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On 24 February 2012, the Dutch Supreme Court (DSC) ruled in favor of taxpayer on the tax treatment of currency exchange results on 'tainted' related party debt.

Summary

According to Dutch law, interest – costs and currency exchange results included – on 'tainted' related party debt is non-deductible. The DSC ruled that this legal provision also applies to "negative costs", such as positive currency exchange results (currency exchange gains). Currency exchange gains are to be netted against non-deductible interest and costs. Any residual currency exchange gains are exempt.

Back ground

Article 10a Dutch Corporate Income Tax Act (DCITA) is an anti base erosion provision, which disallows deduction of *"interest – costs and currency exchange results included – "* paid on debt from a related party if such debt is used by the taxpayer or a party related to the taxpayer to:

- Distribute a dividend or repay capital to a related party; or
- Contribute capital to a related party;
- Acquire or increase an interest in a company which, after such acquisition or increase, is a related party.

The purpose of article 10a DCITA is to disallow interest deduction in certain situations, for example where an internal transfer of a participation creates interest expense at the level of the taxpayer, reducing its Dutch taxable base, while the income from the participation is exempt, or where equity of the taxpayer is substituted by debt in an artificial manner, e.g. by distributing dividends and borrowing back the same amount.

Facts and circumstances

On 24 May 2004, the taxpayer (hereinafter: X BV) borrowed $ 47,564,887 from its 100% Belgian parent company, B NV, at an exchange rate EUR/USD of 1.2146, resulting in a debt of € 39,160,993. On 25 May 2004, X BV granted a participating loan of $ 47,564,887 to its 100% Dutch subsidiary, C BV. On 27 May 2004, C BV made a capital contribution (share premium) to its 95% Turkish subsidiary (hereinafter: D AS).

The interest paid by X BV to B NV fell under the scope of article 10a DCITA, as the debt was owed to a related party and used by X NV to contribute capital (the participating loan was treated as a capital contribution by X BV into C BV), and as such was non-deductible.

On 31 December 2004, B NV converted the loan to X BV into share premium, at an exchange rate of €/$ 1,3621, which resulted in an informal capital contribution of € 34,920,261. The informal capital contribution relieved X BV from its € 39,160,993 debt. As a result, X BV realized a currency exchange gain of € 4,240,672.

In its 2004 CIT return, X BV treated the interest payable in the amount of € 490,880 as non-deductible, but netted that amount against the currency exchange gain of € 4,240,672 resulting in € 3,749,792 of the currency exchange gain being exempt.

Dispute

The tax inspector took the position that:

1) the phrase '*currency exchange results'* only refers to currency exchange losses, which means that any 'article 10a currency exchange gain' can not be netted with the interest; and
2) currency exchange gains are not exempt from tax under article 10a DCITA, since this article only purport to restrict deductibility ('*are non-deducible'),* it does not purport to exempt income or gains.

As a result, the tax inspector disallowed interest deduction in the amount of € 490,880 and included in taxable income the full currency exchange gain of € 4,240,672.

Judgment of the Supreme Court

First of all, the Supreme Court ruled that the phrase *'interest expenses – costs and currency exchange results included –'* refers to the sum of all aforementioned interest expenses, costs and currency exchange results, and that 'results' should be interpreted as to include both currency exchange losses and currency exchange gains. This means that currency exchange gains should be netted against all aforementioned interest expenses, costs, and currency exchange losses. The Supreme court ruled that a positive balance should be exempt from tax.