

Lexel AB and (Dutch) Interest Limitation Rules: How to Clean-Up the Mess (if Any)?

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We Need To Talk About *Lexel AB* …

The (potential) error in *Lexel AB,* C-484/19 in one sentence:

- "56. It must be held that the exception may include within its scope ***transactions which are carried out at arm's length*** *and which,* ***consequently****, are* ***not purely artificial*** *or fictitious arrangements* created with a view to escaping the tax normally due on the profits generated by activities carried out on national territory"

- Did the CJ really mean to decide that as long as intra-group financing transactions are at arm's length, there can be no tax avoidance?

What Is Problematic About *Lexel AB* …

#1. MSs *may* use ALP as a proxy to deny interest deduction (Thin Cap GLO, C-524/04, pt. 81) ≠ MSs *must* use ALP as a proxy to deny interest deduction (arguably Lexel AB, pt. 56)

- Lexel AB is right to the extent it essentially rejects the absence of an objective tax avoidance test – next to the subjective (motive) test in the Swedish limitation rule (*Eqiom*, C-6/16; *Halifax,* C-255/02, pt. 73)

- But objective element of EU tax avoidance test must be derived from *domestic law* and not (autonomously) from EU law

- Base erosion can still take place under arm's length conditions
  - Groups of companies can still "*choose freely the Member State in which their profits will be taxed*" (as rejected in *Oy AA*, C-231/05, pt. 64)

What Is Problematic About *Lexel AB* …

#2. *Lexel AB* seems to concern (in substance) "*an advantage specifically linked to*" the Swedish group contribution scheme; discrimination *should* therefore have been justified in order to respect the allocation of taxation rights (dissenting: CJ in pt. 65; why?)

- Swedish exception (interest limitation) switched-off if group contribution can be made (*i.e.* no group contribution, no switch-off <--> linked advantage)
  - Likewise: "per-element approach" (ex *Groupe Steria*, C-386/14) with respect to (deduction of) cross-border loss & Dutch fiscal unity: *X Holding* C-337/08, pt. 23; *X BV* C-398/16, pt. 40
  - Likewise: "per-element approach" with respect to (pick-up of) cross-border intra-group interest payment & Dutch fiscal unity: Dutch SC BNB 2021/37 (*Hunkemöller*), pt. 4.6.2

Why Problem #1 May (To Some Extent) Be A Solution At The Same Time …

CJ has accepted the possibilty that the underlying loan (debt *vs* equity ratio) may infringe the ALP

- *Thin Cap GLO*, pt. 81:
  - "[t]he question is whether, had there been an arm's-length relationship between the companies concerned, ***the loan would not have been granted*** or would have been granted for a different amount or at a different rate of interest"

- Hence, MSs may still be allowed to deny interest deduction to the extent taxpayer's debt *vs* equity ratio is not at arm's length
  - Subject to counterproof by the taxpayer

Assuming *Lexel AB* (pt. 56) Is Current Law: Does It Create A Mess?

Pt. 56 of Lexel AB may hit (*inter alia*) Dutch interest limitation rules, but with a varying intensity & likelihood

- Article 10a CITA (specific anti base erosion rule more or less comparable to Swedish rule)
  - Dutch SC 2 Sep '22: *de facto* discriminatory (2007 version), preliminary questions whether justified in case where intra-group loan is used for business-driven third-party acquisition
- Dutch SC in Hunkemöller: *fraus legis* does not infringe TFEU freedoms (!?)
- Article 15b CITA (implementation of earnings stripping interest limitation rule of Article 4 ATAD)
  - EFTA Court *PRA Group Europe AS*, E-3/21: Norwegian rules disproportionate
  - However, territoriality / balanced allocation should have been justification (*W AG*, C-538/20, pt. 27; *Oy AA,* C-231/05*,* pt. 64)
  - Ápplying *Lexel AB* would infringe mandatory minimum standard under ATAD

Assuming *Lexel AB* (pt. 56) is Current Law: How to Clean-Up the Mess (If Any)?

Could MSs' legislators reverse Lexel AB in the first place?

- Yes, but subject to the prohibition of abuse of rights (*EC vs Poland*, C-562/19 P, pt. 43)
  - Motive test: intention to circumvent EU law?
  - Objective / consistency test: chosen criteria inconsistent in the light of the objective of the underlying legislation?
- Abuse of rights until now accepted in extreme cases only (*e.g. Gibraltar 2*, C-106/09 P on state aid)

Assuming *Lexel AB* (pt. 56) is Current Law: How to Clean-Up the Mess (If Any)?

Article 10a Dutch CITA: three potential quick fixes (standalone or combined)

- 1. Abolish compensatory levy test & replace by debt *vs* equity ratio test + maintain current business motive test
  - Tax avoidance (para. 3) test no longer (*de facto*) discriminatory (?)

- 2. Restrict Article 10a CITA to group structures involving *definite influence ("**control**")*
  - At least non-EU intra-group loans excluded from CJ's scrutiny (*e.g.* FII 2, C-35/11)
  - Potential bonus bait: intra-group loans (capital movement) potentially absorbed by freedom of establishment → no discrimination if loan is not granted by controlling parent (*cf. Thin Cap GLO*, paras 93 *et seq.*; AG Rantos in *Gallaher*, C-707/20. paras 47 *et seq.*)

- 3. Abolish Article 10a CITA within the EU → the Dutch abuse of law doctrine (*fraus legis*) will continue to do (part of) the job
  - *Fraus legis* does not infringe TFEU freedoms (Dutch SC in *Hunkemöller*) (!?)

Assuming Lexel AB (pt. 56) is Current Law: How to Clean-Up the Mess (If Any)?

Article 15b Dutch CITA (earnings stripping interest limitation): four potential quick fixes

- 1. Introduce debt *vs* equity ratio test *cf.* Article 4(5)(a) ATAD (+ motive test?)
- 2. Extend Dutch fiscal unity repair measure as to include Article 15b CITA as well
- 3. Introduce partial cross-border fiscal unity for purposes of Article 15b CITA only
  - And only to the extent EU law would require to take foreign EBITDA into account
- 4. Regulate (exhaustively) interaction with group taxation regimes at EU level
  - Would require amendment of Article 4 ATAD
  - CJ's competence to assess TFEU compatibility very limited in such case (*RPO,* C-390/15, pt. 54)

Some Final Reflections

(Quick) fixes do not take away underlying fundamental issues inherent to the existing CIT systems that Lexel AB reveals:

- Single entity taxation approach
  - Recognition of legal reality (*e.g.* intra-group loans) is still the starting point when taxing groups of companies (MNEs)

- Difference in domestic tax treatment debt & equity + differences in tax rates / tax bases among MSs
  - Inherently vulnarable to exploitation by MNEs

- So let's harmonize!



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