Deductibility of interest expense restricted in case of excessive and (deemed) abusive financing of participations

Background

Until 18 September 2003, interest expense incurred on a debt financed acquisition of a participation qualifying for the participation exemption (hereinafter: “participation interest expense”) - was deductible if it concerned a Dutch participation and non-deductible if it concerned a foreign participation. The reasoning behind this tax treatment was that there should be no deduction for expenses incurred for generating income which was not taxable at all in the Netherlands. The taxable income of Dutch participations was at least taxed once at the level of the participation, therefore justifying the deduction of interest expense.

After the ECJ ruled that such different tax treatment of the financing of Dutch participations and foreign participations was a violation of the freedom of establishment of the EU Treaty, in the so called “Bosal case” (18 September 2003, case C-168/01), as of 2004 all participation interest, whether relating to Dutch or foreign participations, is deductible. In order to mitigate budgetary effects of the Bosal case, the Netherlands introduced a thin capitalization provision as well as a restriction on compensation of holding and financing losses (“loss ring fencing rules”).

Legislative proposal to restrict deductibility of “excessive participation interest expense”

As part of a wide array of tax measures proposed in order to reduce the budgetary deficit, a legislative proposal to restrict deductibility of participation interest expense was presented to Parliament on 4 June, 2012. In this TNB, we summarize the principal aspects of this legislative proposal. In spite of the proposal to restrict deductibility of participation interest expense, it appears that the thin capitalization provision and loss ring fencing rules will continue to apply. The State Secretary of Finance has indicated that the government is in favor of abolishing the thin capitalization provision, but that there is currently no budget for that. If budget can be found, the State Secretary of Finance says he will propose abolishment of the thin capitalization provision. The loss ring fencing rules were not mentioned.

“Excessive” participation interest

“Excessive” participation interest expense is not deductible if and to the extent it exceeds € 1 million per year. Excessive participation interest expense equals total interest expense multiplied by the fraction which is year-average “participation debt” divided by year-average total debt. Temporary mutations in debt around year start and year end are disregarded. Participation debt is the excess of acquisition price of participations over fiscal equity.

<u>*Example:*</u> Taxpayer A BV’s tax balance sheet

Debit		Credit	
Participations	400	Equity	250
Other assets	300	Debt	450

A BV's profit before interest is 25. A pays total interest expense on debts of 30. Without the proposed restriction, A BV's profit after interest would be -5. Pursuant to the proposed restriction, A BV's participation debt would be 400 – 250 is 150. Excessive participation interest expense is 30 (total interest expense) x 150 (participation debt) / 450 (total debt) is 10. Reduced by the € 1 million threshold, 9 million of interest expense would be non-deductible.

Participation debt is never more than total debt, meaning that other liabilities such as provisions and tax debts do not increase participation debt. And participation debt is never more than the aggregated acquisition price of all participations, meaning that equity is at least zero for purposes of determining excessive participation interest expense.

No accumulation of interest deduction restrictions

Debts of which interest expense is already non-deductible on the basis of other interest deduction restrictions are not debts for purposes of the restriction of participation interest expense. Transactions which are already subject of other interest deduction restrictions, and which would decrease fiscal equity (and consequently increase participation debt), are disregarded for purposes of the restriction of participation interest expense.

Example: Taxpayer B BV's tax balance sheet

Taxpayer B BV declares a divided of 50 to its low tax parent M but borrows back the same funds (remains indebted for the dividend).

B BV's tax balance sheet before the dividend

Debit		Credit	
Participations	250	Equity	100
Other assets	50	Debt	200

B BV's tax balance sheet after the dividend

Debit		Credit	
Participations	250	Equity	50
Other assets	50	Debt	250

B BV's participation debt before the dividend is 250 – 100 is 150. After the dividend, B BV's participation debt is 200. However, the interest expense incurred on the indebted dividend is already non-deductible on the basis of article 10a Dutch Corporate Income Tax Act ("DCITA"). Therefore, the participation debt of B BV after the dividend is reduced by 50, to 150.

The equity of taxpayers who do not account for their participations at acquisition price will be adjusted (upward or downward) for the difference between acquisition price and tax book value.

Exception for "expansion of operational activity"

In order not to impede "proper" expansion of enterprise, the acquisition of a participation or increase of an existing participation which forms and expansion of operational activity (of the group of which the taxpayer forms part) is excluded from the restriction of participation interest expense (i.e. interest is deductible). Internal transfers of participations to Dutch holding companies are (in principle) not considered expansion of operational activity. The qualification as operational activity is based on all facts and circumstances. Examples given of operational activity are manufacturing, distribution, and sales. Passive investment is not operational activity, nor is the contribution of capital to an (active) group financing company. And contribution of capital to an operational participation to cover for losses is not considered "expansion". Participations with both operational and non-operational activity are taken into consideration on a pro rata parte basis. Furthermore, a look-through approach applies in case the taxpayer holds participations through an intermediary holding company.

The acquisition of a participation or increase of an existing participation should be an expansion of operational activity of the group at the time of such acquisition or increase, or in the twelve month periods preceding and following the time of acquisition or increase. The preceding twelve month period should allow groups to expand operational activity and subsequently integrate such expansion in their existing organizational structure, by transferring participations acquired to the Dutch holding company of the group within the twelve month period following the acquisition. The twelve month period after acquisition should allow a participation some time to use capital contributed to it by the taxpayer for an expansion of its operational activity.

Exception to the exception: disregarded expansion of operational activity

There are three situations where expansion of operational activity may still result in non-deductible participation interest expense:

1. The interest is deducted twice ("double dip"), once by the taxpayer and once by a company related to the tax payer
2. Participation interest expense incurred in relation to the financing of a hybrid loan to the participation: the interest is deducted twice ("double dip"), once by the taxpayer and once by the participation, without a levy of tax which is reasonable by Dutch standards on the "interest" income on the hybrid loan (subject to counter proof)
3. It is not plausible that the taxpayer would have acquired the participation, increased the existing participation, or contributed capital to the participation, if interest deductibility would be disregarded. For example, an MNE with HQ outside the Netherlands, with a profitable Dutch operating company, which debt finances an acquisition of a foreign participation and subsequently transfers the participation to the Dutch operating company without the Dutch operating company having any management involvement in the participation.

Exclusion of foreign permanent establishments (PE's)

The restriction of participation interest expense does not apply to assets which fall under the object exemption for foreign profit (from PE's). It applies only to the Dutch head office.

Hedging instruments for interest risks and currency risks on participation debts

The restriction of deductibility also applies to expenses (e.g. brokerage commissions and legal fees) of, and results from, hedging contracts against interest risks on principal amount and against currency risks on interest installments. The restriction of deductibility does not, however, apply to expenses (e.g. brokerage commissions and legal fees) of hedging contracts against currency risks on principal amount, and currency risks on principal amount and results of hedging contracts against currency risks on principal amount.

Definitions for purposes of the restriction

For purposes of the restriction of participation interest expense,
“Debt” means all debts under civil law, including financial lease and hire-purchase. It does not include provisions and tax debts, nor does it include debts which are subject to other interest deduction restrictions and non-interest bearing debts (unless interest not owed is deductible because not charging interest is not at arm’s length);
“Equity” means fiscal equity as defined by case law, including fiscal reserves and hybrid financing;
“Participation” means an interest of 5% or more in the nominal paid-up share capital of another entity which qualifies for the participation exemption, including “deemed participations” under the constructive ownership rules (“meesleep”/”meetrek”).

Entry into force

The proposed restriction of deductibility of participation interest is scheduled to enter into effect on 1 January 2013, without transitional provisions for existing situations.

Conclusions

As a general rule, operational expansion of group activities through acquisition of participations which is not financed in a (deemed) abusive manner should not be affected by the proposed restriction. More specifically, taxpayers which:

1. Have fiscal equity which is equal to, or exceeds, the aggregate cost price of “tainted participations” (i.e. participations which were not an expansion of operational activity of the group or which were financed in an abusive manner, e.g. double dips financing), and/or
2. Have an annual (related and/or unrelated) interest expense of no more than € 1 million, should not be affected by the proposed restriction.

Finally, it should be noted that the proposed restriction could also affect taxpayers who have acquired participations in the past. In other word, taxpayers who do not acquire any participations in 2013 or thereafter may still be affected by the proposed restriction.