European Court of Justice rules that Dutch fiscal unity regime violates EU freedom of establishment – Dutch remedial legislation kicks in retroactively limiting existing benefits in domestic situations

Today, on 22 February 2018, the European Court of Justice ruled that certain benefits of the Dutch fiscal unity regime for corporate income tax purposes also apply in cross-border situations (the so-called “per-element” approach). In its decision, the ECJ follows the opinion of the Advocate General of 25 October 2017, which led the Dutch government to announce remedial legislation with retroactive effect from 25 October 2017 on the condition that the ECJ agrees.

1. The ECJ's decision

Today, on 22 February 2018, the ECJ ruled in the X case (C-398/16) that the Dutch interest deduction limitation rule that prevents base erosion, Article 10a of the Dutch Corporate Income Tax Act (CITA), in combination with the fiscal unity regime, violates the EU freedom of establishment. Accordingly, as a result of the ECJ ruling, the so-called “per-element” approach is confirmed.

The facts of the case include a Dutch company which is part of a Swedish-headquartered multinational. To purchase shares in an Italian company, the Dutch company set up another company in Italy and financed the capital contribution of that Italian subsidiary by way of a loan (plus interest) from a Swedish group company. Upon audit, the Dutch Tax Authority (DTA) denied the deduction of the interest paid to the Swedish company on the intra-group loan pursuant to Article 10a CITA. The Dutch company contested the assessment of the DTA, arguing that it could have deducted interest on the loan if it had been permitted to form a fiscal unity with its Italian subsidiary. Since the Dutch fiscal unity regime restricts the right to form a fiscal unity for Dutch resident companies, and accordingly a fiscal unity cannot be formed with companies in other EU Member States, the taxpayer claimed that its exercise of freedom of establishment is limited.

Under Article 10a CITA, the deduction of interest paid on a debt to an affiliated party whereby the debt is used to fund a capital contribution, a dividend distribution or an acquisition of a participation (so-called "tainted transactions") can be disallowed depending on the business motives for that transaction and the way in which the loan was structured. However, such tainted transactions are usually invisible if they occur within a Dutch fiscal unity, as a result of which the application of Article 10a CITA can generally be avoided in domestic situations. Since the benefits of the Dutch fiscal unity regime are limited to Dutch tax resident entities, such benefits cannot be obtained in cross-border situations. This was considered a (non-justified) restriction to the freedom of establishment by the ECJ as per the ruling issued today. This ruling is in line with the opinion of Advocate General Campos Sanchéz-Bordona in this case, which was published on 25 October 2017.
2. Consequences of the ECJ’s decision

Directly following the opinion of the Advocate General in October of last year, the Dutch government announced remedial legislation with retroactive effect from 25 October 2017, 11 am CET. Based on the announced legislation, some of the benefits of the Dutch fiscal unity regime are no longer applicable in domestic situations, as certain provisions need to be applied as if the entities of the fiscal unity were independently liable to pay tax. The remedial legislation aims to ensure equal treatment of comparable cross-border and domestic situations and, to that effect, the new legislation in fact imposes limitations to the interest deductibility in domestic situations now as well.

At the same time, the Dutch government also indicated that the Dutch fiscal unity regime will be replaced in the foreseeable future by an EU-proof tax group regime. However, it is unclear what that regime will look like and when this will be.

The remedial legislation creates tax compliance risks as it contains retroactively applicable restrictive rules to the benefits of the Dutch fiscal unity regime. It affects, in addition to Article 10a CITA, the following provisions:

a. applicability of interest deduction limitation rules (mainly Article 13l CITA);

b. applicability of loss limitation rules (Article 20a CITA);

c. deductibility of redistribution (Article 11 of the Dividend Withholding Tax Act); and

d. applicability of participation exemption regime (Article 13 CITA).

Furthermore, since the consolidation under the fiscal unity regime has many other benefits, today's ruling concerning the "per-element" approach may also have implications for other legislative provisions, including:

a. applicability of liquidation loss rules (Article 13d CITA);

b. applicability of loss ring-fencing rules (Article 20(4) CITA);

c. deferred (gradual) taxation of assets transferred to EU companies (Article 15 CITA); and

d. applicability of certain restrictions in the innovation box regime (Article 12b CITA).

At this moment it is unclear whether the Dutch government will announce further legislation with regard to these provisions.

3. Actions to take

Considering the above consequences of today's ECJ decision, the following actions are recommended:

• With regard to the period prior to 25 October 2017, consider whether any tax benefit of the Dutch fiscal unity regime (as indicated in section 2) has been unavailable because an EU parent, subsidiary and/or sister company could not be included in a Dutch fiscal unity. If this is the case, contemplate claiming the benefit(s) of a fiscal unity based on the EU freedom of establishment in the tax return and/or in an objection against a tax assessment, with reference to today's ECJ ruling. Claiming such benefits will likely require litigation since the tax authorities will expectedly deny this on a per-case basis.

• With regard to the period after 25 October 2017, assess the impact of the remedial legislation to your business structure. At the same time, with regard to the benefits of the Dutch fiscal unity regime that are not covered by the remedial legislation, consider whether any tax benefits will continue to be available.

Please do not hesitate to reach out to your contact at Baker McKenzie Amsterdam or any of our tax specialists below if you have any questions about today's ECJ ruling and the potential impact on your company.

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