Tax aspects of corporate debt restructuring in the Netherlands

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In the current economic climate a substantial number of businesses and companies are struggling with their corporate debt position. In terms of the life time of (distressed) debt, various phases can be distinguished. Some businesses are renegotiating the terms and conditions of existing debt. Others are swapping debt into equity or buying back debt, sometimes at a heavy discount. Even some businesses need to make all efforts to avoid bankruptcy.

This article will discuss certain Dutch tax aspects of some of these phases, both from a debtor and creditor perspective. In particular the following subjects will be described: (i) origination, (ii) default situations, (iii) restructurings including debt for equity swaps, waiver of debts and a buy back of debts and (iv) purchase of debts by third party (funds).

I. Origination

At origination debtor and creditor will enter into a debt arrangement. Various forms of arrangements can be thought of, either intra-group or externally. For example debtor and creditor can enter into a secured senior facilities agreement or mezzanine facilities agreement or an unsecured facilities agreement. Also the debtor can issue notes or (listed) bonds.

Typically at origination both debtor and creditor will value the debt and receivable at par value respectively. Also debtor and creditor will generally agree among others on an (arm's length) interest rate to be charged on the debt. Even if no interest is charged, under the Dutch transfer pricing rules, the debtor and creditor are generally deemed to have paid and received such interest respectively.

Borrowing costs incurred1 by a debtor subject to tax in the Netherlands – either because it is a Dutch tax resident of the Netherlands or it is a non-Dutch tax resident with Dutch source income through a permanent establishment - on third party debt is generally deductible for Dutch corporate income tax purposes at the statutory rate.2

However, the Dutch tax code contains a number of provisions which limit or deny the interest incurred on related party debt. In short, a party is considered related if directly or indirectly:

1. The borrower owns an interest of at least one third in such party;
2. The party owns an interest of at least one third in the borrower; or
3. A third party owns at least a one third interest in both the borrower and such party.

The provisions limiting the deduction of borrowing costs include among others:

1. The anti-base erosion rules, which – subject to certain business motive tests – apply in case the funds are used for certain profit distributions, capital contributions or acquisitions;
2. The thin cap rules, which apply in case the average debt to equity ratio of the taxpayer exceeds a 3:1 ratio; and
3. The affiliated3 loan rules which apply in case the loan does not have a fixed term or a term exceeding 10 years and the loan legally or in fact either does not bear any remuneration or bear a remuneration which is more than 30 percent below arm's length value.

Furthermore, hybrid debt instruments are requalified into equity for Dutch tax purposes, as a result of which the remuneration paid on such instrument is not tax deductible. Hybrid debt instruments require that:

1. The debt has a term of more than 50 years;
2. The remuneration on the debt is entirely or nearly entirely contingent on profits; and
3. The loan is subordinated to all creditors.

When a related entity guarantees the third party bank debt incurred by a Dutch taxpayer, generally the debt is requalified into related party debt and thereby potentially triggering the above mentioned limitations on interest deductions. However, if the taxpayer can demonstrate that it would have been able to attract the funds without the guarantee, but on different terms and conditions - for example the guarantee only serves to obtain better interest rate conditions - such requalification should not apply.

Interest payments on debt incurred by a Dutch taxpayer should not be subject to Dutch withholding taxes, unless the debt should be considered a hybrid debt instrument as referred to above. In the latter case a 15 percent withholding tax rate applies, which rate could be reduced under the Dutch rules implementing the EU Parent – Subsidiary Directive or relevant tax treaties.

The interest received/accrued on the debt will generally be taxable in the hands of the creditor at the statutory rate, if the creditor is:

1. A Dutch tax resident entity;
2. A non-Dutch tax resident entity which has a Dutch permanent establishment to which the receivable can be allocated; or
3. A non-Dutch tax resident entity which has a substantial interest in the debtor - requiring in short an interest of at least 5 percent of the issued share capital or of a separate class of shares of the debtor – which can not be allocated to a business enterprise conducted by the shareholder/creditor.

Generally shares can be allocated to a business enterprise if the foreign shareholder is engaged in providing equity that is at risk in a manner exceeding portfolio investment and such foreign entity has a certain involvement in the management of the Dutch debtor. If the shares could not be allocated to a business enterprise, Dutch tax under the substantial interest rules could be mitigated under the Dutch rules implementing the EU Interest and Royalty Directive or relevant tax treaties.

II. Default situations

Typically in a secured corporate debt arrangement, the creditor and debtor agree amongst others on certain (financial) covenants and a security package. In this respect shares in a Dutch entity are regularly pledged by the shareholder in favour of the bank/security trustee. The share pledges generally provide that the voting rights in respect of the shares are transferred by the pledgor to the pledgee under the condition precedent of the occurrence of an event of default (either or not in combination with a written notice by the pledgor to the pledgee and the entity the shares of which are pledged that the voting rights will indeed be transferred). An event of default generally includes among others a non-payment situation, breach of a (financial) covenant and an insolvency situation.

The transfer of the above-mentioned voting rights in a Dutch entity upon the fulfillment of the condition precedent can have far reaching Dutch tax consequences, which can be explained as follows. A Dutch parent company (being a Dutch tax resident) owning legally and economically at least 95 percent of the shares of a Dutch subsidiary (being a Dutch tax resident) can form a fiscal unity for Dutch corporate income tax purposes.4 The main benefit is that the taxable profits and losses of the entities combined in such fiscal unity can be off-set.

Many leveraged (private equity) acquisitions in the Netherlands have - in essence - been structured such that a Dutch acquisition entity has been established, attracting funds from banks (and sometimes shareholders) to finance the acquisition of the Dutch target entity. As part of the security arrangements, the acquisition vehicle will have pledged the shares in the Dutch target to the bank. The acquisition entity will have formed a fiscal unity with Dutch target as a result of which the interest expenses at the level of the former entity can be off-set against the taxable profits at the level of the latter entity.

In case the condition precedent is fulfilled, the voting rights in respect of the Dutch target shares will be transferred to the banks, as a result of which the condition that the Dutch acquisition entity legally and economically owns the shares of Dutch target entity is generally no longer met. Consequently, the fiscal unity would be terminated at such moment, meaning that profits and losses can no longer be off-set. Furthermore, upon termination of the fiscal unity an anti-abuse provision may apply according to which – in short – assets that have been transferred within the fiscal unity during a six year period prior to termination need to be valued at fair market value therewith potentially triggering a taxable event.

III. Restructurings

There are various ways of restructuring existing (distressed) debt arrangements, including among others, debt for equity swaps, waivers of debt and buy backs of debt.

During the internet bubble period around 2001 there were in essence two provisions in the Dutch tax code which could affect debt for equity swaps. The first being the levy of capital tax upon the issuance of the share capital.5 In addition, there was a tax levy at the level of the debtor for the difference between the fair market value of the receivable and the book value of the debt at the time of conversion. Both rules have now been abolished. Currently, there is in principle no taxation at the level of the debtor upon conversion. However, there is a specific anti-abuse provision which may apply at the level of the creditor in case of related party transactions. In short, if the creditor or a related party holds a share participation in the debtor of at least 5 percent and the receivable has been depreciated against Dutch taxable profits, the creditor will have to form a reserve for the amount of the depreciation. There will generally be a taxable release of the reserve if and to the extent the shares in the debtor increase in value. Furthermore, another anti-abuse provision applies in case such creditor – after having depreciated the receivable against Dutch taxable profits – would transfer the receivable to a related party or to the assets of a business enterprise (or part of a business enterprise) conducted outside the Netherlands, where an arrangement for the avoidance of double taxation applies to the profits of that enterprise. In such case, the amount previously depreciated against Dutch taxable profits will have to be recaptured immediately.

In case of a debt buy-back, the debtor will generally realise a taxable profit for the difference between the nominal value of the debt and the fair market value for which the debt is acquired. Correspondingly, the creditor will generally incur a taxable loss upon an at arm’s length buy back of shares, assuming the creditor is a Dutch tax resident entity or a non-Dutch tax resident entity with a Dutch permanent establishment to which the receivable can be allocated. In reality the creditor will probably already have taken its losses by depreciating the receivable.

An at arm’s length waiver of debt constitutes in principle a taxable profit for the debtor. However, the Dutch tax code provides that the amount of profits exceeding the tax losses available for off-set will be exempt from tax.6 The question whether or not debt is recoverable and the decision to waive needs to be taken by the creditor, who should act reasonably and with a business approach. In any event, it requires an act from the creditor.

For the creditor the waiver will generally have resulted in a tax deductible loss, assuming the creditor is a Dutch tax resident entity or a non-Dutch tax resident entity with a Dutch permanent establishment to which the receivable can be allocated. However, similar to the debt for equity swap situation, there is a specific anti-abuse provision which may apply at the level of the creditor in case of related party transactions. In short, if the creditor or a related party holds a share participation in the debtor of at least 5 percent and the receivable has been depreciated against Dutch taxable profits, the creditor will have to form a reserve for the amount of the depreciation. There will generally be a taxable release of the reserve if and to the extent the shares in the debtor increase in
value. No reserve will have to be formed and no taxable release will have to occur at the level of the creditor, if either the debtor has not been able to claim an tax exemption for the profit realised in relation with the waiver or – in case the debtor is a taxpayer outside the Netherlands – in relation to the waiver the debtor is subject to a profit tax of at least 10 percent calculated according to Dutch standards in its country of residence.

A non at arm’s length waiver - generally driven by shareholder motives - is considered an informal capital contribution and does not affect the taxable profits of the debtor. Correspondingly, the creditor can not claim a tax loss.

IV. Purchase of debt by third party (funds)

When Dutch (distressed) debt is purchased by a third party, a couple of key Dutch tax aspects arise, including among others the (continued) deductibility of interest at the level of the debtor, the withholding tax position on the interest and the treatment of the interest (and potential increase in value of the receivable) in the hands of the new creditor.

In order to assess the deductibility of interest expenses, it is crucial to determine whether the debt is borrowed from a third party (in which case the interest should be deductible) or from a related party (in which case the interest deduction could be denied or limited). In this respect it should be realised that if a Dutch target entity has been acquired originally through a Dutch acquisition entity established by a (private equity) shareholder, which acquisition entity borrowed debt from a third party bank to finance the acquisition, the debt will become related party debt as of the moment such shareholder would acquire the debt from the banks. In other words, if the (private equity) shareholder holds an interest of at least one-third in the Dutch debtor and it would become the new creditor of the debt, then the debt will be considered related party debt for Dutch tax purposes. As a result, the interest expense on the debt can be denied or limited under the Dutch interest deduction rules such as the anti-base erosion and/or thin cap rules.

There should be no Dutch withholding tax on interest payments made on the debt, unless the terms and conditions would be changed in such a way that the debt should be considered a hybrid debt instrument for Dutch tax purposes.

The new creditor would generally be subject to Dutch corporate income tax at the statutory rate for interest on the loan and increase in value of the loan, assuming that it is:

1. A Dutch tax resident entity subject to the regular Dutch corporate income tax regime;
2. A non-Dutch resident entity with a Dutch permanent establishment to which the receivable can be allocated; or
3. A non-Dutch tax resident entity having a qualifying substantial interest in the debtor as described in paragraph 2 above.

In practice funds have been formed by investors to purchase (distressed) debt portfolios. Generally these funds are located in a tax jurisdiction which best address the above aspects. In this respect, as one of the alternatives, a Dutch tax exempt investment institution (vrijgestelde beleggingsinstelling) as referred to in the Financial Supervision Act can be mentioned. In short, the benefits are that the fund itself is exempt from Dutch corporate income tax, dividends distributed by the fund are not subject to Dutch dividend withholding tax and shareholders/participants in the fund should not be subject to Dutch corporate income tax.

The Dutch tax exempt fund should meet – in summary – the following conditions to qualify:

1. Its sole objective and activity is the investment of moneys and other financial instruments (group finance activities and direct investments in real property do not qualify); 
2. It should diversify risk, but can for example in principle operate as fund of funds, umbrella fund or a feeder fund;
3. It is an (semi) open-ended fund; and
4. It should invest on a collectivity basis meaning that – in essence – there should be at least two participants/shareholders in the fund.

The most important requirement is what can be considered a qualifying financial instrument. This includes among others, cash, transferable shares (in distressed debt entities) and bonds, instruments generally traded on the capital market, (interest) swaps and options on such instruments. As the financial instruments need to be more than a mere contractual arrangement agreed upon and transferred between a limited group of interested parties (such as banks), it may be difficult for example to consider debt positions relating to senior facility agreements as qualifying financial instruments.

A disadvantage of using a Dutch tax exempt investment institution is that it can generally not benefit from tax treaties. If in relation to certain investments tax treaty benefits would be desired or the fund would not be allowed to invest directly in the identified asset, it could be considered to have the Dutch tax exempt fund establish a Dutch cooperative as subsidiary to make the investment. Such cooperative is subject to Dutch corporate income tax at the statutory rates as a result of which it should generally qualify for tax treaty benefits; if properly structured there should be no dividend withholding tax upon dividend distributions by the cooperative to the Dutch tax exempt fund.

V. Final remarks

In these extraordinary times corporate debt restructurings are in the Netherlands – just like in many other jurisdictions – a hot topic. The Dutch tax aspects of these restructurings play an important role. Key points of attention are among others (continued) interest deduction at the level of the debtor, application of withholding taxes and tax treatment of interest and potential increase in value of the loan in the hands of the new creditor. Also the Netherlands may be an attractive jurisdiction for funds purchasing (distressed) debt.

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1. Borrowing costs include paid/acquired interest, currency exchange results, (legal) fees and other amounts payable under a loan.
2. The tax rate is 20 percent for the first Euro 40,000 of taxable income and 23 percent for the taxable income exceeding Euro 40,000 but not exceeding Euro 200,000 and 25.5 percent for taxable income exceeding Euro 200,000 (rates of 2009). 
3. For this purpose parties are affiliated if they participate - directly or indirectly - in the management, control or capital of another party.
4 Under certain conditions a Dutch permanent establishment of a foreign entity can also form part of a fiscal unity. Furthermore, the restriction that a fiscal unity can only be formed in case of a Dutch tax resident/Dutch permanent establishment may be in conflict with EU law, but this will not be further discussed in this article.

5 Capital tax was initially levied at the rate of 1 percent; over the years the rate was reduced to 0.55 percent.

6 Special rules apply to entities that are part or have been part of a fiscal unity, which will not be discussed in this article.

7 See also paragraph 2 above.

8 According to the principle of sound business practice and in particular the principle of prudence a taxable profit needs to be reported only upon a realization moment, for example when the receivable is transferred to a third party or converted.

9 Indirect investments in real property through e.g. so-called Dutch fiscal investment institutions (fiscale beleggingsinstellingen) is under certain conditions possible.