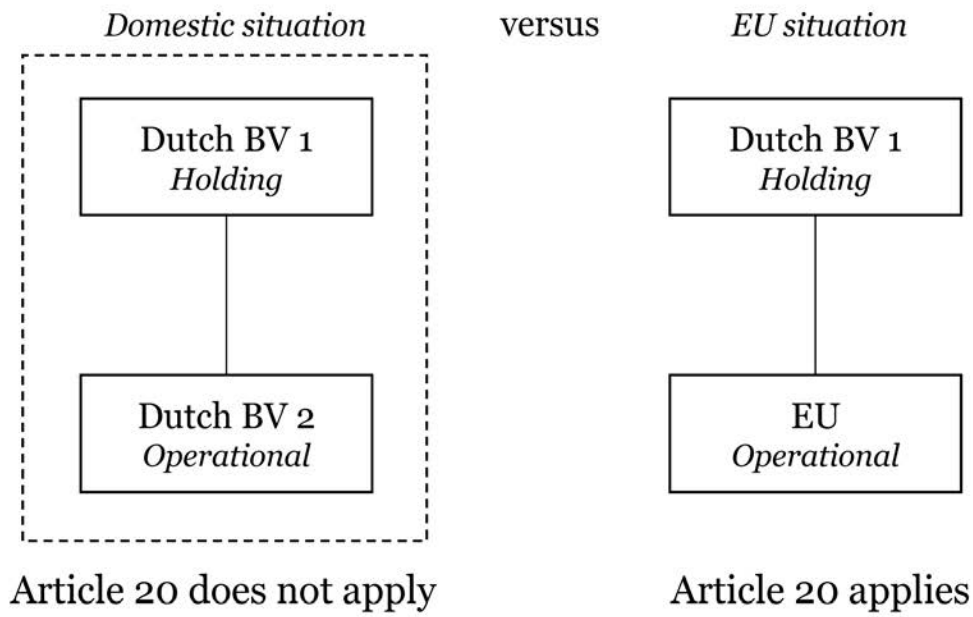
Figure 5. Applying Loss Restriction Rules (Example 4)



holding and financing company, and the loss restrictions of article 20, paragraph 4 of the CITA may apply (see Figure 5).

This (unjustified) favorable element of the fiscal unity for domestic situations has already been the subject of a CJEU judgment in *X Holding BV*, C-337/08 (CJEU 2010). In that case, the CJEU held that excluding nonresident companies from the fiscal unity rules was justified in light of the need to safeguard the allocation of the power to impose taxes to the member states. However, the Court later clarified the scope of the *X Holding* judgment in the *Groupe Steria* decision discussed above. There, the CJEU held that it should not be inferred from the *X Holding* judgment that "any difference in treatment between companies belonging to a tax-integrated group, on the one hand, and companies not belonging to such a group, on the other, is compatible with EU law." The Court clarified that the justification accepted in *X Holding* only related to the provisions of the Dutch rules that allowed losses to be transferred within the tax-integrated group.

Based on the above — and the fact that this provision is not included in the emergency response measures — we believe Dutch taxpayers with EU (operational) subsidiaries could successfully argue that the limitation on using holding or financing losses is, under specific circumstances (if and to the extent the use of a Dutch fiscal unity avoids a loss being qualified as a holding or financing loss) not in line with EU law.

Practical Impact for Taxpayers

Based on the CJEU's judgment and the emergency measures, taxpayers may wish to consider the following actions:

- not applying any adverse provisions in the tax return that could be considered in breach of EU law using the per element approach for fiscal periods before October 25, 2017 (that is, article 10a, 20a, 13l, and so forth);
- filing objections against assessments in which these provisions have been applied;
- assessing the impact of the emergency response measures at the fiscal unity level going forward; and
- not applying article 20, paragraph 4 of the CITA based on the per element approach when a Dutch taxpayer is considered a holding or financing company on a stand-alone basis, but would not be classified as such if considered on a consolidated basis with its non-EU subsidiary.

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Conclusion

In its February 22 judgment, the CJEU confirmed the application of the per element approach previously established in *Groupe Steria*. As a result, some beneficial elements of a domestic group regime should either be granted to EU situations or not be granted at all.

With the announcement of the emergency response measures, the Dutch government opted for the latter. According to the emergency response measures, the fiscal unity must be disregarded when applying specified provisions of the Dutch CITA that might result in unfavorable outcomes for Dutch taxpayers.

Considering that the emergency response measures do not cover all provisions to which the per element approach can be applied — for example, the rules regarding the offsetting of holding or financing tax losses in article 20, paragraph 4 of the CITA — the CJEU judgment might allow some Dutch taxpayers to improve their tax position. The CJEU's judgement also makes clear that the per-element approach could be applied by taxpayers for the period before October 25, 2017, for the provisions included in the emergency response measures.

The emergency response measures are intended to function as interim measures to ensure compliance with EU law. The Dutch government has indicated that within the foreseeable future, a new group regime will be introduced. We anticipate that the concept of full consolidation — a key feature of the existing fiscal unity regime — will not be part of the new group regime. ■

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