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Fraus legis prevents interest deduction in acquisition structure

On July 16, 2021 the Supreme Court rendered judgment on the deduction of interest on a loan to finance an acquisition by an investment fund (ECLI:NL:HR:2021:1152). The Supreme Court ruled that the Amsterdam Court of Appeals had correctly held that the interest was non-deductible.

The case

The case concerned an acquisition structure whereby capital was raised by an investment fund. The investment fund divided the equity contributed by investors among UK Limited Partnerships (LPs) and French Fonds Communs de Placement à Risques (FCPRs), and subsequently contributed it into, and (via convertibles) lent it out to, a Dutch acquisition holding company (originally a cooperative, later converted into a private limited liability company (*besloten vennootschap*; BV)). From a French perspective, the FCPRs are transparent; according to Dutch standards they are non-transparent. The BV, the taxpayer in the proceedings, was incorporated with the acquisition in mind. By entering into a fiscal unity with the acquired companies after the acquisition of the group, the acquisition holding company ensured that the interest payable by it to the FCPRs was directly deducted from the result of the acquired group.

The judgment

The Amsterdam Court of Appeals had ruled in this case that the fraus legis doctrine (law evasion) prevented the interest deduction. The Supreme Court dismissed the appeal in cassation by the taxpayer. Apparently the Supreme Court considered it important that the capital available as equity in the FCPRs was partly made available to the taxpayer as debt, in the form of convertible instruments, which meant that (as a result of entering into a fiscal unity) the interest payable was set off against the profit of the acquired group. Furthermore, the Supreme Court apparently considered it important that – because the FCPRs were regarded as transparent entities in France – there was no compensatory tax in France. According to the Supreme Court, the Court of Appeals was able to rule that in the given circumstances the motive requirement for applying fraus legis was met, despite the fact there was a business-motivated external acquisition. The Court of Appeals substantiated this by ruling that by the interposition of Dutch intermediate holding companies and the creation of a (other than on tax grounds) pointless loan relationship – and to that extent in an artificial way – the acquisition was implemented in a tax-driven manner. Allowing the interest expenses to be deducted would be contrary to the spirit and intent of the Corporate Income Tax Act 1969, because the spirit and intent preclude that the levying of corporate income tax, by on the one hand bringing together the profit of a company and, on the other, artificially created interest expenses (profit shifting), is thwarted in an arbitrary and continuous manner. The freedom of financing that taxpayers in principle have, has limits, which have been exceeded here.

Comments by KPMG Meijburg & Co

In the judgment rendered by the Supreme Court on July 9, 2021, ECLI:NL:HR:2021:1102, in which there was also an acquisition structure, the taxpayer's full interest deduction was maintained, because the Court of Appeals had been able to establish that the interest expenses were, in fact, payable to third parties. In the case at hand, the equity available within the group was onlent to the taxpayer. To that extent, the difference in outcome between these cases is explicable. However, it does not alter the fact that the judgment raises questions.

The judgment of July 9 reiterated the standard position taken in case law that a group has the freedom to navigate investments through a Dutch company and that this Dutch company has the freedom to finance itself with equity or debt. In the judgment of July 16 the invocation of fraus legis was acknowledged on the basis of the Court of Appeals' ruling "that in a – in a decisive sense – tax-driven manner, with the interposition of Dutch intermediate holding companies and the creation of a (other than on tax grounds) pointless loan relationship – and to that extent in an artificial way – the aim to eventually realize capital gains by the purchase and sale of companies is achieved." Based on the freedom to use a Dutch company, and on the circumstance that an external acquisition was being financed, it is unclear which circumstances justify the conclusion that the debt was pointless. The judgment would be better placed in line with case law if the use of the FCPRs had been assessed as a non-business motivated diversion. It now remains somewhat obscure in which cases (for example where a group raises capital and onlends it to a Dutch company which uses the capital to finance an acquisition) there is a non-business motivated diversion of funds.

After the judgment rendered the previous week, this is the second judgment in a series of proceedings about similar cases. Several of those cases are still pending before the Supreme Court. It is expected that one or more judgments about similar disputes will follow in the course of 2021. Those judgments may provide more insight into the limits of the freedom of financing or the delineation of the non-business motivated diversion of funds.

Please feel free to contact your KPMG Meijburg & Co advisor if you have any questions or would like to discuss the above matters.

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