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Dutch Supreme Court renders another judgment on Section 10a and fraus legis

On Friday, March 22, 2024 the Dutch Supreme rendered another judgment on Section 10a Corporate Income Tax Act 1969 ('CITA 1969') and fraus legis. The Supreme Court ruled that refusing an interest deduction under Section 10a CITA 1969 is justified if there is a series of transactions between affiliated entities performed with the decisive aim of avoiding association within the meaning of Section 10a CITA 1969. The Supreme Court additionally clarified several judgments from the recent past about which uncertainty had arisen in the professional literature. Lastly, the Supreme Court ruled that the one-off costs for borrowing funds may be deducted from the profit in one go, unless this essentially involves pre-paid interest. The judgment and its practical consequences are discussed in detail below.

The case

The taxpayer was incorporated in 2011 by a private equity firm as part of an acquisition. The taxpayer has four indirect shareholders established on Guernsey: Guernsey Ltd I, II, III and IV. Guernsey Ltd I holds an indirect interest of more than one-third in the taxpayer (and is thus associated with the taxpayer within the meaning of Section 10a CITA 1969). The Guernsey Ltds II, III and IV all hold an indirect interest of less than one-third in the taxpayer (and are thus not associated with the taxpayer within the meaning of Section10a CITA 1969).

To finance the acquisition, the taxpayer not only took out loans with the Guernsey-based Ltds II, III and IV but also with Ltd V, likewise established on Guernsey. Guernsey Ltd V does *not* hold any interest in the taxpayer at all. The underlying investors in Guernsey Ltd V are however the same as the investors in Guernsey Ltd I, an entity that is associated with the taxpayer.

To finance the acquisition of the X group, the taxpayer also took out a loan with a banking syndicate. For this, taxpayer paid a one-time arrangement fee of 4% of the amount of the credit facility.

In dispute is whether the interest on the loans from the Guernsey Ltds can be deducted from the profit and whether the arrangement fee can be deducted from the profit in one-go.

Interest deduction and fraus legis

The Supreme Court found that Section 10a(1)(c) CITA 1969 does not as a general rule apply if the loan was taken out with an entity that is not associated with the taxpayer within the meaning of Section 10a CITA 1969 (10a association). According to the Supreme Court, there is an exception to this general rule if:

a) taking out a loan with a non-associated entity is part of a series of transactions between affiliated entities; and
b) that series of transactions arose with the decisive aim of avoiding 10a association.

The spirit and intent of Section 10a CITA 1969 would be thwarted if such a series of transactions were to lead to the situation where in determining the profit the interest

deduction would not be able to be refused pursuant to Section 10a CITA 1969 ('10a fraus').

Interest on the loan provided by Guernsey Ltd V
With regard to the interest on the loan provided by Guernsey Ltd V, the Supreme Court found that, based on the main rule, the interest does not fall within the scope of Section 10a(1)(c) CITA 1969. After all, there is no 10a association. However, despite this the Supreme Court did *not* allow the interest deduction. According to the Supreme Court, the incorporation of Guernsey Ltd V (and the underlying LP) and the subsequent provision of the loan by Guernsey Ltd V are part of a series of transactions between affiliated entities performed with the decisive aim of thwarting 10a association. This also means that the loan was not primarily business-motivated, so that the double business motivation test of Section 10a(3)(a) CITA 1969 cannot be successfully invoked. There is also no compensatory tax, because Guernsey Ltd V is not subject to a profit tax.

Interest on the loans provided by Guernsey Ltd II, III and IV
With regard to the interest on the loans provided by Guernsey Ltd II, III and IV, the Supreme Court found that this interest also does *not* fall within the scope of Section 10a(1)(c) CITA 1969. There is no 10a association between the taxpayer and Guernsey Ltd II, III and IV. According to the Supreme Court, other than is the case with Guernsey Ltd V, with regard to Guernsey Ltd II, III and IV there is *no* series of transactions between affiliated entities decisively aimed at thwarting 10a association.

The question that then has to be dealt with is whether the deduction of the interest on the loans provided by Guernsey Ltd II, III and IV must be refused, because that deduction is contrary to the spirit and intent of CITA 1969 as a whole ('CITA fraus'). The Supreme Court found that in a case such as the one at hand – in which there is no 10a association with the lender and no 10a fraus – corporate income tax is admittedly saved, but there is no intra-group profit shifting that has to be combated. Not even if transactions are performed that are not necessary to achieve the relevant – moreover business-motivated – objectives and that would not have been performed without the aim, whether decisive or not, of the envisaged interest deduction.

The foregoing means that the interest on the loans provided by Guernsey Ltd II, III and IV cannot be refused in the present case on the basis of them being contrary to the spirit and intent of CITA 1969 as a whole. This would have the effect of attributing a broader meaning to the spirit and intent of CITA 1969 as a whole than the spirit and intent of Section 10a(1)(c) CITA 1969, which is part of that whole. However, the legislative history of Section 10a CITA 1969 gives reason to assume that in cases such as the one at hand there are no grounds for such a broader meaning, because there is no exceptional situation. A situation such as the present one will always arise where a loan is provided by an entity that is affiliated to the taxpayer but not associated with it, and this does not concern, in short, an artificially created non-association.

Further clarification of Dutch Supreme Court judgment March 3, 2023 (ECLI:NL:HR:2023:330)
The Supreme Court has taken the opportunity presented by this case to also further clarify a consideration (much-debated in the professional literature) in its judgment of March 3, 2023 (ECLI:NL:HR:2023:330). In that judgment the Supreme Court noted that if the taxpayer has convincingly demonstrated that the debt and associated transaction is primarily business-motivated (the double business motivation test), this rules out that the motive requirement for applying the doctrine of evasion of the law (fraus legis) has been met in respect of that debt and transaction. This consideration seemed incompatible with its judgment of July 15, 2022 (ECLI:NL:HR:2022:1086), where the opposite appeared to be the case: the Supreme Court did not rule out fraus legis on principle if the double business motivation test had been met (see our memorandum of March 7, 2023).

The Supreme Court has now clarified that the legal rule formulated in its judgment of March 3, 2023 (ECLI:NL:HR:2023:330) only applies if the lender associated with the taxpayer fulfills a pivotal financial function and does not act as a conduit. Only in that specific situation should it (thus) be held that the loan the taxpayer entered into was primarily business-motivated and this thus rules out that the motive requirement for applying fraus legis has been met with regard to that same loan.

Arrangement fee
With regard to the deduction of the arrangement fee, the Supreme Court found that sound business practice permits such one-off costs to be deducted in one-go from the profit in the year in which they became payable. Such costs arise by entering into or using the loan and are not incurred in exchange for have a specific sum of money constantly available during the term of the loan. According to the Supreme Court, sound business practice therefore does not require one-off borrowing expenses to be capitalized and that asset to be amortized over the term of the loan, albeit that sound business practice does allow such capitalization and amortization.

However, there is an exception to the preceding rule if the parties involved in the loan agreement did not actually intend to (exclusively) agree a one-off fee for borrowing expenses, but intended to (also) reduce the annual interest expense over the term of the loan in exchange for a lump sum payment. Such cases essentially (partly) concern pre-paid interest and if the tax inspector convincingly demonstrates that this is the case, the taxpayer therefore may not deduct the amount paid in one-go from the profit. The taxpayer must then capitalize the amount – in accordance with the matching principle – such that it is deducted from the profit via amortization during the period in which the taxpayer benefited from a lower interest rate.

KPMG Meijburg & Co comments

In this judgment the Supreme Court has once again made clear that when purely tax-driven and artificial attempts are made to stay (just) outside the formal requirements of Section 10a CITA 1969, the interest deduction can be refused by invoking fraus legis.

Furthermore, the Supreme Court ruled that there can still be fraus legis with regard to CITA 1969 itself. However, that is not the case if association is avoided in a non-artificial way and in the special situation where funds are borrowed from a group company with a pivotal financing function that does not also act as a conduit. Why the Supreme Court has explained its judgment regarding the pivotal financing function so restrictively, raises new questions. Why would fraus legis with regard to CITA 1969 still be possible in respect of an external acquisition that is financed with a loan from an associated entity that does not have a pivotal financing function and where there is no non-business motivated diversion?

Our highest judicial body is however very clear about the one-off borrowing costs, such as closing or commitment commission and issue expenses. Deduction in one-go is permitted, as is spreading the costs over the term of the loan. Even if those one-off costs are relatively high, that does not have to be a hindrance. However, it becomes difficult if these one-off borrowing expenses essentially constitute pre-paid interest. In that case, the taxpayer is obliged to capitalize the costs over the term of the loan.

KPMG Meijburg & Co
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