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PRACTITIONERS' CORNER

New Dutch Rules on the Deductibility of Interest on Participations

by Anton Louwinger

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On July 9 the upper house of the Dutch parliament approved a tax bill of law that introduces an additional restriction regarding the tax deductibility for Dutch corporate income tax purposes of financing costs connected with the acquisition of, and the investment in, qualifying participations in subsidiaries.[1]

Under the current corporate income tax rules, benefits (dividends and capital gains) regarding a qualifying participation are generally exempt from Dutch corporate income tax based on the participation exemption, whereas the connected financing costs may be fully deductible for the holder of the participation (if the holder is a taxpayer for Dutch corporate income tax purposes) within the boundaries set by the general thin capitalization rules, certain anti-base-erosion rules, and financing conduit rules.

Purpose of New Rules

The new rules will limit the tax deductibility of excessive interest and related costs for loans attracted to finance the acquisition of, and the investment in, qualifying participations.

This additional limitation aims to stop a taxpayer's tax base from being eroded through (presumed) excessive debt financing of the taxpayer's participations in other entities. In this respect, a ''participation'' is defined as an asset that falls within the scope of the participation exemption. This is not limited to a qualifying shareholding in another entity, but also includes options over such qualifying shares and hybrid loans granted to a specific group of borrowers.

Under the current rules, international groups are able to erode a Dutch company's tax base by having the company, or a company joined in the same Dutch corporate tax group (fiscal unity) as the operating company, act as an acquisition vehicle for both new participations or existing participations. The erosion of the tax base occurs through debt financing by the Dutch company of its investment in the participation. There is currently no need for the Dutch company to be organizationally involved with a participation in order to be entitled to the benefits of the participation exemption and to be able to deduct the connected financing costs, although some anti-base-erosion rules already target perceived abusive structures.

The new rules are designed to ''only'' affect the tax deductibility of interest and related costs that correspond with that part of the debt financing that qualifies as excessive. Such affected interest and related costs are referred to as ''participation interest'' that, with effect from financial years starting on or after January 1, 2013, will no longer be tax deductible for Dutch taxpayers if and to the extent that this participation interest qualifies as ''excessive participation interest.'' This will be the case if and to the extent that the participation interest exceeds an annual threshold of €750,000.

[1] Law of July 12, 2012, to amend certain tax laws and certain other laws (Act implementation tax measures Budget Agreement 2013) (*Wet van 12 juli 2012 tot wijziging van enkele belastingwetten en enige andere wetten* (*Wet uitwerking fiscale maatregelen Begrotingsakkoord 2013*)).

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For purposes of the new rules, ''interest and related costs'' include costs and results of instruments that are intended to hedge:

- the interest rate exposure for loans and similar contracts; and
- currency exchange exposures for interest payments on such loans or similar contractual arrangements (such as financial leases and hire purchases).

Results and costs for currency exchange hedges relating to the principal amount of a loan and similar contractual arrangements fall outside the scope of the new rules. This is in line with the treatment of currency exchange results regarding the principal amounts of these loans and similar contractual arrangements — these are also not covered by the new rules.

Participation Debt

In order to calculate the amount of the excessive participation interest costs, the amount of the so-called participation debt must be determined first. This participation debt is the amount of debt obtained by the taxpayer that, based on the obligatory allocation rules, is deemed to be connected with the qualifying participations held by the taxpayer. The amount of the participation debt is equal to the difference between:

- the average acquisition prices of the qualifying participations in a given tax year; and
- the average amount of the equity of the taxpayer in that same tax year.

If and to the extent the average acquisition prices of the participations exceed the average amount of equity of the taxpayer, the taxpayer's debt is treated as participation debt. However, the amount of the participation debt cannot be higher than:

- the amount of the recognized loans (and similar contractual arrangements) entered into by the taxpayer; and
- the sum of the acquisition prices attributable to all relevant recognized participations.

For purposes of the new rules, it will not be relevant how the investment in a specific participation was actually financed (debt or equity); the allocation rules are the only criteria to be applied. During parliamentary discussions it has been clarified that the scope of these allocation rules does not go beyond the scope of the new interest deduction rules. Also, liabilities other than loans and similar contractual arrangements are not taken into consideration and cannot qualify as participation debt.

Recognition of Debt

The new rules concern both loans from affiliated parties and third-party loans. However, not all loans and similar contractual arrangements are taken into account. Under the new rules, loans and similar contractual arrangements (such as financial leases and hire purchases) are only ''recognized'' if, but for the new rules, the interest and costs regarding such loans or similar contracts would have been taken into account to determine the taxpayer's taxable profits. Therefore, if no tax deduction can be claimed for interest costs based on other interest deduction limitation rules, the relevant loan to which the the nondeductible interest relates is not taken into consideration for the calculation of the unrecognized loans. The same applies to interest-free loans, unless the taxpayer would have been entitled to a tax deduction due to the non-arm's-length nature of the absence of an interest charge.

This nonrecognition does not apply to loans of which the interest costs are partly or wholly not deductible because of the generic thin capitalization rules. The new rules do not contain specific provisions that address the issues that may arise as a consequence of the combined application of the thin capitalization rules and the new rules. This has been explained by the intention to abolish the generic thin capitalization rules with effect from January 1, 2013. The actual abolition will depend on whether sufficient financial means can be found in the state budget to cover the reduction in tax collections that would be caused by the abolition of these rules.

During the parliamentary process of the new rules, a further exception has been added to the rules for determining the amount of the recognized loans. In case a company engages in active group financing activities, loans, and similar contractual arrangements that are entered into by a Dutch taxpayer as a borrower to obtain funds to (actively) onlend to group companies, may be disregarded in establishing the amount of the recognized loans. This exception is relevant for entities involved in treasury and cash-pooling activities.

Amount of Equity

To calculate the amount of the participation debt, the exact amount of a taxpayer's equity is a crucial factor. For determining the amount of a taxpayer's equity, one must look to the concept of ''equity'' as developed in existing legislation and case law. It includes both formal and informal capital contributions. Tax reserves will also be considered to be part of a taxpayer's equity as will certain hybrid loans (with no fixed term or a term of 50 years or more, almost entirely profit dependent interest and subordinated) obtained by the taxpayer.

Acquisition Prices of Participations

A further crucial factor — to calculate the amount of the participation debt — is the total amount of the acquisition prices regarding all relevant participations, which (as stated above) do not only include share interests but also other categories of assets. This total is made up of the original acquisition prices and related acquisition costs for all relevant participations, increased with any formal and construed capital contributions that the taxpayer has made to the subsidiaries

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and decreased with any formal and construed capital repayments and any dividends that are paid out of (profit) reserves existing at the time of acquisition of the participation in a specific subsidiary. If a relevant participation was not acquired but instead newly established, ''acquisition price'' should be interpreted as ''investment costs.''

The new rules use the term ''relevant participations'' to make clear that some participations will not be taken into account when calculating the amount of the acquisition prices of the participations, which effectively results in a reduction of the amount of the participation debt. In order to protect the Dutch business and investment climate, the new measure is structured such that generally only ''set-ups,'' as opposed to genuine investments, are affected. Investments qualify as genuine investments if these result in an actual expansion of the operational activities of the group to which the Dutch taxpayer making the investment belongs.

Under what circumstances there is an expansion of operational activities is a factual question. During parliamentary discussions it was made clear that specific criteria were deliberately left out of the new rules for determining under what exact circumstances there will be an expansion of a group's operational activities. These criteria should develop in practice and case law. However, the position was also expressed that an investment in a company with portfolio investment activities will not qualify as investment in operational activities and neither will capital contributions to an entity engaged in group financing. An equity injection by a Dutch taxpayer in a subsidiary to cover losses suffered by that subsidiary will also not be treated as a genuine investment qualifying for exclusion, as such injection does not result in an increase of the group's overall operational activities.

If a participation is obtained in a company that has both operational and nonoperational activities, or such participation is increased, the acquisition price of the participation in that entity is not taken into account (for purposes of calculating the acquisition costs of the participation) only if and to the extent that it can be allocated to the operational activities of that company. For a participation in an intermediate holding company, one must look at the activities of the underlying subsidiaries. It needs to be established to what extent the acquisition or increase of a participation in the intermediate holding company, or the injection of additional equity in that intermediate holding company, relates to the operational activities of the company's subsidiaries or any lower-tier entities.

In order for an investment in a subsidiary to be ignored, the investment needs to result in an expansion of the operational activities of a group. This expansion must occur:

- at the date of the acquisition of, or investment in, the participation;
- at some stage during the 12 months before that date; or
- during the subsequent 12 months.

This means, for example, that an intragroup share transfer regarding an active operational group company will generally not qualify for the exclusion. This may be different if the relevant entity became part of the group less than 12 months before the transfer and the initial acquisition of that entity resulted in an expansion of the group's overall operational activities.

Even if an investment results in an increase of the group's overall operational activities, some genuine investments in participations will not qualify for exclusion and will therefore be taken into account to calculate the aggregate acquisition costs, which in turn are used to calculate the amount of the participation debt. This will be the case for genuine investments that fall within the scope of any of the following three categories:

(a) if it is likely that regarding the interest costs and related costs connected with the participation, a party that is affiliated with the taxpayer also can claim a tax deduction (for profits tax purposes);

(b) if it is likely that the interest costs and related costs in connection with the financing of the participation, directly or indirectly, correspond with a compensation for the provision of funds to either the entity in which the participation is held or a party that is affiliated with the taxpayer, regarding which compensation a tax deduction for profit tax purposes is, directly or indirectly, obtained while no reasonable level of profits tax is imposed on the receipt of the compensation (double dip); or

(c) if it is unlikely that the acquisition or expansion of the participation, or the provision of equity to the entity in which the participation is held, would have occurred by the taxpayer if the deduction of interest had not been considered.

The parliamentary documents shed light on the scope of the exceptions noted above. These exceptions concern situations in which it is likely that interest costs are deducted more than once, whereas the interest income is not taxed in such way that — on balance — a one-time deduction remains (categories (a) and (b)), or where the structuring of the acquisition of the participation aims to obtain a tax deduction (category (c)). Several examples in the explanatory memorandum try to clarify the scope of the exceptions. These are summarized below.

Category (a) concerns situations in which the same interest amount is effectively deducted twice as a result of, for example, a mismatch in entity qualification. This would include cases in which the Dutch taxpayer is treated as transparent from a non-Dutch tax perspective, as a result of which interest costs for a loan obtained by the Dutch taxpayer to finance a participation

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are taken into account not only for Dutch corporate income tax purposes, but also for the purpose of calculating the taxable profits for non-Dutch tax purposes of a holder of an interest in the Dutch taxpayer.

Category (b) aims to cover cases in which a series of financing or similar transactions (including certain royalty and leasing structures) results in the interest costs and related costs for an investment in a participation being deducted not only by the Dutch taxpayer but also by an entity that is affiliated with the Dutch taxpayer, without the recipient of the amount being adequately taxed (a double dip). If the recipient of the amount is subject to a reasonable level of tax, viewed from a Dutch tax perspective, the exception does not apply and the relevant acquisition price can be excluded from the total acquisition price of the relevant participations. If there is some level of taxation in the hands of the recipient, but not a reasonable one, and the taxpayer can demonstrate that the way the financing has been structured is primarily based on business motives rather than tax planning motives, the acquisition price can also be excluded. Examples of transactions falling within the scope of this exception (and therefore not qualifying for exclusion) are:

- A hybrid loan is provided by the Dutch taxpayer to the subsidiary in which a participation is held. If the interest on such loan falls within the scope of the Dutch participation exemption and a tax deduction can be enjoyed by the subsidiary for the interest costs of the loan, a double dip effectively results as a consequence of the different qualification of the hybrid loan.
- The artificial routing of a financing stream — used for the acquisition of, or the investment in, a participation — via a subsidiary of the Dutch taxpayer to claim an additional interest deduction. For example, a Dutch taxpayer takes up a loan and uses the proceeds of this loan to contribute equity to a low-taxed operating subsidiary, which in turn provides a loan to an acquisition vehicle set up by the Dutch taxpayer. The latter vehicle uses the funds to carry out an acquisition of a participation in a target company. If a tax grouping between the acquisition vehicle and the target company could be established, this would in fact result in a (possibly partial) double dip.
- The use of sophisticated structures in which, through the use of different entity qualification rules, a tax deduction is effectively obtained in two countries. The explanatory memorandum sets out an example in which a Dutch member of a Dutch fiscal unity (tax group for Dutch corporate income tax purposes) is financed with a loan from the Dutch head of the fiscal unity and uses the proceeds to provide equity to a German GmbH & Co Kg (of which it is a participant). If the GmbH & Co Kg is accurately structured from a Dutch tax perspective and the head of the fiscal unity attracts a loan to finance the loan it grants to its fiscal unity member, effectively a tax deduction in Germany and the Netherlands can be obtained. Note that the GmbH & Co KG can be the head of a German fiscal unity (*Organschaft*), allowing the interest costs to be deducted from the operating profits of a German subsidiary.

Category (c) concerns a purpose test and looks at the group's intentions for structuring an acquisition (or a subsequent investment) through a Dutch company with taxable profits. If the purpose of this structuring is to use the taxable profits of the Dutch entity to offset the financing costs, without there being other sound reasons, the transaction falls within this category.

The explanatory memorandum includes the example of an international group with its head office (parent) abroad and a profit-generating subsidiary in the Netherlands that carries out a debt-financed acquisition of a foreign target company, though there will be no managerial and controlling function in the Netherlands. Although in this case there is an expansion of the operational activities of the group as a whole, the intention for structuring the acquisition through the Dutch company will be to allow the interest costs to be offset against the taxable Dutch profits. The question that needs to be answered is whether, if the tax deductibility of the interest costs had not been considered, there would still be sufficient reasons to structure the acquisition via the Dutch operating company. For example, if the Dutch company has played an important role in the acquisition of the foreign target company or if the Dutch company is a regional head office that will also supervise the foreign target company, this question may be answered in the affirmative. This is not an exhaustive list. There may also be other sound arguments.

If the acquisition of a participation (or the expansion of an existing participation) in a subsidiary falls within the scope of one of the three categories, the acquisition price to be allocated to such participation will not be excluded and needs to be taken into account for the purpose of calculating the amount of the participation debt.

Excessive Participation Interest

After the total amount of the acquisition prices regarding the relevant recognized participations has been established, this amount must be reduced by the amount of equity recognized with respect to the taxpayer (the amount of equity cannot be lower than zero) in order to calculate the amount of the participation debt. If this calculation results in a positive balance, the amount of the participation debt will be equal to this balance, unless this amount exceeds:

- the total amount of recognized loans and contractual arrangements; or
- the sum of the acquisition prices attributable to all relevant participations.

If so, the lower of the two latter amounts prevails. As a final step, the amount of the participation debt

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needs to be reduced by the amount of any tainted loan or contractual arrangement (as discussed above) that has resulted in a (proportionate) decrease of the amount of the equity of the taxpayer. An example would be a tainted loan, the interest costs in respect of which are already nondeductible, that relates to the repayment of equity by the taxpayer. The adjustment mechanism aims to eliminate the effect that the transaction to which a tainted loan relates has already had on the amount of equity of a taxpayer.

After the amount of the participation debt has been determined, it also must be determined what portion of a taxpayer's total interest costs and related costs (regarding recognized loans and contractual arrangements, as well as any connected hedge instruments) is to be qualified as excessive participation interest costs under the new rules. The new rules prescribe that the excessive participation interest costs will be proportionate to the ratio between the taxpayer's average participation debt and the average amount of all outstanding recognized loans and similar contractual arrangements of that taxpayer.

All average amounts required to determine the amounts of the participation debt and the excessive participation interest costs must be calculated by taking into account the relevant balances at the start and end of a taxpayer's financial year. In order to avoid taxpayers entering into manipulative transactions to influence the amount of these balances, with a view to reducing the amount of the participation debt or the amount of the excessive participation interest, temporary fluctuations regarding the relevant amounts around these dates will be ignored. The terms ''temporary'' and ''around these dates'' have not been defined in order to leave sufficient room to apply this antiabuse rule in individual cases. It will be up to the courts to provide further guidance.

The participation interest is not deductible if and to the extent that the threshold of €750,000 is exceeded. In other words, only the participation interest costs exceeding the threshold are treated as excessive, nondeductible participation interest costs.

Final Remarks

The new rules take effect on the first day of the first financial year of a taxpayer starting on or after January 1, 2013. Initially, none of the existing structures would be grandfathered. This led to heavy criticism. As a response, the final set of rules do include grandfathering provisions with respect to investments in participations that were made in financial years starting on or before January 1, 2006. Rather than proving that a grandfathered investment resulted in an expansion of the operational activities of the group, a taxpayer may elect to disregard 90 percent of the acquisition price for (and/or capital contribution to) this participation.

Certain implementation rules will be published at a later stage that will deal with various issues surrounding reorganizations and companies being included in, and excluded from, a fiscal unity (tax grouping).

The new rules should complete the framework of limitations applicable to the deductibility of interest costs and no further restrictions to the tax deductibility of interest costs are currently proposed. The existing restrictions to the tax deductibility of interest costs will stay in place, except for possibly the thin capitalization rules. It has been stated that if sufficient financial coverage can be found, the Tax Plan 2013 will include a proposal to abolish the thin capitalization rules.

Regarding ordinary group structures, the new rules are likely to have the most far-reaching consequences for foreign groups with operating entities in the Netherlands, if the groups have structured part of their acquisitions of participations through these Dutch profit-generating companies (or via Dutch holding entities included in a fiscal unity with such profit-generating companies).

The deductibility of all interest and related costs connected with the acquisition of such participations may be affected if these are not grandfathered investments, even if these acquisitions qualified as genuine investments. This is true if the structure of the acquisition is considered to have been selected in order to obtain a tax deduction. It will depend on whether such groups are able to produce different motives for the acquisition structure (other than interest deductibility motives) — whether the participation can be excluded for purposes of the calculation of the amount of the participation debt.

For future acquisitions, international groups may want to review whether the setup of a regional head office in the Netherlands would make them eligible for a tax deduction of excessive participation interest from the taxable profits of a Dutch group company.

Finally, restructuring measures may have to be considered regarding existing structures, in particular those that also include financing activities. ◆

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