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Should the Court of Justice reconsider the Lexel decision?

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The opinion of AG Emiliou in X BV v. the Dutch Ministry of Finance (C-585/22)

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Can a transaction entered into between two associated parties, which is concluded on arm's length terms, be abusive? Does compliance with the arm's length requirement provide "a transfer pricing safe harbour for primary EU law"?[2]

On March 14, 2024, AG Emiliou delivered an opinion in response to the request of the Dutch Supreme Court for a preliminary ruling (C-585/22). The request concerned the interpretation of the judgement in *Lexel* (C-484/19), which centered on Sweden's interest-limitation provision, and which sparked a discussion about the compatibility of the similar Dutch interest-limitation rule contained in article 10a Corporate Income Tax Code (**CITA**) with the freedom of establishment.

AG Emiliou urged the Court "*to revisit the approach it took in the judgement in Lexel*".[3] He concluded that the EU freedom of establishment does not preclude national legislation, which denies the interest deductibility in an intra-group loan transaction motivated "*not by commercial considerations, by the objective of creating a deductible debt*", even if the interest rate imposed in the arrangement is at arm's length.

While acknowledging, in alignment with the AG opinion, that the arm's length principle (**ALP**) should not serve as the proportionality standard for some types of interest limitation rules, this article explores the possibility of the ALP being suitable in certain contexts, rather than being completely disregarded.

The judgement in *Lexel* (C-484/19)

In this case, Lexel AB, a Swedish company, was denied the deduction of interest paid to a French internal bank for a granted loan. The loan was intended for Lexel AB to acquire 15% of the shares in a Belgian group entity from a Spanish group entity. The rationale behind the share ownership transfer between the two group entities was explained by the need of the Spanish subsidiary for financial resources to acquire an external target.

Under Swedish legislation, interest expenses are typically not deductible for loans between

associated parties unless the corresponding interest income is taxed at a nominal rate of at least 10% in the recipient country (**10% rule**). However, exceptions exist, such as when the debt is not primarily aimed at obtaining a significant tax benefit. Furthermore, even if the 10% rule does not apply, interest may be deductible if the taxpayer can demonstrate commercial justifications for the loan.

The Swedish Tax Agency denied the deductibility of interest on the loan from the French internal bank to Lexel AB, arguing that the loan's primary purpose was to generate deductible interest expenses in Sweden rather than in Spain, despite France having a substantially higher nominal corporate tax rate.[4] They argued that the French bank could have directly granted the loan to the Spanish subsidiary for the external target acquisition.

The Court concluded that the restriction on cross-border loan transactions was not justified, particularly in the context of combating tax evasion and abuse. This was because the exception did not exclusively target purely artificial or fictitious arrangements.[5] To focus solely on artificial arrangements, the Court suggested 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."[6]

In the aftermath of the *Lexel* judgement

In 2022, the EFTA Court's judgment in the *PRA Group Europe AS* provided that the Norwegian earning stripping rule (equivalent to Article 4 EU Anti-Tax Avoidance Directive ("**ATAD**")) "*covers both artificial and arm's length arrangements, offering no distinction… and their specific purpose is not solely to counteract purely artificial constructions*." [7] The Court followed the judgement in *Lexel* to conclude that without an opportunity to demonstrate that the transaction took place on arm's length terms, the Norwegian earning stripping rule went against what is necessary to achieve the legitimate objective of preventing wholly artificial arrangements leading to tax avoidance.[8]

Both the judgements in *Lexel* and *PRA* faced criticism in academic and professional circles for establishing an ALP-based safe harbor for multinational enterprises, thereby posing greater challenges for Member States to effectively enforce anti-abuse and anti-mismatch domestic provisions. [9] AG Emiliou echoed this sentiment in his opinion, affirming that the consequence of the *Lexel* judgment is that "*the arm's length principle would, effectively, be turned into an undesirable 'safe harbor' for multinational groups*." [10]

Given these developments, should the Court reconsider the ALP as the proportionality standard for anti-abuse provisions restricting freedom of establishment?

Can an arm's length transaction be abusive?

At the outset, it has to be emphasized that the goal of the ALP is not only to put "a price tag" on the transaction between two related parties. A transaction is deemed to comply with the principle when all its conditions, such as loan terms, for instance, align with the commercially rational behavior expected between two independent entities.

The Commentary on Article 9 of the OECD Model, for instance, specifically addresses an interplay between the ALP in tax treaties and rules on thin capitalization. Similar to the Courts' conclusions

in *Lexel* and *PRA*, the commentary states that Article 9 of the OECD Model does not prevent the domestic thin capitalization rules insofar as their effect is to assimilate the profits to an amount corresponding to an arm's length profit. It further stipulates that Article 9 of the OECD Model 'is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length but also whether a prima facie loan can be regarded as a loan'.[11]

In *Thin Cap Group* litigation, in which the Court established the ALP as a proportionality criterion for tackling purely artificial loan arrangements, it further clarified that 'in order to determine whether the transaction…represents, in whole or in part, a purely artificial arrangement, … the question is whether, had there been an arm's length relationship between 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"* (emphasis added).

AG Emiliou in *X BV* underlined that intra-group loans lacking valid commercial or economic justification, primarily aimed at creating a deductible debt in the borrowing company's jurisdiction, constitute wholly artificial arrangements, irrespective of "whether or not they are carried out on an arm's length basis."[12] Yet, following the ALP as an established principle in international taxation and the Court's decision in *Thin Cap Group Litigation*, to comply with the ALP as a proportionality standard, a loan transaction must satisfy all the three elements described above, including a commercial justification for a loan.

Commercial justification for a loan and the arm's length principle

Returning to the circumstances of the loan transaction in *Lexel*, would an independent party typically secure a loan and undertake the accompanying financial obligations for the purpose of acquiring shares from another entity to assist that entity in raising financial resources? The answer seems straightforward – while the loan might have been justifiable for group-related reasons, its commercial rationale did not align with the ALP.

In fact, the standard of commercial rationality under the ALP as a proportionality criterion is even more stringent than the standard allowing for "any commercial justification" for transactions deemed purely artificial. In the *Hornbach-Baumarkt* case (C-382-16), for example, the Court ruled that the principle of proportionality mandates that a taxpayer should also have the opportunity to provide a commercial justification for transactions not conducted at arm's length, particularly when no interest is charged on a loan.

The Court noted that "*in a situation where the expansion of the business operations of a subsidiary necessitates additional capital due to insufficient equity capital, there may be commercial reasons for a parent company to agree to provide capital on non-arm's length terms*." [13] If group-related reasons can justify capital provision without an interest charge on non-arm's length terms, could similar reasons justify a loan (which would not otherwise be extended between independent parties) at an arm's length interest rate? While the Court's case law does not explicitly answer this question, an affirmative answer seems likely, provided the transaction is not solely motivated by tax considerations and does not result in tax avoidance.

Should the ALP be a safe harbour?

Drawing from the points above, a transaction conducted at arm's length is inherently non-abusive. The ALP should not be narrowly viewed as solely dictating that the applicable interest rate must align with market value, but rather as a guiding principle ensuring that related parties behave in a

commercially reasonable manner. In the context of loan arrangements, this entails scrutiny of the loan amount, interest rate, and the characterization of the transaction as a loan.

However, this conclusion does not entail that the ALP is always suitable as the sole proportionality criterion for interest-limitation rules. This is primarily because the ALP ideally operates on a transaction-by-transaction and entity-to-entity basis. [14] Accordingly, in principle, it is not the function of the ALP to assess the transactions preceding a loan arrangement but rather to assess whether there were genuine commercial reasons for the one tested transaction and whether independent parties would have engaged in the transaction under similar terms.

The Dutch and Swedish interest-limitation rules instead adopt a broader approach to tackling abuse, focusing not only on individual transactions but on the entire arrangement leading to those transactions. The AG in *X BV*, in this regard, emphasizes the importance of examining the overall structure and apparent purpose of the arrangement encompassing the loan. The critical inquiry involves assessing whether the arrangement's structure appears unnecessarily complex and whether it includes steps that seem superfluous except for their impact on the tax liability. ***[15]***

Indeed, analyzing the entire structure leading to a transaction is not the primary function of the ALP. Therefore, if the overall arrangement is deemed artificial but an isolated loan transaction within it is genuine, the ALP should not offer a safe harbor against tax avoidance.

The question, however, is whether and under what circumstances the ALP should still function as a proportionality criterion.

Different interest limitation rules, same proportionality principle?

Interest limitation rules vary in their technical details and objectives. Some are designed primarily to address specific tax avoidance arrangements, such as those in the Netherlands and Sweden discussed in this article. Others, like the earning-stripping rule in the *PRA* case (similar to Article 4 ATAD), have a broader scope and target base erosion without considering taxpayer motives or arbitrage effects.[16] Additionally, there are interest limitation rules aimed at addressing debt-to-equity arbitrage in financial transactions, as seen in the *Thin Cap Group Litigation*.

While the ALP can be at certain instances a proportionality criterion, it is not a one-size-fits-all standard for all types of interest limitation provisions. In cases where an interest limitation rule pertains specifically to the circumstances of a loan transaction and the artificial elements within that transaction (such as interest rate, loan amount, characterization of the loan, and arm's length commercial reasons), the ALP, in its broad substance, can be applied as a proportionality test. In such instances, denying interest deduction *in full* may appear disproportionate. This approach would also align with the ALP as outlined in tax treaties of Member States based on the OECD Model.

However, when the artificiality extends beyond the terms of the transaction to encompass the overall structure leading to the loan, the ALP is indeed an unintended safe harbor for tax avoidance**.**

Burden of proof

Lastly, AG Emiliou addressed the allocation of the burden of proof between the tax authorities and the taxpayer. The AG concluded the following:

"*In the present case, Article 10a(1)(c) of the Law on Corporation Tax, and the obligation for the taxpayer to justify that the arrangement in question is genuine, apply, in principle, only in cases where an intra-group loan has been concluded by a taxable entity with a related entity established in another Member, in which the interest charges collected by the latter are not taxed, or not taxed at a reasonable rate. Those specific circumstances can legitimately be regarded as indications of conduct that might amount to abusive tax evasion, justifying a reversal of the burden of proof.*'' '[17]

In the author's opinion, it is a too far-stretched conclusion to argue that no effective taxation of the interest income at a reasonable rate in a cross-border transaction is an indicator of abusive tax evasion. In case of the effective tax rate applied to the interest income being lower than "a reasonable rate", its lower taxation, for example, due to offsetting the income against losses of the lender does not directly relate to any artificiality elements described above. Lower taxation *per se* is not an indicator of abuse; but only when it is combined with other objective evidence about allegedly artificial structuring of the transaction or an arrangement in its whole.

Conclusion

It would be a significant and constructive step for the Court, in alignment with the opinion expressed by AG Emiliou, to provide further clarification on the substance of the ALP as a proportionality criterion and delineate the specific circumstances in which the ALP may remain applicable. An interesting development would be for the Court to deliberate on the proportionality of a reversal of the burden of proof concerning the Dutch interest limitation rule.

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[2] de Wilde, M. F., & Wisman, C. (2022). After CJEU Now EFTA Court Too Embraces Arm's-Length Standard as a Beacon; What's Next?. *What's Next.*

[3] Para 71, AG Emiliou Opinion in *X BV v. the Dutch Ministry of Finance*, C-585/22.

[4] Para 22, *Lexel AB v Skatteverket*, C-484/19.

[5] Id, para 56.

[6] Id.

[7] Para 57, EFTA, *PRA Group Europe AS*, E-3/21.

[8] EFTA, *PRA Group Europe AS*, E-3/21, answers to the questions referred.

[9] de Wilde, M. F., & Wisman, C. (2022), *supra* n 2.

[10] Para 80, AG Emiliou Opinion, C-585/22.

[11] Para. 2 of the OECD commentary on article 9 concerning the taxation of associated enterprises.

[12] Para. 83, AG Emiliou Opinion, C-585/22.

[13] Para. 54, *Hornbach-Baumarkt*, C382-16

[14] Transfer pricing in practice: conclusions drawn from a recent Supreme Court decision / Author: Herksen, M. van; Lande, M. van der, p. 195; R.S. Collier & I.F. Dykes, On the Apparent Widespread Misapplication of the OECD Transfer Pricing Guidelines: Risk and Post-BEPS Problems for the Arm's Length Principle, 76 Bull. Intl. Taxn. 1 (2022), Journal Articles & Opinion Pieces IBFD (accessed 12 Apr. 2024), at sec. 3.4.2.

[15] Paras. 90-91, AG Emiliou Opinion, C-585/22.

[16] A. Zalasin?ski, Norwegian Interest Limitation and the EEA Right of Establishment: Comments on the EFTA Court's Decision in PRA Group Europe AS (E-3/21), 63 Eur. Taxn. 1 (2023), Journal Articles & Opinion Pieces IBFD (accessed 12 Apr. 2024), sec. 4.3.

[17] Para 98, AG Emiliou Opinion, C-585/22.

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