

Fundamental freedoms, intra-group loans and the fight against tax avoidance: the Court of Justice clarifies the *Lexel* case doctrine

In the Judgment of 4 October 2024, X BV (C-585/22), the Court of Justice clarifies the position adopted in the *Lexel* case (C-484/19) and concludes that compliance with the arm's length principle does not protect intra-group transactions that do not reflect economic reality from being categorised as a wholly artificial arrangement.

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1. Introduction

The Court of Justice, in its recent judgment of 4 October 2024, X BV (C-585/22), has addressed the compatibility with the freedom of establishment (Article 49 TFEU) of national tax legislation under which a taxpayer's debt incurred through a loan granted by a related entity, connected with the acquisition or extension of an interest in another entity, is presumed – subject to rebuttable – to constitute an artificial arrangement

and therefore disallows the deduction of interest paid from the taxable corporate income.

Although the Court reiterates, as in previous decisions, that anti-abuse measures aimed at preventing tax avoidance may justify restrictions on fundamental freedoms, the interest and relevance of this judgment lies in the fact that the Court qualifies and clarifies the position set out in the judgment of 20 January 2021, *Lexel* (C-484/19),

on whether intra-group loans can be categorised as wholly artificial arrangements, even if they are granted on an arm's length basis and interest is set at the normal market rate, which shows a stricter approach to cross-border tax planning.

2. Background

The facts at the origin of the main proceedings are, in summary, as follows: X is a company incorporated under Dutch law which belongs to a multinational group of companies. That group includes, inter alia, companies A and C, both established in Belgium. A is the sole shareholder of X and the majority shareholder of C. In 2000, X acquired the majority of the shares in a company incorporated under Dutch laws, in which A acquired the remaining shares. X financed that acquisition by means of loans contracted with C, which used for that purpose own funds obtained through a capital contribution made by A.

In the corporate income tax assessment notice addressed to X for 2007, the Netherlands State Secretary for Finance refused to deduct the interest paid by that company to C. Dutch tax law in force at the material time did not allow the deduction of interest paid on intra-group loans used for the acquisition or extension by the taxpayer of shares in entities which became related entities as a result of the acquisition or extension. However, by way of exception, it allowed the interest paid to be deducted if the taxpayer proved (a) that the loan and the legal transaction to which it was linked were conclusively based on economic grounds, or (b) that the creditor of the interest was taxed on it at a tax which taxed the income in a reasonable manner, that is to

say a tax which carries a tax rate of at least 10 % of the taxable income determined in accordance with Dutch law.

The Dutch Supreme Court asks the Court of Justice whether freedom of establishment precludes national legislation such as that described above, which refuses in full the deductibility of financing costs where the debt is considered to constitute a wholly artificial arrangement or is part of such an arrangement, even if that debt was incurred out on an arm's length basis and the amount of that interest does not exceed that which would have been agreed between independent undertakings.

3. The Court's reply

The Court's reasoning is, in summary, as follows:

- The Dutch legislation at issue may indeed entail a difference in treatment having a dissuasive effect on the exercise of freedom of establishment if, under the Dutch tax system, a tax at a rate of less than 10% were not applicable, so that that condition, apparently used objectively and indistinctly in national and cross-border situations, would affect only cross-border situations, a matter which it is ultimately for the national court to assess.
- National and cross-border situations are comparable in the light of the objective of the national legislation at issue, which is none other than to confer the possibility of deducting, in the context of the determination of profit, interest on debts due to a re-

- lated entity - whether or not they are established in the same State - only where that interest is not artificially generated.
- Although the Dutch tax legislation at issue may lead to a difference in treatment which has an adverse effect on freedom of establishment, the restriction created is justified by the need to prevent tax fraud and avoidance. The Dutch legislation seeks to “prevent a group’s own funds from being presented, in a contrived manner, as being funds borrowed by a Netherlands entity of that group and the interest on that loan from being deducted from the taxable profit in the Netherlands”. That objective also applies to cases where, as in the present case, an entity becomes an entity related to the same taxpayer only following the acquisition or extension.
 - The contested legislation is suitable and does not go beyond what is necessary to attain the objective pursued. The possibility for the taxpayer to rebut the presumption that interest paid on loans granted by a related entity for the purpose of acquiring or extending a holding in another entity constitutes an artificial arrangement makes it possible to limit the refusal to deduct loan interest “solely to situations in which the loan within a group of connected companies is dictated by tax reasons to such an extent that that loan is not necessary for the attainment of economically justified objectives and where it would not have been contracted at all between entities which have no special relationship”.
 - Nor does the total denial of the right to deduct go beyond what is necessary to achieve the objective pursued. Where the artificial nature of a given transaction results from an exceptionally high rate of interest on such a loan which, moreover, reflects economic reality, the principle of proportionality requires the deduction of the proportion of interest paid which exceeds the normal market rate. By contrast, where the loan is, in itself, devoid of economic justification and, but for the relationship between the companies and the tax advantage sought, would never have been contracted, it is consistent with the principle of proportionality to refuse the deduction of the whole interest.
- However, as already stated, the most important aspect of that decision is that the Court of Justice clarifies and clarifies what was held in the *Lexel* case. In that judgment, the Court held that “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” (para. 56). The referring court questions whether, on the basis of that statement, it is possible to conclude that transactions consisting in contracting debts with an entity connected to the taxpayer do not, by definition, constitute purely artificial arrangements if they have been carried out on an arm’s length basis. The Court, following the recommendation of Advocate General Emiliou, rejects that inference and emphasises that the examination of compliance with arm’s length conditions relates not only to the terms of the loan contract relating, in particular, to the

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amount or the interest rate, but also to the economic sense of the loan at issue and the related legal transactions. The latter examination involves verifying the economic validity of that loan and the related legal transactions, by ensuring that such transactions could have been concluded between the companies party to the contract in the absence of a special relationship. This amounts to ascertaining the economic reality of the transactions whose absence constitutes one of the decisive factors in classifying a purely artificial arrangement transaction. An examination of the formal conditions of the transactions alone is not sufficient to assess the economic reality of a given transaction.

4. Conclusions

In the light of this judgment, compliance with the arm's length principle does not constitute a 'safe harbour' that protects intra-group financial transactions that have no economic or commercial justification from being regarded as a wholly artificial arrangement. The Court's emphasis on the economic substance of transactions over formal compliance with transfer pricing rules is indicative of a stricter approach to cross-border tax planning, which underlines the importance of sound documentation clearly demonstrating the commercial

justification for cross-border intra-group transactions.

In Spain there is a similar rule in Article 15h of the Corporate Income Tax Act which prevents the deduction of financing costs arising from debts owed to entities in the same group intended to acquire, from other group entities, shares in the capital or equity of any type of entities, or to make contributions to the capital or equity of other group entities, unless there are valid economic reasons for carrying out such transactions. Although the Spanish rule differs from that analysed in the judgment under discussion, the Court's ruling may serve as a point of reference in the interpretation of those situations that fall within the scope of the aforementioned Article 15h of the Corporate Income Tax Act or which, not falling within the literal scope, may raise the question, for example, in cases in which the acquisition is made from a third party and not from a group entity.

However, it can be understood that, as the *Lexel* judgment makes clear, intra-group financial transactions that are genuine or that reflect economic reality are protected by EU law, even in cases where a tax optimisation strategy is present.

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