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Dutch Supreme Court: what qualifies as equity under civil law can not be requalified as debt for tax purposes

On 7 February 2014, the Dutch Supreme Court ruled, in two distinct cases, that the civil law qualification of capital as equity can in principle not be requalified as debt for tax purposes, and that the participation exemption can be applicable to the proceeds

Facts

In the first court case the claimant, a Dutch BV, was incorporated by a group of companies as part of a restructuring of an acquisition financing. Whereas before the restructuring the financing had been treated as debt for tax purposes, after the restructuring the Dutch BV treated (its part of) the financing as equity and applied the participation exemption to the proceeds. The tax inspector, lower court and higher court all denied the application of the participation exemption because before the restructuring there was a loan in place for almost the same amount (but provided by another group company) on which the remuneration had been treated as taxable interest income.

In the second court case, the claimant, a Dutch BV, had provided shareholder loans to an Australian participation. Pursuant to a restructuring, the shareholder loans were redeemed and the Australian participation issued “Redeemable Preference Shares” (“RPS”), governed by Australian law. The interest on the shareholder loans had been reported as taxable income by the Dutch BV. However, after the restructuring, the Dutch BV applied the participation exemption to the proceeds from the RPS. While the tax inspector and the lower court denied application of the participation exemption to the proceeds from the RPS, the higher court confirmed the application of the participation exemption. The relevant conditions of the RPS were (i) an annual, cumulative interest, which increased during the term up to a maximum of 12%, (ii) issuance and redemption of RPS against the nominal value (no original issue discount), (iii) preferred position prior to ordinary shares in case of payment of remuneration and redemption of principal amount, (iv) redemption was possible at any moment, but mandatory after 10 years, and (v) RPS holders did not have voting rights,

except in case of dissolution of the company or decisions regarding the RPS. In Australia the RPS qualified as long term debt and the remuneration is tax deductible.

Supreme Court decisions

On 7 February 2014, the Dutch Supreme Court ruled in both cases that what qualifies as equity under civil law in principle can not be requalified as debt for tax purposes and that, therefore, the Dutch participation exemption can be applicable.

In the first court case, the Supreme Court ruled that in principle the civil law qualification of capital as equity should be followed for tax purposes. If according to civil law the provision of the funds should be qualified as share capital, this qualification should also be followed for the application of the Dutch participation exemption. The Supreme Court mentioned that this does not change when (i) the shareholder has the possibility to terminate the provision of the funds within a few years, (ii) the provision of funds has similarities with a loan (such as the remuneration received), and (iii) there is a negligible risk that the capital will be used for repaying debts and therefore, there is barely a difference compared to providing a loan. The Supreme Court indicated that making a distinction between capital and a loan on the basis of the risk that the funds are used for repaying debts would lead to legal uncertainty. Finally, the Supreme Court also ruled that there is no abuse of law (fraus legis) when a taxpayer makes use of its free choice from different possibilities to fund its participations, taking into account the purpose and scope of the Dutch participation exemption.

In the second court case, the Supreme Court referred to the first court case and followed the analyses of the higher court, which held that in principle the civil law qualification should be followed for tax purposes and that the RPS are quite comparable to cumulative preferred shares governed by Dutch law (while Dutch corporate law does not recognize redeemable preference shares, it does recognize cumulative preference shares) which qualify as equity for Dutch tax purposes. The Supreme Court mentioned that the civil law qualification of capital as equity does not change for tax purposes, not even when (i) a redemption is mandatory after 10 years, (ii) the RPS bear an annual, cumulative remuneration, (iii) the issuance of the shares is economically in line with drawing down a (subordinated) loan, and (iv) the contribution of funds to the shares according to Australian and Dutch accounting principles are qualified as debt. This could also be the case with cumulative preferred shares with limited voting rights that are issued by Dutch companies. Also the fact that the remuneration on the RPS is tax deductible in Australia does not change the outcome. After all, the Dutch participation exemption is not dependent on whether or not the remuneration is tax deductible with the subsidiary. Finally, the Supreme Court ruled, also in line with the first court case, that there is no abuse of law (fraus legis) when a taxpayer makes use of its free choice from different possibilities to fund its participation, taking into account the purpose and scope of the Dutch participation exemption.

Comments

Over the past decades, the Dutch Supreme Court has ruled on various cases concerning the requalification of debt into equity. These are the first cases where the Supreme Court has ruled on the reverse requalification: from equity into debt. Each time, whether it concerns the requalification of debt into equity or equity into debt, the Supreme Court has held that the qualification of capital under civil law should in principle be followed for tax purposes. However, in its debt to equity requalification cases, the Supreme Court has accepted three situations where debt should be treated as equity for tax purposes: (1) sham loans (a loan on paper but the clear intent of the parties being to provide equity), (2) loss financing (at the time the loan was granted it was already clear that the loan would never be repaid), and (3) loans that in fact serve as equity (profit dependent remuneration, subordinated to all other creditors, and repayable only upon bankruptcy or liquidation, or a term of more than 50 years).

While the above situations are exceptions to the main rule (no requalification of debt into equity), debt can in fact be requalified as equity for tax purposes in these situations. Whether equity can be requalified into debt for tax purposes remains uncertain. These recent decisions from the Supreme Court make clear that requalification of equity into debt – if at all possible – is not easily arrived at.