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By PwC Deutschland | 31 March 2022

ECJ: Withholding tax on notional interest in case of interest-free loans compatible with EU law

In a Bulgarian case the European Court of Justice (ECJ) held that EU law does not preclude national legislation imposing withholding tax on notional market-based interest (mandated under local tax anti-avoidance rules). Such withholding tax cannot be exempt under the regimes of the IRD (EU Interest - Royalty Directive 2003/49/EC) and the PSD (EU Parent-Subsidiary Directive 2011/96/EU) as there have been no actual payments of interest.

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Background

In the case of dispute, a Bulgarian company received an interest-free convertible loan with a 60-year maturity from its EU-based sole shareholder. Under the loan arrangement, the Bulgarian borrower could waive the obligation to repay the loan if at any time after the date of financing the outstanding loan is converted into capital of the Bulgarian subsidiary. Pursuant to the Bulgarian tax regulations interest-free loans and loans deviating from the relevant market conditions are considered tax avoidance by way of an irrebuttable presumption. Hence, the Bulgarian tax authorities assessed 10% withholding tax on a notional market interest that should have been payable to the shareholder.

ECJ decision

The ECJ noted that there was unequal treatment here, which constitutes a restriction on the free movement of capital pursuant to Art. 63 TFEU. However, this infringement is justified in the opinion of the court since retention at source is a legitimate and appropriate means of ensuring the tax treatment of the income of a taxable person established outside the State of taxation and an appropriate measure to prevent tax evasion.

The ECJ went on to say that EU Member States may adopt measures to prevent and combat of tax evasion/tax avoidance, as far as these are proportionate and justifiable in terms of the objectives to be achieved. This includes taxation at source of notional interest on interest-free loans granted by foreign companies or foreign shareholders. As far as the Bulgarian case is concerned the ECJ pointed out that this national legislation must therefore be regarded as capable of safeguarding a balanced allocation between the Member States of the power to impose taxes and ensuring the effective collection of tax in order to prevent tax avoidance.

On the question whether the Bulgarian legislation goes beyond what is necessary to achieve those objectives, Viva Telecom Bulgaria claimed that the duration of the recovery procedure provided for in the statutes is excessive, since a possible refund of excess withholding tax paid by a resident company on the gross amount of notional interest relating to an interest-free loan granted by a non-resident company may occur only after three years have elapsed. However, subject to the checks to be carried out by the referring court, it is apparent to the ECJ from the explanations provided by the defendant that such refund is made, as a general rule, within a period of 30 days from the date on which the application was made and that it is only in exceptional cases that the procedure may last up to three years. In light of the duration of the general recovery procedure taking up to 30 days, the Bulgarian legislation does not appear to go beyond what is necessary to attain the objectives that it pursues.

Source:

The ECJ case reference is C?257/20 *Viva Telecom Bulgaria* judgment of 24 February 2022. - The complete ECJ-decision to be found **here**.

Keywords

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interest-free loan, notional interest, notional tax