Netherlands: tax treatment of hybrid finance instruments in the wake of two landmark cases

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The Dutch Supreme Court has given its judgment in two landmark cases regarding the classification of hybrid finance instruments.1

The question in both cases was whether shares can be requalified as a debt instrument for tax purposes.

As in many jurisdictions, the distinction between equity and debt for the purposes of taxation is of great importance. The Dutch Supreme Court’s final decision in both cases stated that the classification of shares under Dutch civil law is decisive.

These two cases demonstrate that the tax treatment of hybrid finance instruments is in the spotlight in the Netherlands. That same issue is growing in importance globally, as demonstrated by the interest hybrid finance instruments attract from the OECD, the G20 and the European Commission in their fight against tax avoidance by multinational enterprises.2

The tax treatment of equity and debt in the Netherlands

As in many other jurisdictions, under Dutch tax law, remunerations for debt (interest) are generally deductible, while remunerations for equity (profit distributions) are not deductible. Furthermore, in principle a 15 percent Dutch dividend withholding tax is levied on profit distributions, while no Dutch withholding tax is levied on interest payments.3 Both interest and profit distributions are taxable in the hands of the recipient.

Dutch corporate tax law provides for an exemption, the so-called participation exemption (deelnemingsvrijstelling), of income derived from equity investments in a subsidiary in case a shareholder owns at least 5 percent of the nominal paid-in share capital in the subsidiary, provided the shares are not held as a portfolio investment.

Requalifying debt into equity for Dutch tax purposes

A number of court cases have resulted in a defined framework to requalify debt into equity for Dutch tax purposes. In principle, whether a financial instrument should be considered debt or equity is determined on the basis of its civil law qualification.4 In the Caspian Sea case,5 the Dutch Supreme Court made clear that the essential characteristic of a loan is the repayment obligation of the debtor. This means that if the recipient of a certain financing is not obliged to repay the amount, the financing is, in principle, not considered a loan.

There are, however, three exceptions as result of which debt for civil law purposes is nevertheless considered to be or at least treated as equity for Dutch tax purposes. These exceptions are sham loans (schijnleningen), loss...
financing loans (bodemloze putleningen) and participating loans (deelnemerschapsleningen).

To qualify debt as a participating loan, the following conditions developed in Dutch case law need to be cumulatively met:

(i) The remuneration on the loan is dependent on the profit of the borrower
(ii) The loan is subordinated to the claims of all other creditors and
(iii) The loan has no term or is perpetual (a loan having a term in excess of 50 years is considered to have met this condition).

Therefore, a loan qualifying as debt for civil law purposes which is not a sham loan, a loss financing loan or a participating loan is considered debt for Dutch tax purposes.

Recent developments in Dutch case law: requalification of equity into debt?

The 7 February 2014 judgements are the first court cases in which the Dutch Supreme Court addresses the question whether equity for tax purposes (shares) can be requalified into debt.

Australian redeemable preference shares

A Dutch corporate taxpayer had an indirect 16 percent interest in an Australian company to which it had granted shareholder loans. After a restructuring in 2004, the Dutch taxpayer received newly issued redeemable preference shares (RPS) in the Australian company and the shareholders loans were repaid. The characteristics of the RPS are that 1) they annually pay cumulative preferred dividend of 8 percent increasing to 12 percent of the amount contributed on the RPS; 2) they have basically no voting rights; 3) they will be redeemed within ten years; and 4) they rank in priority over ordinary shares.

Where previously the Dutch taxpayer was taxed on the interest received on the shareholder loans, after the restructuring, the participation exemption applied on the income derived from the RPS. As a consequence, although the payments on the RPS were still deductible under Australian tax law, they were no longer taxed at the level of the Dutch taxpayer under the Dutch participation exemption rules.

The Dutch Supreme Court ruled that as a starting point the classification of a finance instrument is decided by the civil law qualification thereof. With reference to its other decision dated 7 February 2014, the Dutch Supreme Court judged that if a shareholding exist for Dutch civil law (shares) the participation exemption should apply. The fact that the remuneration on the RPS is deductible in Australia and that the RPS have the characteristics of a debt instrument, should not have any adverse consequence on the application of the Dutch participation exemption.

Abuse of law – bank-refinancing case

A consortium of banks had financed the acquisition of a listed Dutch company (the target) by a Netherlands Antilles company (HoldCo). At some point it was decided to restructure the financing in order to realise tax exempt interest income for the banks and, therefore, lower borrowing costs for HoldCo. To this extent the banks established a transparent fund which, together with HoldCo, incorporated a new intermediate holding company (NewCo). This NewCo issued A shares and B shares. HoldCo contributed its shares in the target on the A shares, while the banks through the transparent fund contributed the outstanding amount on the acquisition debt on the B shares. As a result of this restructuring, the banks argued that benefits derived from the B shares were exempt from Dutch corporate income tax by virtue of the participation exemption.

The Dutch Supreme Court judged that, under Dutch civil law, a holder of shares is subordinated to all creditors, and any contributions made by shareholders are therefore available for recourse by creditors of the company. This is not affected if (i) the shareholder has the right to terminate its financing after a certain period and (ii) such finance instruments has certain economic similarities to a loan. Therefore, if a shareholding exists for Dutch civil law purposes, the classification for tax purposes should follow that.

Furthermore, the Dutch Supreme Court rejected the tax authorities’ appeal on the abuse of law doctrine (fraus...


The Dutch Supreme Court made it once more clear that taxpayers are free to finance a subsidiary with either debt or equity, taking into account the intent of the participation exemption.

**Final remarks**

The Netherlands takes as a starting point the Dutch civil law qualification of a finance instrument. Generally, *qualification in another jurisdiction is not relevant* for the civil law qualification of an instrument in the Netherlands. Therefore, *instruments qualifying as equity in another jurisdiction may very well qualify as debt for Dutch tax purposes and vice versa*. Finally, the Dutch participation exemption applies to all income derived from operating subsidiaries, even to payments received on hybrid finance instruments that were deductible in the other jurisdiction.

It is recognised by the G20, the OECD and the European Commission that mismatches by hybrid finance instruments are one of the most important tools for multinationals in lowering their worldwide corporate income tax liability and that therefore the use of these instruments in tax avoidance schemes should be prevented. The OECD’s suggestion to have anti-avoidance rules and rules specifically targeting hybrid mismatch arrangements and the European Commission’s suggestion to amend tax treaties and the Parent-Subsidiary directive are **not yet implemented in the Netherlands**. The Dutch State Secretary of Finance made it clear that the Netherlands would not unilaterally change its legislation regarding hybrid finance instruments. The Dutch State Secretary of Finance would like to await the outcome regarding the proposal to amend the Parent Subsidiary Directive.

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1. Dutch Supreme Court 7 February 2014, no. 12/03540 and no. 12/04640.
3. Certain exceptions apply to this rule.

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