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Government Relaxes Thin Capitalization Rules

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COUNTRY DIGEST

Government Relaxes Thin Capitalization Rules

On December 4 the Dutch government published a policy statement[1] that relaxes the soon-to-be-abolished thin capitalization rules. The policy changes, which relate to the election to apply the group ratio test, took effect on December 4.

The thin cap rules, which were added to the Dutch Corporate Income Tax Act with effect from January 1, 2004, will be abolished as of January 1, 2013, or if a taxpayer's tax year is not the calendar year, the first day of the first financial year starting after January 1, 2013. (For prior coverage, see *Tax Notes Int'l*, Oct. 1, 2012, p. 34, *Doc 2012-19630*, or *2012 WTD 184-2*.)

The thin cap rules limit the deductibility of interest costs if a borrowing company is considered excessively debt financed. The limitation only applies to the extent that the interest costs relating to the excessive debt financing can be considered to be because of affiliated parties. Whether a taxpayer qualifies as excessively debt financed is determined, in principle, on the basis of the fixed ratio of 3 to 1.

A taxpayer may elect to apply a group ratio test instead of the fixed ratio test. Under this alternative test, a company does not qualify as excessively debt financed if the taxpayer is not more highly leveraged than the overall group to which it belongs. In principle, the group ratio test is to be applied using data derived from the taxpayer's financial statements and the group's overall consolidated financial statements.

Group Ratio Test

The Dutch Supreme Court has ruled that in some circumstances the thin cap rules also apply if no consolidated group financial statements are prepared. In the relevant case (No. 10/01719, Nov. 18, 2011), the Dutch taxpayer argued that one of the conditions for applicability of the thin cap rules is that the Dutch taxpayer is part of a group for Dutch corporate law purposes and that in the absence of consolidated financial statements, no such group should be deemed to exist. The Supreme Court ruled that the existence of a group (for Dutch corporate law purposes) needs to be determined based on the criteria laid down in the relevant provision. The Court deemed it irrelevant that the Dutch accounting rules — which refer to the same criteria to be applied for Dutch corporate law purposes — provide an exemption from the obligation to prepare consolidated financial statements.

Obviously, non-Dutch accounting rules that a nonresident member of a Dutch group may be subject to may apply totally different criteria to determine whether consolidation needs to occur at the level of that (higher-tier) entity. That will not affect the outcome of the analysis of whether the foreign entity should be considered a member of the same group for Dutch corporate law purposes.

Without consolidated financial statements at the level of the head of the group, there seems to be no basis for a Dutch taxpayer to elect for the group ratio test. After all, the group ratio is to be derived from data included in the group's consolidated financial statements.

The Dutch state secretary for finance has determined that this is unreasonable and that in such a case the purpose and scope of the group ratio test justifies the determination of the group ratio as if consolidated financial statements had been prepared.

Election to Apply Group Ratio Test

The thin cap rules state that the election for the group ratio test, which can be made for each separate year, should be made in the tax return for the relevant year. In principle, no election can be made after the assessment for the relevant tax year has become final. In a deviation from previous policy, taxpayers may now submit a request for an ex post facto reduction of the Dutch corporate income tax assessment for a given year if it appears (after the assessment has become final) that erroneously no election was made.

It should be noted that the state secretary for finance believes that it is always advantageous to elect the group ratio test if the group ratio exceeds the fixed

[1]No. BLKB2012/1642M.

ratio of 3 to 1. This is not necessarily true since different principles will be applied to determine the level of debt financing obtained by a Dutch taxpayer. For example, when determining the relevant debt amount, netting is allowed when applying the fixed ratio test, which is not the case with the group ratio test.

The state secretary for finance considers it important that the election for the group ratio test is made solely for the relevant year. If in a subsequent year the group ratio is lower than the fixed ratio, the group ratio does not need to be selected again. Also, there are no potentially adverse tax consequences from electing for the higher group ratio. In the view of the state secretary for finance, this means that not opting for the higher group ratio must be explained by a mistake made by, or on behalf of, the taxpayer. Therefore, taxpayers now have the option to request an ex post facto reduction in these cases. Such requests must to be submitted to a centralized department within the Dutch tax authorities. ◆

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