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Court Allows Application of Thin Capitalization Rule

by Eric van der Stoel

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The lower tax court of Breda on February 17 in Case No. AWB 08/5350 ruled to allow the application of the Dutch thin capitalization rule to a Dutch resident company that had accepted an interest-bearing loan from its Belgian resident owner.

Facts

The taxpayer concerned was a Dutch resident company (X BV) of which all shares were held by X CVA, a Belgian-resident partnership limited by shares (*commanditaire vennootschap op aandelen*). X CVA also owned shares in two other foreign companies. The shares of X CVA were listed on the Brussels and Paris stock exchanges. The group was involved in real estate rental activities. The financial figures of X BV and the two other foreign companies were included in the consolidated annual accounts as prepared by X CVA for commercial purposes. In the year concerned (2005), X CVA had granted an interest-bearing loan to X BV.

Issue

The tax inspector claimed that X BV could not deduct the interest on the loan under application of the Dutch thin capitalization rule. The fact that X BV was excessively financed in the sense of the thin capitalization rule was not an issue. However, X BV argued that the restriction on the interest deduction should not apply in its situation.

The Law

Since January 1, 2004, the Dutch Corporate Income Tax Act 1969 (CITA) has included a restriction on the deduction of interest in the form of a thin capitalization rule (article 10d of the CITA). In brief, this rule restricts the deduction of interest due on loans granted by affiliated companies if the debt-to-equity ratio of the company concerned exceeds 3 to 1. One of the requirements for the application of the rule is that the company concerned should belong to a group in the sense of article 24b of book 2 of the Dutch Civil Code.

Decision

The lower tax court of Breda decided in favor of the tax inspector — that is, the interest was not deductible — rejecting various arguments of X BV.

First, X BV had argued that X CVA was not a company in the sense of the CITA — that is, the interest was not due to an affiliated company as required by article 10d of the CITA. As the shares in X CVA were freely transferable (that is, were listed on a stock exchange), the court decided that X CVA should be treated as a company in the sense of the CITA. The court referred to a decision of the Supreme Court of November 24, 1997 (No. 17.988, published in BNB 1978/13).

Second, X BV argued that it was not part of a group as meant in article 24b of book 2 of the Dutch civil code. The court disagreed. It reasoned that the group requirement can be derived from the consolidated annual accounts prepared for commercial purposes. The financial figures of X BV were consolidated in the annual accounts of X CVA in accordance with the rules of Belgian company law that deal with the annual accounts. Because these Belgian rules, like the Dutch rules, are based on European directives, the court held that X BV should be treated as being part of a group in the sense of article 24b.

Third, X BV argued that the thin capitalization rule would not apply if X BV could have formed a fiscal unity (that is, filed a consolidated tax return for Dutch tax purposes) with its non-Dutch-resident parent company X CVA. The fact that the CITA did not allow the fiscal unity between X BV and its non-Dutch-resident parent company should be treated as a violation of EU law, X BV said. However, the court noted that X CVA and X BV had not actually applied for a fiscal unity with the Dutch tax authorities (for example, by claiming that EU law should allow the fiscal unity). Therefore, the court ruled that X BV could not use this argument.

Fourth, X BV argued that the thin capitalization rule of article 10d CITA violates the EU interest and royalty directive (2003/49/EC, as amended). The court reasoned that the thin capitalization rule is not a levy on interest payments but a restriction of the deduction

of these interest payments. Accordingly, the court decided that the thin capitalization rule does not fall within the scope of this directive.

Fifth, X BV argued that the thin capitalization rule violates the EU freedom of establishment and/or free movement of capital. The court reasoned that the rule applies both to domestic and foreign taxpayers and that there is no direct or indirect distinction based on the place of residence. Accordingly, the court also rejected this argument.

Finally, the court refused to accept X BV's sixth argument, that the thin capitalization rule violates the Belgium-Netherlands treaty (signed June 5, 2001) or the OECD model treaty. It used similar reasoning as that regarding X BV's fourth argument.

Discussion

Regarding X BV's third argument, it is interesting to note that the European Court of Justice recently held that the Dutch fiscal unity rules, regarding the impossibility of forming a fiscal unity between a Dutch resident parent company and a non-Dutch-resident subsidiary, do not violate EU law (*X Holding BV v. Staatssecretaris van Financien* (C-337/08). (For prior coverage, see *Tax Notes Int'l*, Mar. 8, 2010, p. 835, *Doc 2010-4389*, or *2010 WTD 44-7*.) A similar decision will most likely be rendered concerning the forming of a fiscal unity between a nonresident parent company and a Dutch resident subsidiary. Nevertheless, this impossibility of forming a fiscal unity could have an impact when judging whether the thin capitalization rule is compatible with EU law. Companies belonging to a Dutch resident group could escape the thin capitalization rule by forming a fiscal unity, while this is not possible in an international group structure.

X BV's fourth argument — that the thin capitalization rules violate the EU interest and royalty directive — also raises an interesting point leading one to question whether the court's reasoning is correct. Dutch literature noted this potential violation before the adoption of the directive and the enactment of the Dutch thin capitalization rule.[1] Article 1 of the directive provides that interest payments will be exempt from any taxes in the state of source. The aim is to avoid double taxation. It is doubtful whether the decision of the court is correct — that is, that the directive only deals with the levy of tax on interest payments in the state of source and not with the deduction of interest in this state. More clarity on this issue may arise when the ECJ renders its decision in *German Scheuten Solar Technology* (C-397/09), which deals with a restriction on the deduction of interest under German tax law.[2] (For the ECJ reference, see *Doc 2009-26644* or *2009 WTD 232-21*.) ◆

♦ *Eric van der Stoel, Otterspeer, Haasnoot & Partners, Rotterdam*

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[1]D.M. Weber, *Weekblad Fiscaal Recht* 6518, Feb. 27, 2003, p. 315.

[2]*See also* D.M. Weber, *Weekblad Fiscaal Recht* 6847, Feb. 18, 2010, p. 212. @FOOTNOTEBEG =

(Footnote continued on next page.)

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