Winstdrainage door rente aftrek : (beoordeling van artikel 10a Wet op de vennootschapsbelasting 1969)

Marres, O.C.R.

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SUMMARY

This thesis is the culmination of research into the effectiveness of Section 10a, Wet op de vennootschapsbelasting 1969 (Dutch Corporate Income Tax Act 1969; ‘CITA’), in countering base erosion resulting from the deduction of interest. Base erosion is the artificial creation of debt designed to minimise corporate income taxation.

In Chapter 1 the scope of the research is set out. This research aims at answering the following questions:

(i) To what extent is the legal certainty guaranteed by applying Section 10a, CITA?
(ii) Is Section 10a, CITA effective in countering base erosion, and is there no overkill?
(iii) Is the provision in breach with EC law or international law?
(iv) Are there better alternatives?

Chapters 2, 3 and 4 outline the context of Section 10a, CITA. Chapter 2 deals with the deductibility of interest for the computation of taxable profit in general. The disparity in the treatment of dividend and interest is the first topic discussed in this chapter. Since the legal basis underlying corporate income tax is obscure, it is difficult to assess who is intended to be the ultimate corporate income tax subject (i.e. the company itself or the shareholder) and how the item to be taxed should be determined. There seems to be no satisfactory justification. Assuming that corporate income tax should be regarded as taxation levied on a company independent of its shareholders, the distinction between (deductible) interest and (non-deductible) dividends can be justified by the circumstance that the company owns its capital and can use it without incurring costs. If one accepts that shareholders demand a return on their investment, and that a normal return on capital should be deductible, my view is that only the retained earnings should be taxed (since the distributed amount reflects the demanded return). If, however, one takes the position that corporate income tax should be regarded as a tax that is (eventually) borne by the shareholders, then the distinction between interest and dividends can be justified by the fact that the interest decreases the shareholders’ return on investment.

Chapter 2 also deals with the CITA’s treatment of interest. As a principal rule, interest paid on loans borrowed in order to finance the company’s enterprise is deductible. This deduction, however, is subject to many restrictions. The following questions need to be answered in order to determine the deductibility of such interest:

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(i) Should the interest be qualified pro forma as interest for tax purposes, or be (re)qualified as a dividend distribution (i.e. choosing substance over form)? In principle, the qualification under civil law prevails, with a few exceptions (paragraph 2.2).

(ii) Is the loan used to finance the enterprise of the company? If Section 2(5), CITA, applies (as is the case for NVs (public companies), BVs (private companies), other companies whose capital is dividend into shares, co-operations and certain mutual funds), such use is deemed (paragraph 2.3).

(iii) Is the deduction of interest subject to specific legal limitations? This research focuses on Section 10a, CITA. Other limitations are dealt with in paragraphs 2.4-2.6.

(iv) Is deduction disallowed under the doctrine of fraus legis? This question is addressed in paragraph 3.3.

Chapter 3 discusses the case law regarding the doctrines of appropriate taxation (richtige heffing) and fraus legis in the context of base erosion caused by interest deduction. Since the criteria for application of these doctrines are identical, no distinction will be made between them. The case law regarding taxable years prior to the introduction of Section 10a, CITA, may be summarised as follows. Interest deduction may be denied if a debt is created in connection with an acquisition of shares in a group company, by means of a dividend distribution or a capital contribution, provided that:

(i) there is an absence of significant sound business reasons underlying an integrated set of juristic acts, a composition of transactions for which there are no, or no significant, sound business reasons or there are transactions involved (within the integrated set of juristic composition of transactions) that have no purpose other than tax evasion (relevant criteria in this respect are: there is a real change in financial interest and control, the loan has a real ‘financing function’), and

(ii) the deduction of interest would lead to a conflict with the purpose and intent of the CITA: this conflict does not occur if the interest is either directly or indirectly subject to Dutch individual or corporate income tax, or to a foreign tax which is reasonable according to Dutch standards, even if a set-off of losses means that no tax is actually payable.

The sound business reasons criterion is not used to distinguish business expenses from hidden profit distributions, but to exclude tax-driven schemes from eligibility for interest deduction. Interestingly, the criterion is applied from the perspective of the group as a whole, departing from the rule that each company must be taxed individually based on the facts and circumstances pertinent to that company.

In my view, the case law regarding base erosion caused by interest deduction remains relevant, despite the introduction of Section 10a, CITA, for the simple reason that this section is a codification of that case law. The case law can thus be used to in-
Interpret Section 10a, CITA, unless the text or explanatory comments in the Parliamentary history cannot be reconciled with such interpretation.

The introduction of Section 10a, CITA, did not leave much room for the doctrine of *fraus legis*. The vast body of case law regarding *fraus legis* leads one to the conclusion that this doctrine cannot be applied if the abusive situation at issue was, or should have been, taken into consideration by the Dutch Parliament when they codified the doctrine in the CITA. In cases of base erosion caused by interest deduction which do not fall within the scope of Section 10a, CITA (e.g. acquisitions of non-related companies, or the acquisition of assets other than shares), the doctrine of *fraus legis*, in my view, only applies in exceptional cases (such as very artificial financing arrangements).

Chapter 4 contains a description of the history of Section 10a, CITA. Initially, the Dutch Revenue attempted to combat base erosion with the doctrines of appropriate taxation (*richtige heffing*) and *fraus legis*. Since the Under Minister of Finance viewed the result as unsatisfactory, he proposed specific legal anti-base erosion provisions by presenting Bill 24 696 to Parliament. This bill follows the proposals of a working group ("Tax infrastructure working group", especially 'sub-group II'). Bill 24 696 resulted into the Law of 13 December 1996, *Bulletin of Acts and Decrees* 651, which added Section 10a to the CITA.

The application of Section 10a, CITA, is addressed in Chapters 5 and 6. Chapter 5 discusses the various rules and criteria for applying Section 10a, CITA.

According to Section 10a (1), CITA, interest payments (as well as expenses and currency exchange results) are non-deductible if they regard (in law or in fact, directly or indirectly) outstanding profit distributions, redemptions or contributions of share capital, or the redemption or grant of 'hybrid loans' (loans which actually function as equity) to the creditor. This does not apply if the taxpayer can prove (i.e. show that it is likely) that the outstanding liabilities were entered into for sound business reasons.

According to Section 10a (2), CITA, interest payments (as well as expenses and currency exchange results) on loans owed (in law or in fact, directly or indirectly) to a related party, are non-deductible if they regard:

a. a profit distribution, redemption of share capital or redemption of a hybrid loan, or

b. the acquisition of (or paying in on) shares, jouissance shares (winstaandelen), participatory rights, certificates of participation in, or the grant of hybrid loans to, a company, except to the extent such acquisition or grant results in changes to the ultimate interest in, or control of, that company, or

c. a capital contribution or other use of capital by the taxpayer, or a Dutch-based related entity or person, directly or indirectly to the entity, or on behalf of the entity or person to which the loan is owed.
Section 10a (3), CITA, provides that the deduction disallowance of Section 10a (2), CITA, does not apply if the taxpayer can prove that:

a. the loan and the transaction it relates to were entered into for sound business reasons, or
b. the amount of tax the creditor owes on the interest is reasonable according to Dutch standards, and the creditor has no losses available for set-off from the year in which the loan was granted, as a result of which no reasonable amount of tax will effectively be levied.

Common to all the situations that fall within the scope of Section 10a, CITA, is the absence of actual changes of circumstance as a result of the transactions: in other words, the absence of sound business reasons. The absence of sound business reasons is deemed to exist – although the taxpayer is afforded the opportunity to prove otherwise – in the case of certain legal transactions, such as a loan combined with either a dividend distribution, capital contribution or transfer of shares. The sound-business reasons criterion is the core of Section 10a, CITA; the provision counters tax-driven schemes. The requirement of sound business reasons should be interpreted in light of the case law regarding base erosion caused by interest deduction: 'sound business reasons' should therefore be interpreted as 'not tax driven' (see Chapter 5.3.7). Those sound business reasons should, in themselves, form a sufficient basis for concluding the transactions. This may be deduced from the actual 'financing function' of the loan or the actual 'financing need' (Chapter 3.2.1).

Section 10a (2)(c), CITA, is quite different from the other provisions, since it is not aimed at loans that are borrowed in connection with certain intragroup transactions, but at situations in which money originating from the taxpayer or a Dutch group company is lent back. In such a case, what assets or activities are financed with the loan is irrelevant.

In theory, it is possible to indicate in which cases sound business reasons are absent: in cases where interest is created arbitrarily, or (regarding Section 10a (2)(c), CITA) where money transfers take unnecessary detours. In practice, the sound business reasons criterion is unsatisfactory. There is a very fine line between acceptable tax planning (cases in which intragroup transactions would have been entered into even without the intended tax consequences) and unacceptable tax evasion. In my opinion, short of implementing generic rules, such as debt/equity ratios, there is no viable way to counteract the abusive deduction of interest.

Section 10a is not aimed at every loan without an 'actual financing function', but at loans connected with certain transactions (such as capital contributions, dividend distributions and acquisitions of group companies). This can be explained by reference to the case law regarding base erosion, which only regards loans with these connections. It is easy to understand why the case law dealt with these types of transactions, given the liquidity of funds and the transferability of shares. In my
view, having Section 10a, CITA, be more generally worded, so as to include situations with other transactions, would lead to unnecessary uncertainty.

Section 10a, CITA, only applies to internal loans, i.e. loans from the recipient of the respective payments (e.g. dividends, capital contributions, etc.; subsection 1) or a related company (subsection 2). Strictly speaking, this is a questionable limitation. If a loan is borrowed from a third party, there is an actual financing need from the point of view of the group as a whole, but that financing need is not caused by the transaction mentioned in Section 10a, CITA, which is an intragroup transaction. In other words: if there is a financing need somewhere in the group, it is accepted that the interest deduction is taken by the Dutch taxpayer, even if this is done arbitrarily (e.g. via a dividend distribution to the company with the actual financing need).

Chapter 6 discusses the concurrence of Section 10a, CITA, with other rules. Discussed at the outset is its concurrence with the rules regarding the fiscal unity (a type of tax consolidation). Section 15, CITA, provides that if a taxpayer (parent) holds the legal and beneficial title to at least 95 percent of the par value of the paid-up shares in another taxpayer (subsidiary), then, at the request of both taxpayers, tax will be levied on them as though they were a single taxpayer, in the sense that the activities and equity of the subsidiary form part of the activities and equity of the parent. As a consequence of this fiction, legal relations between companies within the fiscal unity are, in principle, disregarded for corporate income tax purposes. Section 10a, CITA, is inapplicable to these relations. Section 15, CITA, does not affect companies outside the fiscal unity: if, for example, a taxpayer borrows a loan from its grandparent, and distributes the money to its parent, which is part of the grandparent's fiscal unity, this distribution is not considered a dividend payment to the creditor (this situation, therefore, does not fall within the scope of Section 10a (1), CITA, but Section 10a (2)(a), CITA).

The concurrence of Section 10a, CITA, with legal mergers and demergers is also discussed. An important question is whether a legal merger or demerger can eradicate a Section 10a, CITA, 'taint' (e.g. because after a legal merger or demerger the loan would no longer be connected with a previously acquired group company). The provisions regarding the legal merger and demerger contain legal fictions designed to secure the application of Section 10a, CITA, after the merger or demerger. Sections 14a (2) and 14b (2), CITA, provide that the assets and liabilities acquired via a legal demerger and merger, respectively, will retain the same claims they had with regard to the taxation of the merging/demerging company. If the loan has been tainted by a transfer of shares in a group company (Section 10a (2)(b), CITA), and the same group company subsidiary merges or demerges, the legal fictions of Section 13j (2) and 13k (2), CITA, become important. These fictions provide that a loan that is tainted under Section 10a (2), CITA, and is connected with shares in the merging/demerging company, is deemed to be connected with the shares that the taxpayer owns in the acquiring company directly after the merger/demergers. Although the connection between the loan and the previously acquired shares in the group company is deemed
to exist, one may argue that if the taxpayer and the group company are no longer related, the interest deduction is no longer disallowed under Section 10a (2)(b), CITA.

If a loan is tainted due to an acquisition of shares in a group company, and those shares are transferred in a share-for-share or asset merger, the shares issued to the taxpayer in connection with such a merger 'trade places' (from a tax point of view) with the transferred shares (Section 13i (2)(a), CITA, and the second sentence of Section 14 (1), CITA). This means that, in principle, the loan remains tainted, and the interest deduction will still be disallowed. Furthermore, Section 13i (1)(b), CITA, provides that if the shares form part of a qualifying participation, and these shares are transferred in a share-for-share merger, then the loan borrowed in connection with the transferred shares is deemed to have been borrowed in connection with the issued shares.

The following applies in respect of calculating the reduction of tax for exempt foreign income. If a reduction for the avoidance of double taxation is claimed regarding the profit of a foreign permanent establishment, that profit must be calculated using the same method used in calculating the profit of a Dutch permanent establishment of a non-resident taxpayer. Therefore, Section 10a, CITA, should be applied.

Furthermore the concurrence of Section 10a, CITA, with Section 10d, CITA, (thin capitalisation rules) has been discussed. If the interest deduction is disallowed under Section 10a, CITA, the tainted loan is regarded neither as debt nor equity under Section 10d, CITA. The loan is thus not considered in calculating the debt/equity ratio.

Finally, the application of Section 10a, CITA, to fiscal investment funds is discussed. These funds are subject to a zero percent rate under Section 28, CITA, which prevents erosion of investment funds' corporate income tax base. However, since these funds are under the obligation to distribute their total profits to their shareholders, erosion of the distribution base might occur.

Chapter 7 regards the ius gentium (international public law, law of nations) and European law. The first relevant aspects in respect of European law are the 'Treaty freedoms' (freedoms of goods, persons - both employees and establishments -, services, capital movements and payments). In a situation in which Section 10a, CITA, applies, the freedoms of establishment and capital may be at stake. Although Section 10a, CITA, is a non-discriminatory measure, the 'reasonable proof' provision of Section 10a (3)(b), CITA (regarding the compensatory tax) may make it less attractive for companies to borrow a loan from a company in other Member States. The same applies for the reasonable proof provision in the case of a compensatory tax that may be invoked if Section 10a (1), CITA applies.

Assuming Section 10a, CITA, hinders one or more of the Treaty freedoms, it must be established whether the national measure (in this case, the interest disallowance) pursues a legitimate aim which is compatible with the EC treaty and is justified by pressing reasons of public interest. In that event, the hindrance must also be such
that it ensures achievement of the aim in question and does not go beyond what is necessary for that purpose.

The need to preserve the coherence of the tax system cannot be invoked as a justification with respect to Section 10a, CITA. In the case of a wholly artificial arrangement, however, a justification based on the risk of tax evasion may be invoked. The definition of a wholly artificial arrangement promulgated by the EC Court of Justice is stricter than the sound business reasons criterion of Section 10a, CITA. Therefore, this justification cannot be invoked in every case which falls within the scope of Section 10a, CITA. If tax evasion is occurring, it must also be established that the national measure (in this case, the interest disallowance) ensures achievement of the aim in question (counteracting tax evasion) and does not go beyond what is necessary for that purpose. The interest deduction is presumably suited to counteracting tax evasion, but because the compensatory tax functions as a safe haven (and therefore does not apply to every case of tax evasion), one may doubt whether the measure as a whole is suited to that purpose. Furthermore, the disallowance of the total amount of the interest goes beyond what is necessary for preventing abuse. In my view, the tax levied on the recipient should be taken into account.

Section 58 of the EC treaty becomes relevant when the freedom of capital movements is hindered. This section gives Member States the right to apply the relevant provisions of their tax law which distinguish between taxpayers in disparate situations with regard to their place of residence or the place where their capital is invested. In my view, Section 10a, CITA, is not a provision as meant in Section 58 (1)(a) of the EC treaty, since it does not distinguish between taxpayers in disparate situations with regard to their place of residence or where their capital is invested. If this were different, and Section 58 (1)(a) of the EC treaty were applicable, this would ultimately have no other consequences, since Section 58 of the EC treaty is interpreted very strictly.

The freedom of capital also applies to capital movements between Member States and non-EU countries. Section 57 of the EC treaty seems to be of little interest in this respect. According to this provision, Section 56 of the EC treaty forms no impediment to restricting the freedom of capital movements between Member States and non-EU countries that existed on December 31, 1993. As far as Section 10a, CITA, is concerned, only the provisions of subsections 2(a) and 2(b) could possibly be considered as existing restrictions, and only in some cases. Moreover, it is uncertain whether these provisions are restrictions involving 'direct investment...establishment, the provision of financial services or the admission of securities to capital markets' as mentioned in Section 57 of the EC treaty.

Although the freedom of capital movements also applies to capital movements between Member States and non-EU countries, this does not mean that this freedom is protected to the same extent as the freedom of capital movements between Member States. Since there is no mutual recognition of tax legislation in relationships with non-EU countries, a restriction of capital movements between Member States and
non-EU countries is justified insofar as a tax benefit is disallowed. This means that the interest deduction can be disallowed even without the involvement of wholly artificial arrangements, provided that the interest deduction disallowance does not go beyond what is necessary for preventing abuse.

The solution for the violation of the EC freedoms is closing the loophole for cases in which there is a compensatory taxation that is compatible with Dutch standards. A purely objective criterion should be applied, independent of a compensatory taxation, that criterion preferably being the determination of whether there is a wholly artificial arrangement.

The interest disallowance of Section 10a, CITA, does not contravene either the EU Parent-Subsidiary or the Interest and Royalties Directive, and does not violate any double taxation conventions or non-discrimination clauses in human rights conventions.

Chapter 8 contains the results of a comparative analysis of the US and German tax regimes. In that respect, I have conducted research into the relevant criteria for corporate interest deduction under US and German corporate income tax laws.

Interest is generally deductible in the US. Abuse may be countered with a substance over form approach. If a transaction has both the form and substance of a loan, the interest deduction may still be disallowed under a specific provision in the US Internal Revenue Code 1986. First of all, there are tracing rules disallowing deduction in the event that the corresponding income item is untaxed, or is taxed at a lower rate. There are also rules preventing the mismatch of interest deductions and income inclusions. Most important in the context of this study are probably the 'earnings-stripping' rules, since they essentially aim to prevent erosion of the taxable base in the United States: they combat the 'stripping' of earnings that is accomplished by the heavy use of debt-financing instead of equity. It generally applies to corporations that have excessive interest expenses. In short, interest deduction is denied if the following conditions are met:

- the debt/equity ratio exceeds 1.5 to 1;
- the corporation's interest expense exceeds 50% of its adjusted taxable income;
- the interest is not subject to US tax, including a (unreduced) withholding tax; and
- the interest is payable to a related party, or the loan is guaranteed by a related party (a loan by the related exempt party to a third party who lends the funds on to the U.S. taxpayer may be regarded as a direct loan from the related party).

Apparently there is no need for a general anti-abuse clause. Abuse may be combated, however, by using common law doctrines, under which a recharacterisation of transactions may take place using a substance over form approach. Evasion or avoidance may also be a criterion of a specific deduction disallowance.
Interest is also generally deductible in Germany. The two most important provisions disallowing interest deduction are the thin capitalisation rules of Section 8a, \textit{Körperschaftsteuergesetz} 1977 (the German Corporate Income Tax Act 1977; 'KStG') and the disallowance of a lump-sum deduction of 5\% of the dividends and capital gains under Sections 8b (3) and (5), KStG. The lump-sum approach of Sections 8b (3) and (5), KStG entail that, effectively, 95\% of the income is exempt, and that the actual expenses related to the income are deductible. Therefore, the only actual interest deduction disallowance is found in Section 8a, KStG. Under this provision, interest is recharacterised as a hidden profit distribution if – in essence – the following conditions are met:

- interest payments exceed EUR 250,000;
- the lender is a shareholder or related party, or a third party, that has recourse against such shareholder or related party (according to the \textit{Bundesministerium der Finanzen}, the provision only applies to loans from third parties in cases of back-to-back loans);
- the shareholder directly or indirectly holds more than 25\% of the shares; and
- the debt/equity ratio exceeds 1.5 to 1, or the interest rate is not fixed.

Fixed interest rates are not recharacterised if the company can prove that it could have obtained the same loan (i.e., subject to identical conditions) from a third party. Irrespective of the debt/equity ratio, interest is recharacterised as a hidden profit distribution if a loan is borrowed from a related party in respect of an acquisition of share capital in a group company (the \textit{de minimis} limit of EUR 250,000 is not applicable).

According to Section 42, \textit{Abgabenordnung} 1977 (the German General Tax Act 1977; 'AO'), tax law may not be bypassed by any abusive fact pattern, i.e. any artificial arrangement, which fails to comply with the fundamental principles of German tax law and is not justified by sound business reasons. My research has not uncovered any cases in which the deduction of interest by a corporate taxpayer was denied pursuant to Section 42, AO. The \textit{Bundesfinanzhof} seems to take the position that, barring extraordinary circumstances, the tax-abuse clause of Section 42, AO, cannot be applied if a specific anti-abuse provision applies. If this reasoning is applied to the deduction of interest by group companies, one might conclude that Section 42, AO, is inapplicable because of the thin capitalisation rules. Naturally, under extraordinary circumstances, this might be different.

Chapter 9 deals with relevant developments and possible alternatives to Section 10a, CITA. There have been some relevant European developments since this provision was introduced (especially discussions regarding Home State Taxation and Common Base Taxation), as well as domestic developments, such as the introduction of thin capitalisation rules, and the plans for amending the CITA with effect from 2007. Chapter 9 also discusses some alternative legislative rules (i.e. rules that might exclude the application of Section 10a, CITA):
1. A criterion other than a company's profit may be used to define the corporate income tax base. This, however, would lead to difficulties in the application of double tax treaties.

2. The disparate treatment of equity and loans may be abolished. This might be done by allowing the deduction of dividends, or by disallowing the deduction of interest. Both alternatives will lead to problems, especially in cross-border situations, which makes this an unlikely alternative.

3. Intragroup interest could be treated in a tax-neutral fashion (i.e. no deduction or taxation of interest). With this alternative, the disadvantages of the disallowance are less serious (i.e. less than they would be if all interest were disallowed), but the many definition problems are not eliminated.

4. The introduction of an analytical system could be considered. Financing activities could be dealt with in a separate 'box'. This box could encompass either all financing activities, or just group financing activities. In this alternative, interest payments and income would be dealt with in one separate box, as a result of which the interest could not be set off against the operating profit. One disadvantage would be the discouragement of investment in the Netherlands, since interest costs would be higher. Instead of allocating interest payments to the financing box per se, the interest payments could be allocated to the activities and assets to which they relate. As a result, interest on loans could be set off against operating profits, but only to the extent the loan was borrowed in order to finance the operating activities.

5. Section 10a CIT A could be replaced by an interest deduction disallowance for group interest if the creditor's interest income is not taxed at a reasonable rate. In comparison with Section 10a, CIT A, the major change would be that the intent underlying the loan would no longer have to be considered. This rule would therefore be broader and harsher, but less vague.

6. Section 10a, CIT A, could also be replaced by a more generic anti-abuse provision, e.g. a more general codification of case law regarding fraus legis or (preferably) of the EC Court of Justice case law regarding abuse of law. Such a provision would inevitably be rather vague, and would reduce the complexity of Section 10a, CIT A, but would increase the uncertainty surrounding it.

7. Finally, the function of Section 10a, CIT A, could be fulfilled by 'mechanical' rules, such as thin capitalisation rules. The consequence of repealing Section 10a, CIT A, would be that companies would arbitrarily increase their debt/equity ratios to meet the accepted ratio. The advantage would be the resultant increase in equality: each company could reach the same limit.

Chapter 10 contains the conclusions. In my opinion, because of the related international aspects, the distinction between equity and debt should be maintained. If one wished to combat abuse by interest deduction, this could be done by specific anti-
abuse provisions, generic or mechanical provisions (such as thin capitalisation rules), or a combination of these provisions. Section 10a leads to a lack of legal certainty and to overkill. The disadvantage of specific anti-abuse provisions is that they are inevitably vague: the fine line between abusive and bona fide transactions is drawn arbitrarily. As soon as clear criteria are applied, however, the dual threats of underkill and overkill will arise.

Because of the disadvantages of an interest deduction allowance founded on the taxpayer’s sound business reasons, I prefer ‘mechanical’ interest deduction rules. Thin capitalisation rules are internationally customary and already exist in the CITA, and are thus the best alternative. My view is that Section 10a, CITA, should be repealed.