International Tax

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Supreme court confirms treatment of hybrid instruments for participation exemption purposes

Contacts

Pie Geelen
pigeelen@deloitte.com

Marie Oudemans
maoudemans@deloitte.com

The Dutch Supreme Court issued two landmark decisions on 7 February 2014 regarding the distinction between debt and equity for Dutch tax purposes. These decisions settled an issue that had been the subject of substantial debate, and they should be of major practical importance in terms of refinancing transactions. In both cases, the court held that an instrument that is considered equity from a legal perspective will be treated as equity for purposes of the application of the participation exemption. The court also held that the refinancing transactions that converted the taxpayers' loans into preferred shares were permissible exercises of the taxpayers' freedom to choose among methods of obtaining financing, as opposed to tax-abusive transactions.

Facts of the cases

In the first case, a banking syndicate initially financed a Dutch company that acquired a Dutch target though a loan. Through a complex multi-step refinancing transaction, the borrower then contributed the Dutch target in return for the common shares of a Dutch special purpose vehicle (SPV) and the banking syndicate acquired cumulative preference shares (CPS) in the SPV to replace its interest in the loan. For the banking syndicate, the new financing instrument was economically similar to the original loan in terms of remuneration, repayment, ranking and control (which was accomplished, for example, by way of additional agreements to manage the minimum term of the financing arrangement and to allow the bank syndicate to claim repayment by forcing a liquidation of the SPV).

In the second case, a Dutch company refinanced an Australian subsidiary by converting a loan to the subsidiary into redeemable preference shares (RPS) in the subsidiary. Features of the RPS included an annual cumulative return, issuance and repayment against nominal value, a higher repayment priority than other shares (but lower than debt), and limited voting rights. Payments on RPS are tax deductible in Australia.

The issue in both cases was whether the participation exemption should apply to income distributed on the CPS and RPS, respectively. The Dutch tax authorities took the position that the preferred shares should be reclassified as debt and the distributions taxed as interest income, rather than as dividends eligible for the participation exemption. Alternatively, the tax authorities claimed that the refinancing transactions should be regarded as tax abusive schemes that should be ignored or reclassified for tax purposes (as a result of which, the preferred dividends would be taxable).

The lower courts reached differing conclusions as to whether the participation exemption should be denied (and if so, on what grounds) and both cases ultimately were appealed to the Supreme Court.

Applicable law and decision of the Supreme Court

Under the participation exemption, dividends and other profit distributions, currency gains (or losses) and capital gains (or losses) on the disposal of a qualifying participation or part thereof are exempt from corporate income tax in the hands of the Dutch company holding the relevant participation if certain conditions are satisfied.

The Supreme Court rejected the tax authorities' position that an instrument that qualifies as equity from a legal perspective can be reclassified as debt for purposes of the application of the participation exemption. The court explained that, because the purpose of the participation exemption is to avoid double taxation, the relevant criterion in determining whether income is eligible for the participation exemption is whether it was received as remuneration for contributed share capital, so that if an instrument is considered share capital for corporate law purposes, that classification also applies for purposes of determining whether the participation exemption applies. The court held that the legal classification of the financing instrument as equity is the key to satisfying this criterion.

The Supreme Court opined that the main legal characteristic of equity is its risk profile, i.e. it ranks lower in priority than any (subordinated) debt and, in principle, is not repayable at the expense of creditors. If an instrument satisfies this main characteristic and otherwise qualifies as equity from a legal perspective, then the presence of other, debt-like features (such as a fixed remuneration, the ability to enforce repayment and a risk profile structured similarly to that of a creditor) do not result in a reclassification as debt for tax purposes. Further, the court stated that, to ensure legal certainty, it would not make exceptions to this rule (although conversely, certain equity-like debt instruments may be reclassified as equity).

Additionally, the Supreme Court noted that the application of the participation exemption does not depend on whether the subsidiary is able to deduct the dividends paid (as was the case for the Australian subsidiary) or on the accounting treatment at the level of the parent company or the subsidiary.

The Supreme Court also rejected the tax authorities' argument that the taxpayers abused the tax law. The court confirmed that the taxpayers were free to choose the form in which to finance their subsidiaries. Exercising this freedom does not violate the abuse of law doctrine, so the court held that the refinancing transactions were not tax abusive.

Comments

The Supreme Court decision settles the debate as to whether an instrument classified as equity for legal purposes can be reclassified as debt for purposes of the Dutch participation exemption, by confirming that it cannot. The decision to deny any exceptions (even for hybrid mismatches) in favor of a clear rule is positive for taxpayers. Additionally, the court's acknowledgement that a refinancing transaction that converts a lender's interest from debt to equity is not, in itself, considered tax abusive should provide welcome certainty.