The Far-Reaching Consequences of the ECJ Decision in *Bosal* and the Response of the Netherlands

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1. INTRODUCTION

In the celebrated case of *Bosal Holding BV v. State Secretary of Finance* (Case C-168/01), decided on 18 September 2003, the European Court of Justice (ECJ) ruled that a Dutch tax provision (Art. 13(1) of the Corporate Income Tax Act (CITA)) which denied a deduction for expenses relating to participations in foreign subsidiaries violated the freedom of establishment clause in Art. 43 of the EC Treaty. The ECJ held that the provision was incompatible with the EC Treaty because the provision placed Dutch parent companies with subsidiaries in other EU Member States in a disadvantageous position compared to Dutch companies with Dutch subsidiaries.

The *Bosal* decision brings the European Union one step closer to tax harmonization. In various cases over the past few years, the ECJ addressed a series of direct taxation issues, including thin capitalization and controlled foreign company rules, group relief and exit taxes. One of the core principles that can be derived from some of these cases is that the EC Treaty prohibits the Member States from treating intercompany transactions involving subsidiaries in other Member States differently for tax purposes from intercompany transactions involving domestic subsidiaries.

This article analyses the *Bosal* decision and the extent to which it applies outside the European Union. The article also examines the response of the Dutch government to the decision, with emphasis on the new thin capitalization rules and whether they are compatible with EC law.

2. THE *BOSAL* CASE

2.1. The facts

Bosal Holding BV was a Dutch holding company with Dutch and foreign subsidiaries, both within and outside the European Union. Bosal's shareholdings in its subsidiaries qualified under the Dutch participation exemption. Bosal borrowed funds to finance these shareholdings and claimed a deduction for the interest paid. The Dutch tax authorities denied a deduction for the interest expenses relating to the foreign subsidiaries.

The Dutch participation exemption exempts from the corporate income tax dividends received by a Dutch parent company from its subsidiaries as well as capital gains derived from the disposition of shares in the subsidiaries. Under the participation exemption (before *Bosal*), expenses relating to a participation in a *foreign* subsidiary could not be deducted. Expenses with respect to a loan were deductible only if the loan related to a *Dutch* subsidiary or if the subsidiary had taxable income in the Netherlands. In effect, such expenses were deductible only if the subsidiary financed with the loan was a Dutch company or a foreign company with a Dutch branch. As a result, Dutch multinationals were unable to deduct the interest expenses incurred in connection with the acquisition of foreign subsidiaries.

The effect of these rules may be illustrated by a Dutch parent company that had subsidiaries both in the Netherlands and in other EU Member States. The parent company took out loans in connection with the Dutch subsidiary as well as the foreign subsidiaries. The parent company could deduct the interest expenses relating to the Dutch subsidiary, but not those relating to the non-Dutch subsidiaries.

Bosal challenged the non-deductibility provision as it applied to its subsidiaries in other EU Member States on the grounds that the provision was incompatible with the freedom of establishment principle in the EC Treaty.

2.2. The ECJ decision

The ECJ found that the limitation in Art. 13(1) CITA constituted an obstacle to setting up subsidiaries in other EU Member States and was therefore contrary to EC law. Although Art. 43 of the EC Treaty prohibits the Member States from taking measures that violate the freedom of establishment principle, the Member States are allowed to apply provisions that may violate this principle if the Member States can demonstrate that the provisions are justified. The Dutch government advanced three arguments to justify Art. 13(1) CITA:

– an argument based on the need to ensure the coherence of the national tax system;
– an argument based on the territoriality principle; and
– an argument based on the need to preserve the tax base of the Netherlands.

The ECJ rejected all three arguments. With respect to the need to preserve the coherence of the national tax system, the ECJ pointed out that, according to settled case law,[1] for a measure to be justifiable, there must be a direct link between the granting of a tax advantage and the offsetting of that advantage by a fiscal levy and both the advantage and the levy must be in the context of the same tax and the same person. This was not the case in *Bosal* since there were several different legal persons, each of which was a separate taxable person. Concerning the argument based on the principle of territoriality, the ECJ stated that the difference in the tax treatment in question depended on whether parent companies have subsidiaries that make taxable profits in the Netherlands. The ECJ pointed out, inter alia, that the limitation on the deductibility of costs incurred by a parent company established in the Netherlands in connection with the capital of its subsidiaries established in other Member States constitutes a hindrance to establishing subsidiaries in those Member States. Because of that limitation, a parent company might be dissuaded from carrying on its activities through a subsidiary established in another Member State since such subsidiaries normally do not generate profits that are taxable in the Netherlands. Finally, with respect to the need to preserve the tax base of the Netherlands, the ECJ noted that case law clearly establishes that the need to prevent the diminution of tax receipts does not justify a restriction on EC law, in particular, the freedom of establishment principle.

2.3. Consequences of *Bosal* for EU participations

In principle, the *Bosal* decision applies only with respect to subsidiaries in the EU Member States. The Dutch Secretary of State, however, has accepted its application in relation to the European Economic Area (EEA) (i.e. the European Union plus Liechtenstein, Norway and Iceland) because the EEA Treaty contains a provision identical to the freedom of establishment principle in the EC Treaty.[2] In the authors' opinion, the *Bosal* decision also applies to subsidiaries in certain Central European countries based on the non-discrimination and freedom of establishment provisions in the "Europe agreements" (or "association agreements") with those countries.[3]

In addition, although *Bosal* concerns the deduction of interest expenses, some cases pending before the Netherlands Supreme Court with respect to capital expenditure costs (e.g. notary public fees), reorganization costs, public listing costs and "investor relations" costs will be affected by *Bosal*. For this reason, according to the authors, the *Bosal* decision brings the European Union one step closer to tax harmonization. This is not to suggest that *Bosal* and some cases pending before the ECJ will lead to complete harmonization; rather, the likely outcome is that doing business across borders will become easier as the rules become more closely approximated.[4]

2.4. Impact of *Bosal* on participations in associated countries

As mentioned above, in the authors' opinion, the *Bosal* decision also applies in relation to several Central European countries that have entered into association agreements with the European Union. The basis for association agreements can be found in Art. 310 of the EC Treaty, which provides: "The Community may conclude with one or more States or international organizations agreements establishing an association involving reciprocal rights and obligations, common actions and special procedures."

To take one example, the association agreement with Poland, which entered into force in 1993, has as two of its objectives the improvement of trade and the harmonization of economic relations between the parties. Art. 44(1)(ii) of the agreement provides: "From the entry into force of this Agreement, activities of EC companies and EC subjects will receive treatment that is not less favourable than that which is provided to Polish companies and subjects." Art. 44(4) of the agreement defines the right of establishment as the right to establish and manage subsidiaries, branches and agencies and to exercise economic activities by means thereof. In combination, these two provisions would seem to suggest that Poland is required to afford the same "not less favourable" treatment to subsidiaries, branches and other permanent economic activities.

According to the ECJ in *Jany* (Case C-268/99) in 2001, the provisions of an association agreement have direct effect if the wording of a provision establishes a precise and unconditional principle. The principle enunciated in the right of establishment provision appears clear: the treatment afforded to companies and subjects of the EU Member States must be no less favourable than that given to Polish companies and subjects.

The authors therefore conclude that a Dutch undertaking should be able to appeal to the Polish tax authorities on the basis of the freedom of establishment provision in the

1. *Baars* (Case C-251/98), [2000] ECR I-2787 and *Verkooijen* (Case C 35/98), [2000] ECR-I 4071.
2. See Art. 31 of the EEA Treaty. See also Decree CPP03-1611 of 27 August 2003, answer to question 1.1.3.3.
3. For more details on association agreements, see van den Hurk, Hans, "Does the Reach of the European Court of Justice Extend Beyond the European Union?", 56 *Bulletin for International Fiscal Documentation* 6 (2002), at 275.
4. It is important to note that, based on the expected outcome of the pending cases, it may be possible to object to tax assessments that have become final.

association agreement in the same way as it can appeal to the tax authorities of an EU Member State based on the freedom of establishment provision in the EC Treaty. It must be admitted, however, that the circumstances of the *Bosal* case are different from those contemplated in association agreements. Art. 13(1) CITA hinders a company resident in the "country of origin" from investing in the "country of destination". Association agreements, on the other hand, provide only that the country of destination may not restrict investment in that country. Nevertheless, it is clear from some ECJ decisions, albeit in the context of EC law, that a country of origin may not impose restrictions on its residents investing in another EU Member State (see e.g. *Bosman* (Case C-415/93) 1995).

This discussion seems to suggest that situations in which an investment is made from an EU Member State into an "associated country" also falls within the scope of the relevant association agreement. A final proviso that should be noted is that all association agreements contain exceptions with respect to certain kinds of enterprises. Thus, before resorting to such an argument in practice, it is important to ensure that the activities of the company concerned are not of a kind that is excluded from the scope of the relevant agreement.

In conclusion, it would seem that the measures of an EU Member State which hinder or prohibit investments in an associated country contravene the applicable association agreement.

2.5. Impact of *Bosal* on third countries

As the freedom of establishment principle applies only in relation to the EU and EEA states, it should be considered whether it is possible to invoke the free movement of capital principle in the EC Treaty (Art. 56). If successful, such an approach would enable a company to deduct costs even in relation to subsidiaries outside the EU or the EEA since the free movement of capital is the only freedom provided in the EC Treaty that applies with respect to transactions involving non-EU and non-EEA countries. A problem with this approach, however, is that this rule is without prejudice to applying to third countries any restrictions that existed on 1 January 1994 under national law (see Art. 57(1) of the EC Treaty). As Art. 13(1) CITA already existed when the EEC was established in 1958, it would seem impossible at first sight to challenge that provision in relation to third countries.

Even this situation is not as straightforward as it might seem. The part of Art. 13 CITA that deals with foreign exchange results was introduced in 1995 and became applicable in 1997. Before 1997, foreign exchange costs were always deductible and, correspondingly, foreign exchange gains were always taxable. Since 1997, such gains/losses have fallen within the scope of the participation exemption, which means no deduction of losses or taxation of gains; and now, as a result of the *Bosal* decision, it is possible to deduct from Dutch income foreign exchange losses that relate to participations in other EU Member States. Conversely, foreign exchange gains are taxable. For example, assume that, in 1998, a Dutch parent funded the acquisition of a wholly-owned UK subsidiary with a loan in British pounds evidenced by a note of GBP 10 million. If the British pound fell from EUR 1 to 0.75 in 1999, the note would decrease in value by EUR 2.5 million. Under Dutch law after 1997 but before *Bosal*, the consequent gain would be exempt. If, on the other hand, the British pound rose from EUR 1 to 1.25, the note would increase in value by EUR 2.5 million, and the consequent loss would not be deductible under Dutch law.

Since the *Bosal* decision, however, such a loss has again become deductible if it relates to a transaction within the European Union. Further, because the free movement of capital principle also applies in relation to non-EU and non-EEA transactions, provided the national provision did not exist before 1994, the part of Art. 13 CITA that deals with foreign exchange results under the participation exemption can be challenged.

2.6. Third countries and non-foreign exchange costs

Another argument that *Bosal* applies outside the European Union is based on recent developments in the literature which see *Bosal* and other ECJ decisions as indicating that the ECJ wants to regard the free movement of capital principle the same way as it regards the free movement of goods and services principle. Such an interpretation would be possible only if the ECJ rejects the exception for national laws existing on 1 January 1994 as being in conflict with EC law.[5] Although it appears that the ECJ's policy is that exceptions must be strictly adhered to, there is a suggestion in some cases that the limitation in Art. 57(1) should be applied restrictively. See *Sandoz* (Case C-439/97, 1999) and *Scientology Church* (Case C-54/99, 2000).

3. RESPONSE OF THE DUTCH GOVERNMENT

3.1. Deductible costs

After the ECJ decision in *Bosal*, the Dutch Ministry of Finance published a document (dated 2 October 2003) explaining its point of view. The document indicates that the Dutch tax provision stating that costs are deductible only if they "give rise to taxable profits in the Netherlands" must be read to mean that "such costs must give rise to taxable profits in the EU or EEA". Perhaps more significant is the Ministry of Finance's statement regarding the treatment of foreign exchange results from transactions within the EU and EEA. The following is a summarized translation:

> The deduction of costs (of a loan) is not limited, although I want to make it clear that, if a taxpayer has achieved benefits as a consequence of foreign exchange results, the following applies:

5. Or as was stated in Knobbe-Keuk, B., "The Ruding Committee Report – an impressive vision of European Company Taxation for the year 2000", *EC Tax Review*, 1992/1, at 22, 30: Art. 58(1)(a) "must be regarded as an outrageous violation of the spirit of the Rome Treaty".

> Foreign exchange results must be balanced with other participation-related costs. A negative result will be deductible. A positive result will not be taxed to the extent it relates to foreign exchange results.

Although this statement appears logical, Table 1 illustrates its shortcomings:

Table 1

	Example 1	Example 2	Example 3
	(amounts in million)		
regular costs	-/- 1	-/- 1	-/- 1
foreign exchange results	-/- 0.5	+/+ 0.5	+/+ 1.5
net tax consequence	-/- 1.5	-/- 0.5	+/+ 0.5

One consequence of the Ministry of Finance's interpretation is that, in Examples 2 and 3, the regular costs that are deductible as a result of *Bosal* are offset against the foreign exchange gains that are tax exempt under the Dutch participation exemption. This suggests that the interpretation does not take the ECJ decision into account. In effect, the Ministry is ignoring either its own tax law (which brings foreign exchange gains under the participation exemption) or *Bosal* (by not granting a deduction for foreign participation-related costs). Neither approach is acceptable because the Ministry is essentially offsetting an advantage that results from an ECJ decision by refusing to apply a Dutch tax provision. It seems likely that more cases on this issue will arise.

3.2. Impact of *Bosal* on cross-border fiscal unity

One of the major benefits of the *Bosal* decision is that it provides more clarity with respect to cross-border operations, and the decision can be used to provide additional support for allowing the creation of a cross-border fiscal unity. For example, under the current Dutch fiscal unity (or tax consolidated group) rules, Dutch resident parent companies may form a fiscal unity with their Dutch subsidiaries. Subsidiaries forming a part of a fiscal unity are deemed to be "merged" into the parent company. The parent company is subject to tax based on the combined results of the group; thus, the parent company may offset losses incurred by a subsidiary against its own profits, which alleviates the overall tax burden of the group.

Groups with foreign subsidiaries may generally not include them in a fiscal unity; thus, the losses of these subsidiaries may not be offset against the profits of the Dutch parent company. It is possible, however, that a prohibition on fiscal unities that include one or more foreign subsidiaries is in breach of EC law. If this is the case, groups with foreign subsidiaries might be able to realize considerable savings.

It should be noted that, in the case of a cross-border fiscal unity, a foreign subsidiary is treated as a permanent establishment (PE) subject to certain conditions. The losses of the foreign subsidiary are, as a consequence, deducted from the Dutch profits. If the foreign subsidiary subsequently becomes profitable, the relevant profits are taxed in the Netherlands and no exemption is granted. This arrangement applies until the foreign losses previously charged against the Dutch profits are exhausted, essentially preventing losses from being deducted twice. In essence, the advantage is one of timing. A timing advantage is important because it enables a fiscal unity to pay tax only if the fiscal unity makes a profit, thus providing a way to optimize cash during an economic downturn.

These rules may be illustrated by a Dutch parent company parent with an EEA subsidiary established in Norway. If the fiscal unity regime applies, the subsidiary is regarded as the PE of the Dutch parent. The fiscal unity is only for purposes of the CITA, i.e. the PE does not come into existence by virtue of the facts, but as a result of a fiction in Dutch domestic law. Norway, where the subsidiary is established, recognizes only the subsidiary (not the PE). But from a Dutch perspective, however, because of EC law (specifically the *Bosal* decision) and Dutch tax law, there is only a PE. Purely by virtue of the operation of Dutch tax law, the subsidiary's losses may be offset against the profits of the Dutch parent.

A fiscal unity, however, can sometimes produce less beneficial results than expected. A parent company could try to retain its deferral advantage by, for example, terminating the fiscal unity when the subsidiary anticipates becoming profitable. Terminating the fiscal unity revives the subsidiary's independent tax position. Any advantages derived by the parent company from its subsidiary on termination of the fiscal unity generally remain untaxed under the participation exemption, albeit the exemption applies only to the extent the advantages exceed the losses that were charged against the Dutch profits in the past. If the parent company does not pay dividends and values the subsidiary at cost, however, the parent company can continue to defer taxation.

A challenge to the fiscal unity rules seems inevitable on the grounds that excluding foreign subsidiaries from a fiscal unity is an infringement of EC law.

3.3. Legislative response

The Dutch government quickly introduced legislation responding to the *Bosal* decision. The legislation, which entered into force on 1 January 2004, has three main objectives. First, it abolishes the limitation on the deductibility of costs relating to foreign exempt participations. This change has been welcomed by Dutch taxpayers because it allows (financing) costs relating to foreign exempt participations to be offset against profits from Dutch sources. Second, to preserve the Dutch tax base, thin capitalization rules were introduced to prevent the unlimited deduction of financing costs from the acquisition of foreign exempt participations. Third, the new legislation introduces a restriction on loss carry-overs to prevent "pure" holding companies from offsetting tax losses against taxable profits from other profitable activities. The issue now is whether the legislation introduced in response to *Bosal* is consistent with EC law. The rest of this article looks at the thin capitalization rules and the restriction on loss carry-overs and examines their compatibility with EC law.

4. THE NEW THIN CAPITALIZATION LEGISLATION

4.1. Overview

Under the new thin capitalization ("thin cap") rules, if a company has "excess liability", a portion of the interest on its debt may not be deductible. The rules apply in the following circumstances:
– the taxpayer is part of a group of companies;
– the taxable intragroup interest received does not equal or exceed the deductible intragroup interest due;
– the taxpayer's debt-to-equity ratio exceeds 3:1 plus a threshold of EUR 500,000 (the safe haven test); and
– the taxpayer is part of a group that, on a consolidated basis, has a higher debt-to-equity ratio than the debt-to-equity ratio of the taxpayer itself (the group ratio test).

If a company has excess liability, the interest deduction on "money loans" may not be fully deductible. The taxpayer determines whether it has excess liability by applying the *safe haven* or *group ratio* test. The basis for the determination is the average of the debt-to-equity positions at the beginning and at the end of the financial year. The maximum amount of non-deductible interest ("cap") is the net amount of interest that is due on loans to related parties. Special provisions for foreign PEs of Dutch taxpayers also apply, and additional rules on this aspect will be issued in the future. Although the thin cap rules are characterized as anti-abuse measures, there are no provisions allowing taxpayers to demonstrate that a transaction is not abusive.

4.2. Features of the rules

4.2.1. Limitation on deductibility

If a taxpayer has excess liability, the limitation on deductibility applies to the interest on "money loans". The Dutch thin cap rules are, by their nature, a limitation on the deductibility of interest expenses. Interest is not recharacterized as a dividend, nor is the principal amount recharacterized as capital. Foreign exchange gains are still subject to tax, and exchange losses are deductible.[6]

The restriction on the interest deduction is calculated using a mathematical formula. The part of the interest to which the restriction applies is equal to the ratio of the excess liability to average liability. The limitation on deductibility is equal to:

(excess liability / average liability) x interest on money loans

The amount of non-deductible interest is determined solely on the balance sheet ratio, and specific excessive loans are not disqualified. When applying the thin cap rules, a proportionate part of all loans is affected. As non-deductible interest is not attributable to specific loans, there are no provisions allowing a taxpayer to avoid the rules by demonstrating that a loan is not abusive. It is irrelevant whether the interest is taxable in the hands of the recipient or whether the loan would have been granted by an independent third party. The definitions of "average liability", "excess liability" and "money loans" are important; notably, the definition of "average liability" is not the same in the safe haven test and in the group ratio test.

The definition of "money loan" narrows the scope of the deduction limitation. The interpretation of the term "money loan" is significant because the deduction limitation applies *only* to money loans; interest on debt claims that do not qualify as money loans is unaffected by the thin cap rules. The latter interest is deductible regardless of the taxpayer's capitalization ratio. A money loan is an agreement whereby a creditor temporarily provides a principal sum of money to a debtor. There is some doubt as to whether current accounts and trade debts qualify as money loans, and the parliamentary history is unclear on this point. The parliamentary history clearly provides, however, that a financial lease is not considered to be a money loan;[7] thus, the interest component of a financial lease is not affected by the thin cap rules. The substance-over-form principle generally applicable in Dutch tax law is apparently not to be applied with respect to the concept of "money loan".

It appears that, for interest to fall within the scope of the thin cap rules, it must be payable on what is a money loan in form. This form-over-substance interpretation may mean that the thin cap rules attack only debt positions originating from transactions whereby a principal sum of money is made available by one party to another. In other words, a debt claim would be classified as a money loan only if it originates from the supply of a principal sum of money. Debts of a different origin, such as payables for the supply of goods and services, would not qualify as a money loan and would therefore not fall within the scope of the rules. Under this interpretation, it would be relatively simple to circumvent the thin cap rules because a taxpayer could finance a company by leaving all the intercompany payables outstanding. The tax authorities, however, are expected to take the position that a qualifying money loan is deemed to exist when the parties maintain a debt position for financing purposes, regardless of the origin of the debt. Under this approach, the authors think it would be equitable not to treat true current accounts and trade debts as qualifying money loans because in principle they do not have a financing purpose. On the other hand, current accounts and trade debts that are left outstanding for an extended period of time with a financing purpose could be considered as qualifying money loans. In practice, the dividing line will be difficult to establish.

4.2.2. Group requirement

The thin cap rules apply only if the taxpayer is part of a group within the meaning of the Dutch statutory (civil law) provisions for financial reporting. It is irrelevant that the definition of "group" in the Dutch statutory provisions governing financial reporting does not apply to the combi-

6. Borrowings in strong currencies such as the Japanese yen, with negligible interest rates, may thus become an auspicious option. As interest on such borrowings is low, the effect of the thin cap rules will be negligible.
7. Written answer to Question No. 132 of the First Chamber of the parliament in the first term session of various legislative proposals on the tax package (29,210, 29,035, 29,209 and 29,036).

nation of a subsidiary and its non-resident parent company.

The group requirement gave rise to some confusion in the legislative history because the requirement was said to be satisfied if a company's balance sheet is consolidated in the balance sheet of a Dutch company or a non-resident company. This explanation is incompatible with the specific wording of the law. The law requires a group relationship according to Dutch standards. Whether a consolidated balance sheet is drawn up is a different issue. Since groups are not necessarily required to consolidate and group companies need not necessarily be included in a consolidation, it seems meaningless to deduce the existence of a group relationship from the consolidated financial statements. Moreover, the legislation makes it clear that the group requirement is purely a test under domestic law. It is difficult to see how financial statements consolidated under foreign law will be of any use in determining whether the group requirement is met.

4.2.3. Safe haven test

To determine whether there is excess liability, the taxpayer may choose between applying the safe haven test or group ratio test. Under the safe haven test, a debt-to-equity ratio of 3:1 is acceptable. To ensure that small and medium-sized companies are not adversely affected by the rules, the first EUR 500,000 of borrowed capital is not considered to be excess liability. The 3:1 ratio was selected because it seems reasonable compared to the ratios in other countries that have thin cap regimes. The Dutch method of determining the ratio, however, is completely different from that used in other countries – it is unique in the way it defines both equity and liability.

"Equity" is defined as equity according to the balance sheet for tax purposes, excluding fiscal reserves, which makes tax planning difficult. Fiscal reserves are generally formed whenever possible because they lead to deferred taxation. As fiscal reserves reduce the available equity for the safe haven test, however, such reserves may now give rise to an immediate and permanent increase in tax liability.

Liability is defined as the balance of the money loans received and the money loans provided. Debt relationships that do not include money loans are not considered for purposes of the thin cap rules. Thus, flow-through financing companies are not affected by the rules. Such companies usually maintain a balance between loans receivable and loans made; thus, the balance of the loans is nil and there is no excess liability. Financing companies that are in a similar situation but have other types of financial assets, such as trade receivables or operating assets leased out, may encounter difficulties. Although their assets are loans in substance, there is reason to think that trade receivables and receivables from financial leasing do not qualify as money loans and therefore are not available for netting out the corresponding debt. This is the downside of the formal interpretation of the term "money loan".

The netting of receivables is generally favourable because it reduces the likelihood that the taxpayer will be considered to have excess liability. If despite precautions, however, the taxpayer finds itself in an excess liability position and is therefore subject to the limitation on deductibility, the required netting may be unfavourable. For purposes of the safe haven test, the average liability is also determined on a net basis. The net debt represents the denominator in a fraction that determines how much of the interest is not deductible. The result of netting the average liability (the denominator) and the excess liability (the numerator) is that the non-deductible part of the interest increases. Since ultimately the non-deductible part of the interest is a fraction of the gross interest rather than the net interest, netting the loans can lead to surprisingly unfavourable results.[8] In many cases, however, the tax burden will be mitigated by applying a cap (see 4.2.5.).

4.2.4. Group ratio test

As an alternative to the safe haven test, the taxpayer may apply the group ratio test. This test uses a different methodology from that used by the safe haven test. Under the group ratio test, the taxpayer may have a debt-to-equity ratio equal to the debt-to-equity ratio of the group of which the taxpayer is a part. This test was added to the legislation at the request of the corporate sector in the Netherlands, and its purpose is to allow for situations in which (for sound business reasons) it is impossible to meet the 3:1 capitalization ratio. The group ratio test may be beneficial for banks and corporations in dire financial difficulties.

The group ratio test applies a relative benchmark rather than an absolute benchmark, i.e. the capitalization ratio of the group as a whole rather than only the taxpayer's ratio. This capitalization ratio is derived from the consolidated balance sheet of the group's ultimate parent; the balance sheet may be drawn up according to Dutch law or the law of another jurisdiction. Further, the comparative basis for the group ratio test is different from that of the safe haven test in that the group ratio test:
– is based on the taxpayer's balance sheet for financial reporting purposes;
– takes all liabilities into account; and
– does not allow the netting of borrowings and loans.

The difference between equity for tax purposes and equity for commercial purposes may be considerable; thus, applying the group ratio test may lead to a very different result even if the group's debt-to-equity ratio, used as a benchmark, is roughly equal to the 3:1 ratio used for the safe haven test. For example, significant differences may arise because, unlike the commercial balance sheet valuation of participations, the fiscal balance sheet valuation may be at the historical cost, depreciation is accelerated for tax purposes, or the acquisition of goodwill evaporates for purposes of group tax treatment.

8. This may be illustrated by the case of XBV, which has a subsidiary (X Sub), a parent company (X Parent) and equity of 2. XBV borrows 200 from X Parent at an annual interest rate of 5% (the interest due each year is 10) and relends 150 to X Sub. The permitted debt is 3 x 2 = 6. The excess liability is (200 – 150) – 6 = 44. The non-deductible portion under the safe haven test is 44 / 50 x 10 = 8.8. If the same interest rate is calculated on the debt claim as on the interest claim, the deductibility of the interest on the basis of the cap is limited to 10 – 7.5 = 2.5. This is equal to the full interest payable on the net debt.

Under the group ratio test, *all* amounts included in the financial statement as liabilities qualify for determining the average liability and excess liability. This applies to the taxpayer's balance sheet serving as the comparative basis as well as to the consolidated balance sheet of the ultimate parent company serving as the benchmark. Although only money loans are taken into account in determining the debt level for the safe haven test, all liabilities, including provisions, are taken into account for the group ratio test. Thus, for example, a pension provision may render it impossible to apply the group ratio test!

Unlike the safe haven test, borrowings and receivables are not netted when applying the group ratio test. A large flow-through loan may therefore make it impossible to apply the group ratio test. In such a case, the financing would need to be contributed to a separate company. Under the safe haven test, the separate financing company would not have a net debt position and would not be affected by the thin cap rules. Having cleared its balance sheet of the flow-through financing, the taxpayer would be left with a better capitalization ratio for applying the group ratio test.

Unfortunately, the group ratio test is plagued by some practical complications. It is not always clear which balance sheet should be used as the benchmark. For instance, the legislation does not address the situation where the taxpayer's fiscal year deviates from its reporting year[9] or where its financial year deviates from the parent company's financial year. In addition, technical difficulties arise with respect to the comparative basis. One would expect that a taxpayer includes its own single company balance sheet in the comparison with the consolidated balance sheet of the parent company. Strangely enough, the taxpayer also may use its consolidated balance sheet as the comparative basis. In certain situations, this appears to be beneficial – for instance, if loans are borrowed from a consolidated subsidiary. Since loans to subsidiaries are eliminated through consolidation, the consolidated balance sheet states a lower amount of debt than the single company balance sheet. By allowing the consolidated balance sheet to be used as the comparative basis, borrowing from group subsidiaries escapes the thin cap provisions.

A fiscal unity (tax group) must use a consolidated balance sheet that includes the group subsidiaries as the comparative basis. If such a balance sheet is not available, it must be drawn up. A partner in a fiscally transparent partnership is required to use a consolidated balance sheet that includes the partnership. If the principal company of the group is also the parent company of the tax group, the group requirement is by definition satisfied. The consolidated balance sheet of the parent company may be used as the comparative basis, but it also serves as the benchmark. Since the comparative basis and the benchmark are the same, there is no relative undercapitalization; thus, the thin cap rules do not apply to the group companies included in the tax group. This is surprising because the Dutch tax group can borrow more than a proportionate share of the total borrowings. In fact, the Dutch tax group can borrow even more than the total borrowings of the group, e.g. if the Dutch companies borrow from the equity of non-resident group companies. The method for applying the group ratio test for which a consolidated balance sheet may be taken as the comparative basis essentially results in non-application of the thin cap rules! By introducing the group ratio test, the legislature inadvertently provided a way for Dutch groups to avoid the thin cap rules without having to formally distinguish between the "nationalities" of the group companies. Also as a result of the group ratio test, the scope of the thin cap rules is limited to non-resident groups and group companies of Dutch groups which, for one reason or another, do not receive group tax treatment – as is the case, for example, with joint ventures (group tax treatment requires a 95% shareholding).

4.2.5. Cap

The amount of interest that is non-deductible under the thin cap rules may not exceed the balance of the total interest due to group companies (cap). This rule guarantees that interest paid to third parties is not caught by the thin cap rules. As in the safe haven test, the cap amount is determined on a net basis. For purposes of the safe haven test, the principal sums of all loans made and amounts borrowed are netted. In contrast, the cap is based on the balance of the interest paid and the interest received by affiliated entities. This is a profit and loss test rather than a balance sheet test. Moreover, only interest on loans between "related entities" is taken into account, not interest in general.[10]

Unfortunately for the taxpayer, when calculating the cap amount, external funds borrowed through an intermediary group company do not qualify as external loans; instead, using a form-over-substance approach, such loans are deemed to be related-party loans. Conversely, external loans covered by group guarantees may qualify as group loans based on the substance-over-form approach, which may give rise to particular difficulties in practice. The explanatory memorandum to the legislation indicates that an external loan guaranteed by a group company qualifies as an external loan only if and to the extent the company could have borrowed the principal on its own account, which may be difficult to prove in practice. The lack of guidance on which loans qualify as actual third-party loans and which do not complicates the taxpayer's ability to determine its potential exposure to the thin cap rules in actual cases.

The cap can be used to mitigate the disadvantage caused by undercapitalization. The restriction on deductibility may be narrowed through external borrowings and internal relending or by borrowing and relending with a positive interest spread. The interest spread can be increased by borrowing and relending in different currencies (e.g. arm's length interest rates produce a considerable spread if a loan is borrowed in Japanese yen and relent in euro). Although the cap ensues that, in effect, all third-party debt

9. This arises if a subsidiary is granted group tax treatment halfway through the financial year.

10. Entities are related if there is at least a one-third direct or indirect interest between them. This is the third definition of "group" that plays a role in the thin cap rules, i.e. for the thin cap rules to apply, the taxpayer must also be part of a group under the Dutch financial reporting law, and the group ratio test is based on a consolidated group under the Dutch or foreign financial reporting law.

remains fully deductible, third-party loans formally remain within the scope of the thin cap rules. Strictly speaking, the non-deductible interest should be allocated proportionally to all the interest paid. Allocating non-deductible interest to third-party loans results in an overly broad application when the thin cap interest deduction applies in conjunction with the interest temporization rules.[11]

4.2.6. Special rule for PEs

The thin cap legislation includes special rules applicable to foreign PEs of Dutch taxpayers. As the exempt PE income is calculated under Dutch rules, non-deductible interest incurred by a PE would actually give rise to a tax benefit. For example, if the interest is disallowed in calculating the PE's profits, the amount of the PE's profits exempt from tax in the Netherlands increases, thus increasing the reduction of Dutch tax granted as double taxation relief. A special provision in the thin cap rules prevents the rules from becoming a tax subsidy by limiting the non-deductible interest incurred by a PE to the amount of non-deductible interest taken into consideration by the taxpayer/entity of which the PE is a part. It remains possible, however, to fully neutralize a thin cap problem by allocating the non-deductible interest to a PE.

Not all the rules governing application of the thin cap rules have been made public. The legislature has given the State Secretary of Finance authority to issue additional regulations with respect to foreign PEs of Dutch taxpayers. It is unlikely that such foreign PEs will be put on a par with Dutch PEs of non-resident taxpayers since the delegation of authority does not pertain to Dutch PEs of non-resident taxpayers. Consequently, how the thin cap rules are applied to Dutch PEs of non-resident taxpayers is determined solely on the basis of the existing legislation. Unfortunately, there is no guidance in the legislation, and fundamental questions are left unanswered, such as whether undercapitalization should be determined on the basis of the balance sheet of the PE or of the company as a whole.[12]

4.3. Resolving a thin cap problem

Group companies must both detect and resolve potential Dutch thin cap problems. It will be a formidable challenge for groups with considerable operations in the Netherlands to establish in a timely way the parameters that constitute their thin cap position. Financial records do not distinguish between money loans and other types of debt. An early and reliable forecast of the entity's financial position at year-end is of vital importance. If such a forecast manifests a potential thin cap issue, it may be addressed in various ways. Non-resident multinationals may reinforce the equity position of their Dutch subsidiary by contributing another group company. In most cases, this can be accomplished without additional tax charges by applying the exemptions in the EC Merger Directive and the participation exemption. Other solutions may include:

- refinancing intercompany loans with external loans;
- repaying the money loans and increasing the other debts;
- selling assets to group companies for cash or for a purchase price that remains due as a money loan;
- leasing rather than purchasing assets;
- factoring accounts receivable; or
- securitizing assets.

As the Dutch thin cap rules provide specific reference dates, many of these transactions are expected to be concluded just before year-end. It will be difficult for the Dutch tax authorities to challenge such transactions under the abuse of law doctrine since the purpose of the thin cap rules is to encourage taxpayers to improve their capitalization ratios. The tax authorities, however, may potentially challenge a transaction if it improves the entity's capitalization ratio only for a very short period of time.

5. RESTRICTION ON LOSS CARRY-OVERS

The new rules on tax losses restrict the carry-over of tax losses where a taxpayer carries out almost exclusively holding or financing activities. The rules are designed to prevent *Bosal*-type claims by passive holding and financing companies from being used to shelter gains from active operations. The wording of the rules, however, is general and broad in scope.

The availability of tax losses in pure holding companies is to become a mere fiction. In substance, such losses serve no purpose because no taxable profit is realized from the holding company's activities due to the participation exemption. The restriction also applies to pure financing companies which, by their nature, do not benefit from the *Bosal* decision. Consequently, the possibilities for carrying forward "old" financing losses are now reduced.

According to the legislation, tax losses incurred by certain holding or financing companies may be carried over only if the following requirements are met:

- the losses are carried over to profit-making years in which the company carries out holding/financing activities ("activities requirement");[13] and
- the balance of intragroup receivables compared to the same balance in the loss-making year must not have increased ("receivables requirement"). This require-

11. When applying the cap rule, in substance, none of the interest on intercompany loans may be deducted. Part of the non-deductible interest, however, is to be allocated to third-party borrowings. The part of the interest on intercompany loans that is in substance not deductible, but in form unaffected by the thin cap rules, can be subject to further limitations under the interest temporization rules (Sec. 15ad CITA). In effect, the interest is subject to a limitation twice. The objective of both the thin cap rules and the interest temporization rules is to limit the deductibility of the interest on intercompany loans. If both rules are combined, however, the deductibility of part of the interest paid on third-party loans is also limited. This unintended consequence of the rules should be addressed in new legislation.

12. Given the purpose of the rules, it would seem that undercapitalization should be determined on the basis of the PE's balance sheet. The letter of the law, however, does not permit this. Moreover, in the Second Chamber, it was confirmed that the company's balance sheet should be taken as the basis, which is interesting (and confusing) because, in the First Chamber, it was firmly stated that the PE's balance sheet, not the company's balance sheet, should serve as the basis for determining undercapitalization.

13. If, however, more than 25 full-time employees carry out duties of a different nature, the company is not regarded as a holding/financing company under this provision.

ment does not apply if the balance of intragroup receivables was not increased for the purpose of offsetting outstanding losses.

The activities requirement is satisfied if 90% of the company's operations consist of holding and financing activities in any given year. A year does not qualify as a holding and financing year if a limited number of other activities was carried out in a relatively short period in that year. This may be advantageous in a year in which a loss is incurred since it precludes application of the loss carry-over restriction. It is disadvantageous in a profit-making year because the profit may not be offset by "old" holding and financing losses. For consolidated tax groups, whether the activities requirement is met is determined by reference to the tax group as a whole. Tax groups often comprise a holding and financing company and one or more operating subsidiaries. In general, relatively few activities are required for performing holding and financing functions. In such instances, the activities of the operating subsidiaries generally prevent the tax group from being classified as a holding and financing company. If a tax group has used such a structure for many years, the loss carry-over restriction will not have any consequences.

Under Dutch law, a tax group may include only domestic subsidiaries. Consequently, the loss carry-over restriction does not generally apply to holding companies with resident subsidiaries, but it does apply to Dutch holding companies with non-resident subsidiaries that cannot form part of a tax group.

The receivables requirement is very rigid. Although it prevents pure holding companies from using *Bosal*-type losses to set off new financing profits, it also limits the possibilities for loss carry-overs for companies that have carried out financing activities for years. It stands to reason that the intercompany receivables in such groups will have proliferated over time – if only for the need to reinvest the net profits. Nevertheless, loss carry-overs are not possible. Thus, these rules seem to overshoot their mark.

The question arises whether the loss carry-over restriction is contrary to EC law because the Member States should not be allowed to introduce laws that undermine a decision of the ECJ. In a 2003 case, *Weber's Wine World* (Case C-147/01), however, the ECJ stated that, if a Member State introduces a law that not only restricts the meaning of a decision but also has a real effect in the future, the law is not in conflict with EC law per se. This means that it remains unclear whether or to what extent the new law is consistent with EC law.

6. THE DUTCH THIN CAP REGIME AND EC LAW

The ink on the new thin cap legislation was barely dry when the first responses from tax practitioners hit the press. One of the most frequently raised questions was whether the thin cap rules are compatible with EC law. When the discussions first commenced, the government replied that the thin cap rules apply to both cross-border and domestic situations. This response is understandable considering that the ECJ case law endorses thin cap rules if they apply to domestic as well as cross-border situations (*Lankhorst-Hohorst* (Case C-324/00) 2002). In *Lankhorst-Hohorst*, the ECJ held that a tax treatment that differs depending on where a parent company is resident constitutes an obstacle to the freedom of establishment which is prohibited by Art. 43 of the EC Treaty. After *Lankhorst-Hohorst*, the German government (as well as the governments of several other EU Member States) amended their thin cap rules to apply to both domestic and cross-border transactions.

The *X & Y AB* case (Case C-200/98, [1999] ECR-I 8261) involved a rule whose effect was similar to the rule in *Lankhorst-Hohorst*. The rule at issue was a Swedish law governing the tax treatment of share transfers. Under the law, a transferor was denied a deferral of the capital gains tax on shares transferred at undervalue where the transferee company (in which the transferor had an interest) was established in another EU Member State. The ECJ concluded that provisions that treat an investment in a subsidiary in another EU Member State less favourably than a domestic investment are likely to have a deterrent effect on the exercise of the freedom of establishment and therefore violate Art. 43 of the EC Treaty.

The Dutch government learned from *Lankhorst-Hohorst* and *X & Y AB* that any legislation to mitigate the effects of *Bosal* must be neutral. No distinctions could be made with respect to whether interest is paid to a domestic parent or to a parent resident in another EU Member State. The government, however, failed to take account of certain aspects of Dutch tax law, one of them being the possibility of creating a fiscal unity between a Dutch parent and its Dutch subsidiaries. Under the fiscal unity rules, Dutch subsidiaries become part of the parent in such a way that transactions between the parent and the subsidiaries are invisible. The benefits of fiscal unity have been widely accepted and utilized. Because a fiscal unity is relatively easy to establish, it is obvious that, by utilizing this regime, application of the thin cap rules in a domestic situation is in fact illusory. In the authors' opinion, the Dutch situation is not much different from the situations in Germany and Sweden mentioned above. The only difference is that the rules in those countries constituted a direct infringement of EC law while the Dutch rules do not. An infringement of EC law arises only when other aspects of Dutch law are brought into play. This should not make a difference for purposes of EC law because the ECJ will scrutinize all effects of the law, not only the law itself, in determining whether the law contravenes EC law.

The thin cap regime also can be avoided in a domestic context by using hybrid loans. If, from a tax perspective, a loan from a parent to a subsidiary (not in a fiscal unity) is a hybrid loan (i.e. the interest is recharacterized as a dividend and is not deductible for the subsidiary), the participation exemption will apply if the parent has a qualifying participation in the subsidiary (see Art. 10(1)(d) CITA in conjunction with Art. 13(3)(b) CITA). Therefore, the recharacterization would not lead to any disadvantages.

It should be noted that the Interest and Royalties Directive has been applicable in the Netherlands from 1 January 2004. This Directive states that the EU Member States may not levy a withholding tax on outgoing interest, nor may they levy tax by assessment. The thin cap rules can be applied to challenge the disallowance of certain interest deductions; thus, the tax base will be relatively higher, effectively giving rise to higher taxation. In the authors' opinion, the result is the same as if tax were levied by assessment; thus, it may be possible to challenge the thin cap rules on this basis as well.

The discussion above demonstrates that, from a domestic perspective, Dutch companies will rarely have to contend with the thin cap rules. For this reason, the rules will probably have a shorter lifespan than anticipated by the government.

7. CONCLUSION

The *Bosal* decision is the latest in a line of cases requiring the EU Member States to re-evaluate their tax policies. This article has, among other things, demonstrated some of the deficiencies of, and loopholes in, the new thin cap rules in the Netherlands. Nevertheless, at least for the time being, this is the regime that applies in the Netherlands. It is, in effect, a regime that may actually create opportunities for groups operating internationally.