KPMG Meijburg & Co Tax & Legal

Dutch Supreme Court clarifies Section 10a CITA 1969 interest deduction limitation in acquisition structures

On Friday, July 15, 2022 the Dutch Supreme Court rendered two judgments on the deduction of interest on loans that served to finance external acquisitions by private equity funds. In particular, the Supreme Court answered several outstanding questions about Section 10a Corporate Income Tax Act 1969 ('CITA 1969'), such as when is there an 'intra-group (non-business motivated) diversion'. The judgments by the Supreme Court will ensure that the interest deduction limitation of Section 10a CITA 1969 can be applied less quickly than the Dutch Tax and Customs Administration has been advocating in practice. However, this certainly does not mean that it will now be easy to deduct interest on an acquisition loan. The reasons for this include the fact that the Supreme Court has developed the 'non-business motivated loan doctrine', Section 10a CITA 1969 has meanwhile been tightened, hybrid mismatch measures (ATAD2) apply and generic interest deduction limitations, such as the earnings stripping measure, have been included in CITA 1969. And last but not least, *fraus legis* (fraud of law) can also still throw a spanner in the works. The Supreme Court judgments are discussed in more detail below.

Case 1 (ECLI:NL:HR:2022:1085)
The first case concerned an acquisition structure whereby various separate subfunds of the investment funds A and B, along with various co-investors, indirectly held a Dutch acquisition company via a Luxembourg parent company. In 2011 the Dutch acquisition company purchased the shares in the Dutch holding company of the target group. This external acquisition was financed with funds including a loan from the Luxembourg parent company (a 'shareholder loan'). The Luxembourg company had raised these funds from the aforementioned subfunds by issuing preferred equity certificates (PECs). After the acquisition, several of the acquired Dutch target group companies were included in a fiscal unity with the Dutch acquisition company. In dispute was the deduction of interest on the shareholder loan in the year 2011/2012.

The Court of Appeals in The Hague ruled that the interest on the shareholder loan was non-deductible pursuant to Section 10a CITA 1969, because there had been an intra-group non-business motivated diversion of the funds used for the acquisition. The Court of Appeals noted, among other things, that the fact that the PEC holders did not qualify as related entities as referred to in Section 10a(4) CITA 1969 was not decisive when assessing whether there is an intra-group non-business motivated diversion, but that a non-business motivated diversion can also take place via other involved parties (i.e. that do not qualify as related as referred to in Section 10a(4) CITA 1969).

The Supreme Court ruled – insofar as relevant – that for the purposes of assessing whether funds used for the acquisition were diverted within the group, only entities that qualify as a related entity as referred to in Section 10a(4) CITA 1969 have to be considered. According to the Supreme Court, in the present case this meant that because the PEC holders do not belong to the same group as the Dutch acquisition company, the funds that the Dutch acquisition company used for the external acquisition had not been diverted.

The Supreme Court referred the case to the Amsterdam Court of Appeals for further consideration and to rule on it with due observance of this judgment. This should include an assessment of any issues not yet dealt with.

Case 2 (ECLI:NL:HR:2022:1086)
The second case concerned an acquisition structure whereby various separate subfunds of investment funds, along with various co-investors, indirectly held a Dutch acquisition company via a Luxembourg parent company. In 2010 the Dutch acquisition company purchased the shares in the Dutch holding company of the target group. The equity raised from the investors was lent to the Luxembourg company via various separate subfunds and by the co-investors, for which the Luxembourg company had issued preferred equity certificates (PECs). The Luxembourg company contributed approximately EUR 43 million of the funds raised with the PECs as capital and lent the remainder to the Dutch acquisition company (a 'shareholder loan'). The Dutch acquisition company then used the funds:

a) for the external acquisition of the existing Dutch holding company of the target group;
b) to refinance the current debts of that target group.

After the acquisition, several of the acquired target group companies were included in a fiscal unity with the Dutch acquisition company. In dispute was the deduction of interest on the shareholder loan in the year 2010/2011.

The Amsterdam Court of Appeals ruled that the shareholder loan qualified as a non-business motivated loan and that the interest must be set at the risk-free interest rate, in this case 2.5%. Furthermore, the Court of Appeals ruled that, pursuant to Section 10a CITA 1969, this 2.5% interest was non-deductible insofar as the shareholder loan was used for the acquisition and came from the investment fund's various subfunds. According to the Court of Appeals, there was a non-business motivated diversion.

Insofar as relevant, the Supreme Court ruled, with reference to the judgment discussed in case 1 above (ECLI:NL:HR:2022:1085), that there was no intra-group diversion of the funds used for the acquisition, because none of the (indirect) PEC holders qualifies as a related entity as referred to in Section 10a(4) CITA 1969. According to the Supreme Court, the documents do not contain any indication that the funds were otherwise diverted. The Supreme Court therefore ruled that the Dutch acquisition company's invocation of the rebuttal provision of Section 10a(3) CITA 1969 was successful.

However, since the Court of Appeals had ignored the tax inspector's essential argument that the created interest deduction was not only contrary to the spirit and intent of Section 10a CITA 1969 but also to the spirit and intent of the Act as a whole (*fraus legis*), the judgment of the Court of Appeals could not be upheld. The Supreme Court referred the case to the Court of Appeals in The Hague for further consideration and to rule on it with due observance of this judgment.

If you have any questions about the above, Meijburg's advisors would be pleased to use their expertise to help you.

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July 18, 2022