

Interest Components of Earn-Out Payments Ruled Not Deductible

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Reprinted from *Tax Notes Int'l*, February 18, 2013, p. 649

COUNTRY DIGEST

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The Dutch Supreme Court on February 8, in Decision No. 12/03657, ruled in favor of the Dutch tax authorities and held that the deemed interest component of earn-out payments made by a corporate taxpayer in connection with the acquisition of a share interest in another entity is not tax deductible.

The Court confirmed the June 19, 2012, decision of the High Court of Arnhem (No. 11/00415), in which the court held — following an April 14, 2011, decision of the Lower Court of Arnhem — that the deemed interest component of earn-out payments for the acquisition of a shareholding that qualifies for the participation exemption is taxed in the same manner as the earn-out payments. To the extent that these payments are not treated as part of the purchase price of the shares, they fall within the scope of the participation exemption and are therefore nondeductible.

Facts of the Case

On May 31, 2006, X BV purchased all the shares in the share capital of A BV (the participation) from B Management BV (the seller). X BV and the seller agreed on a purchase price consisting of a base price and a number of (possible) earn-out payments that were dependent on the cumulative results achieved by the participation from 2007 through 2013 (and on whether specific employment relations would be continued). The total (ultimate) purchase price, including the future earn-out payments, would fall within a specific range; a minimum and a maximum price were agreed between X BV and the seller. If the 2006 result of the participation were negative, the minimum price would be adjusted downwards, which in fact happened.

The shares in the participation qualified for the participation exemption. As a consequence, all benefits — dividends, capital gains, and capital losses (except for some liquidation losses) — that X BV would obtain from these shares would be exempt from Dutch corporate income tax. Under the 2006 participation exemption rules, if a shareholding or a part thereof is sold or acquired at a price that wholly or partly consists of a

right to one or more installments of which the total number or size in the year of disposal or acquisition is not yet known, any change in value of that right in the hands of the alienator, and any change in the value of the corresponding obligation of the acquirer, fall within the scope of the participation exemption. The same treatment applies to any adjustment made to the initially agreed purchase price for the shares.

In 2006 X BV included the participation in its Dutch tax books for an amount that was equal to the sum of the base part of the (adjusted) purchase price and the net present value of the estimated future earn-out payments. A corresponding liability for (the payment of) the net present value of the earn-out payments was also included in the tax balance sheet. The net present value of the earn-out payments was calculated applying an annual notional interest of 5 percent taking into account the (adjusted) minimum purchase price and the estimated future (profit-dependent) payments. At the end of 2006, the payment obligation was increased with the amount of the interest accrual relating to that year. X BV claimed a tax deduction for the accrued interest in 2006. The tax authorities denied the deduction.

Supreme Court Decision

The Dutch Supreme Court held, in line with the lower courts' rulings, that the Dutch tax authorities were correct to deny the deduction. The Court said it followed from the legislative history that the participation exemption rules on identical tax treatment of changes in value of a right to (potential) future installments of a purchase price in the hands of an alienator and the corresponding obligation in the hands of the buyer were intended to prevent the seller and buyer from applying different estimations of the initial right and the corresponding initial obligation.

Otherwise, in light of the tax deduction that would arise for the buyer should the value of the obligation increase, and the tax claim that would arise for the seller if the corresponding right value went up, the buyer would be inclined to estimate the initial obligation as low as possible while the seller would be inclined to estimate the corresponding initial right as high as possible. This system, estimation of the initial

right and (taxable) adjustments afterwards, applied for tax years before 2002 and led to many discussions and case law (the so-called estimation case law). By excluding the changes in value from the profits on which Dutch corporate income tax is imposed, any discussion about the correct value of the right and the corresponding obligation is avoided. It was explicitly confirmed during parliamentary proceedings (Second Chamber 2001/02, 28 034, No. 3, p. 29) that the exclusion from taxable profits, due to the applicability of the participation exemption, also applies to changes in value caused by currency exchange fluctuations and to accounting for deemed interest accrual.

In its decision, the Supreme Court held that if, as in this case, part of the purchase price consists of a right to one or more installments of which the total number or size is not yet fixed in the year of sale or acquisition (but a certain minimum amount has been agreed to), then the total number of installments is still not fixed, nor is the total amount that is ultimately received or paid for this right or obligation. After all, in this case, it was uncertain when this minimum amount would become payable and the ultimate total purchase price could exceed the agreed minimum amount. The Supreme Court held that in such a case, in light of the

purpose of the relevant rules, the participation exemption also applies to the agreed minimum amount and to the notional interest component included therein.

Comments

In light of the Supreme Court's considerations, it is likely the decision on the interest component attributable to the minimum purchase price would have been different had the minimum purchase price agreed to between X BV and the seller been payable on a specific date or dates, so that the earn-out arrangement would only have concerned any excess purchase price (that is, the part on top of the agreed minimum purchase price). In that case, the relevant interest component would not have fallen within the scope of the relevant participation exemption rules and would have constituted costs for which X BV could have claimed a tax deduction. Meanwhile, in the seller's hands, the relevant interest component would have been taxable, assuming that the seller is a resident taxpayer for Dutch corporate income tax purposes. ♦

♦ *Anton Louwinger, tax partner, Hogan Lovells International LLP, Amsterdam*