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Clarity and lack of clarity after new Supreme Court judgment on Section 10a CITA 1969

On Friday, March 3, 2023 the Dutch Supreme Court rendered a new judgment (only available in Dutch) on the interest deduction limitation of Section 10a Corporate Income Tax Act 1969 ('CITA 1969'). The Supreme Court ruled, among other things, that if there is a business-motivated '10a transaction', the associated debt is, in principle, also business-motivated if the relevant funds were not diverted. With regard to this diversion of funds, the Supreme Court ruled that this cannot, in principle, be the case if the related debtor fulfills a pivotal financial function within the group. In so ruling, the Supreme Court has provided clarity and ensured that the deduction of interest will not typically be limited in situations where there are active group financing companies. As a final point, the Supreme Court also ruled on the application of fraus legis (evasion of law) in cases where a taxpayer successfully invokes the double business motivation test of Section 10a(3)(a) CITA 1969. In doing so, the Supreme Court did not explicitly indicate how that decision compares to earlier case law.

Direct financing of a business-motivated transaction results in a business-motivated debt

With regard to an external acquisition (a business-motivated 10a transaction) that had been debt-financed, the Supreme Court had in the past ruled that the associated debt is in principle business-motivated if the relevant funds were not diverted through related entities. In the present case, the Supreme Court ruled that this basic assumption not only applies to external acquisitions, but also to each 10a transaction that is primarily business-motivated. The direct financing of a business-motivated transaction therefore in principle results in a business-motivated debt.

No diversion in situations where the related creditor has pivotal financial function

In the context of the business motivation of the debt, the Supreme Court further noted that a debt is in principle business-motivated if the related entity to whom the taxpayer incurred the debt performs financing activities such that it thus fulfills a pivotal financial function for the group. According to the Supreme Court, in such cases it cannot be said that funds were diverted, notwithstanding the fact that the funds (may) have been acquired from entities belonging to the same group. That is otherwise insofar as the entity only acted as a conduit for the provision of those funds. The obligation to furnish facts and the burden of proof for this exception rests on the tax inspector.

In assessing whether the related entity fulfills a pivotal financial function, the circumstances of the case must be considered in a coherent manner. Key in this is that the entity or independent business unit fulfills an active financing function within the group. Furthermore, the relevant entity or independent business unit must mainly be involved with performing financial transactions for group companies, such as the borrowing and lending of funds and managing surplus group funds. Also, that entity (or business unit of that entity) must be independent in its daily business operations, including the management of the loaned-out funds, and must have sufficient specialist personnel for this and, in the case of an independent business unit, its own accounts and records. The mere fact that that entity (or business unit of that entity) is tied to a centrally-defined strategy for the group does not stand in the way of its independence.

Double business motivation test successfully invoked and how this relates to fraus legis

As last point, the Supreme Court addressed the fact that the tax inspector had argued that the deduction of interest in the present case would be contrary to the spirit and intent of Section 10a CITA 1969. 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. According to the Supreme Court, in that case the deduction of interest cannot be refused on the basis that this doctrine had been invoked by the tax inspector.

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It is good that the Supreme Court has made clear in this judgment that with regard to 10a transactions, if there is a business-motivated transaction the associated debt is in principle business-motivated if the funds were not diverted through related entities. In practice – and also in the present judgment – the tax inspector contended that this principle only applies, in short, to external acquisitions.

A more important practical point is that the Supreme Court has clearly explained in this judgment how the doctrine of the diversion of funds relates to an entity that fulfills a pivotal financial function within the group; for which, in addition to the above points, it also appears to be relevant that the entity also raised funds from third parties. In summary, according to the Supreme Court it cannot be said of an entity with such a pivotal function that there was an intra-group diversion of funds within the meaning of case law, and thus there is, in principle, a business-motivated debt. That is otherwise insofar as the entity only acted as a conduit for the provision of those funds. The obligation to furnish facts and the burden of proof for this exception rests on the tax inspector. These legal grounds are of crucial importance especially for entities or independent business units that fulfill a cash pool or inhouse banking function.

The grounds put forward by the Supreme Court as regards the evasion of law (fraus legis) are also striking. It seems to follow from those grounds that if a taxpayer successfully invokes the double business motivation test – which means that the deduction of interest is not limited pursuant to Section 10a CITA 1969 – this rules out that the motive requirement for applying the doctrine of evasion of law has been met in respect of that loan/debt and transaction. The question that arises is how these legal grounds relate to the Supreme Court judgment of July 15, 2022 (ECLI:NL:HR:2022:1086) (only available in Dutch), as that judgment seemed to imply the opposite: that the Supreme Court did not exclude the application of fraus legis in principle if the double business motivation test of Section10a(3)(a) CITA 1969 had been met. A possible explanation for this is that in those proceedings it had also been stated that fraus legis must be applied to the part of the debt to which Section 10a CITA 1969 cannot be applied and to which the double business motivation test thus also did not apply.

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