taxnotes® international

Volume 114, Number 6 ■ May 6, 2024

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Reprinted from *Tax Notes International*, May 6, 2024, p. 831

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Recent Dutch Tax Developments in M&A Transactions

by Ashley Peeters and Michael Molenaars

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In this installment of In Step With Stibbe, Peeters and Molenaars discuss recent Dutch tax developments that are relevant to mergers and acquisitions transactions with a Dutch component.

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Recently, several Dutch and EU publications have been released that address tax topics relevant to M&A transactions. Topics in these Dutch court opinions, EU and Dutch advocate general opinions, and Dutch knowledge group positions (KGP)[1] include:

- the Dutch anti-base-erosion rules;
- currency exchange results in light of the Dutch participation exemption;
- the tax treatment of transaction costs and transaction bonuses; and
- warranty and indemnity (W&I) insurance.

We discuss these topics below and briefly touch upon certain pillar 2[2] aspects of M&A transactions.

Dutch Anti-Base-Erosion Rules

The Dutch anti-base-erosion rules aim to prevent an artificial erosion of the Dutch tax base by creating interest charges within a group of affiliated taxpayers. The rules prohibit the deduction of interest on loans to affiliated companies used to finance dividend payments or capital repayments, among other things, or the acquisition of an interest in a company that qualifies as an affiliated company of the taxpayer after acquisition (these transactions are also known as tainted transactions). If the taxpayer proves that both the transaction and its financing are predominantly based on business motives, an escape applies whereby as a result the interest would be deductible.

Advocate General Nicholas Emiliou[3] of the Court of Justice of the European Union and Advocate General Peter J. Wattel[4] of the Dutch Supreme Court recently published opinions regarding these Dutch anti-base-erosion rules. The Dutch Supreme Court issued a decision in a case involving the aforementioned rules on March 22, 2024.[5]

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[1]Within the Dutch tax authorities are several so-called knowledge groups that specialize in different aspects of Dutch taxes. Tax inspectors may submit cases to a particular knowledge group and it will take a position in a KGP. Before March 2023, KGPs were disseminated only within the Dutch tax administration, but as of March 2023 KGPs are publicly released, which is highly relevant to taxpayers and tax practitioners.

[2]The EU minimum tax directive (Council Directive (EU) 2022/2523 of December 14, 2022).

[3]Opinion of Advocate General Emiliou in *X BV v. Staatssecretaris van Financiën*, C-585/22, ECLI:EU:C:2024:238 (Mar. 14, 2024).

[4]Opinion of Advocate General Wattel, 23/02746, ECLI:NL:PHR:2024:85 (Jan. 26, 2024) (in Dutch).

[5]Dutch Supreme Court, 21/01534, ECLI:NL:HR:2024:469 (2024).

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Emiliou Opinion

The Dutch Supreme Court had petitioned[6] the CJEU to clarify its so-called *Lexel* decision[7] on whether intragroup loans may be regarded as wholly artificial arrangements in light of the Dutch anti-base-erosion rules, and if such loans are carried out on an arm's-length basis. It could be derived from the CJEU's *Lexel* decision that loans based on arm's-length terms cannot be considered wholly artificial and therefore not abusive.

The expectation was that Emiliou would either (1) provide a deeper nuance to the *Lexel* decision, or (2) confirm that — in line with *Lexel* — a distinction should be made between loans entered into on an arm's-length basis and those that are not.[8] Contrary to the expectation, Emiliou's opinion finds that whether an intercompany loan has been concluded on arm's-length terms is irrelevant in deciding whether a loan has been concluded for genuine business reasons.

The advocate general submits that the decisive consideration is whether the entering into of the loan is overall devoid of economic or commercial justification and whether the sole or main purpose of the loan is to generate deductible interest payments at the borrowing company. He agrees with the Dutch government that the latter type of loan cannot be regarded as "reflecting economic reality," even if its terms and conditions are at arm's length and should fall under the scope of the Dutch anti-base-erosion rules. However, the actual purpose of those rules is solely to deny the deduction of interest on loans that have been entered into in connection with exempt income and not to target every situation whereby the sole purpose is to generate deductible interest payments, especially if there is an actual financing need for the business activities of the borrower. It is now up to the CJEU to answer the preliminary questions and decide whether and to what extent the Dutch anti-base-erosion rules are compatible with EU law.

Wattel Opinion

On January 26, 2024, Wattel issued an opinion in a case that was submitted to the Dutch Supreme Court. The main question was whether the doctrine of *fraus legis* could be applicable if the relevant interest deduction does not fall under the scope of the Dutch anti-base-erosion rules. In other words, is the scope of *fraus legis* broader than the scope of the existing Dutch anti-base-erosion rules?

The doctrine of *fraus legis* implies that if a taxpayer acts contrary to the purpose and purport of the law, the intended tax benefits must be refused. Two requirements must be met for the doctrine to apply:

1. There must be conflict with the purpose and purport of the law, which is broader than the mere text of the law (the purpose requirement), and
2. the predominant motive for entering into the transaction is tax evasion (the motive requirement).

In the underlying case the plaintiff stated that the anti-base-erosion rules would not be applicable because the recipient of the interest payment was not deemed an affiliated party (this is one of the conditions for the anti-base-erosion rules to be applicable). Therefore, the plaintiff believed the interest payment could not be deemed artificial under the rules and *fraus legis* should also not be applicable. Even if there are no affiliated parties, Wattel observed that, based on legislative history, in exceptional cases in which interest deduction does not fall under the scope of the anti-base-erosion rules but the boundaries of permissible tax savings have clearly been exceeded, interest deduction can still be denied on the grounds of *fraus legis*. Wattel stated that there would be a presumption that the parties are acting in good faith when the parties are not affiliated, but that this does not mean that application of the *fraus legis* doctrine is not possible when there is clear motive for tax evasion. Further, Wattel advised the Dutch Supreme Court to provide more clarity on the doctrine of *fraus legis* with regard to the antiabuse rules. There will be more

[6] Request for a preliminary ruling from the Netherlands in *X BV v Staatssecretaris van Financiën*, Case C-585/22 (Sept. 7, 2022).

[7] *Lexel AB v. Sweden*, C-484/19 (CJEU 2021).

[8] Loans entered into on an arm's-length basis are, in principle, regarded as genuine and entered into based on business motives; loans that are not contracted that way may be regarded as artificial.

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clarity when the Dutch Supreme Court eventually issues its ruling.

Dutch Supreme Court

The Dutch Supreme Court has issued a decision on the anti-base-erosion rules[9] in separate litigation in a different case In this case, the parties were, in principle, not affiliated for purposes of the Dutch anti-base-erosion rules. The Dutch Supreme Court decided that the legislative history provides room for the application of *fraus legis* in exceptional cases where the boundary of allowed tax savings is clearly crossed. However, based on the legislative history, those cases are already extensively codified, and application of *fraus legis* regarding interest deductions will not likely occur in practice. The Dutch Supreme Court ruled that, in this case, the parties partly did not intentionally create an artificial situation in which they would not be deemed affiliated for the purposes of the Dutch anti-base-erosion rules. The decision in favor of the parties was only in part because a co-investor vehicle was also created that was considered artificial because it was intentionally put in place to avoid tax and it was an affiliated party for purposes of the Dutch anti-base-erosion rules. As a result, it should not be deemed an exceptional case with a clear crossing of the boundary of allowed tax savings and hence the interest on those specific loans was partly deductible.

Based on the advocate general opinions and the recent decision of the Dutch Supreme Court, it is clear that the exact boundaries of the anti-base-erosion rules and the interaction with *fraus legis* are not fully crystallized. When funding, for example, a hypothetical Dutch BidCo to acquire a Dutch target entity, it would be important to take into account and analyze the potential application of the anti-base-erosion rules.

Currency Exchange Results

The general rule under the Dutch participation exemption is that costs regarding the acquisition or sale of a qualifying participation[10] fall under the scope of the exemption and are not considered when determining the taxable profit and will not be deductible for Dutch tax purposes. The foregoing also applies to profits or losses that result from hedging instruments for the currency exchange risks of participation.

According to paragraph 1.7.4. of the decree of the Dutch underminister of finance, No. 2020-0000000002 (March 9, 2020), it has been approved that, for example, when a hedging instrument is used for the future payment of a purchase price in a different currency (one different from the functional currency of the taxpayer) to acquire a participation, profits and losses resulting from the currency exchange on the derivative will also fall under the scope of the Dutch participation exemption to the extent prior written approval has been obtained from the Dutch tax authorities.

In a March KGP,[11] a taxpayer acquired a participation that applied a currency other than the taxpayer's. The taxpayer planned to contribute capital to its new subsidiary in several tranches and the question was whether the hedging instruments for those envisaged capital contributions could also fall under the scope of the clarification as specified in the decree. The knowledge group is of the opinion that profits or losses from hedging instruments regarding capital contributions in a different currency should also fall under the scope of the Dutch participation exemption. However, it is noted that prior written approval is required in this respect to prevent last-minute taxpayer decisions regarding whether it would be beneficial (when there is a currency exchange profit) to request the approval, or whether it would be better (in case of a loss) to not let it fall under the scope of the Dutch participation exemption. The KGP further clarifies that there is no all-or-nothing approach for the several tranches of capital contributions, which means that if one prior approval is forgotten, this will, in principle, not affect the other contributions if there is timely prior written

[9] Dutch Supreme Court, 21/01534, ECLI:NL:HR:2024:469. Please note we will only discuss the *fraus legis* aspect of this ruling and will not discuss the other aspects of the case.

[10] In general, this is the case when a shareholder holds an interest of at least 5 percent of the nominal paid-up and outstanding capital of a company, subject to certain antiabuse rules.

[11] KG:023:2024:3.

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approval for those other contributions. Based on the foregoing, it is important that timely prior approval is acquired to be able to include the results under the scope of the Dutch participation exemption.

On February 6, 2024, a knowledge group released a KGP[12] regarding the situation when a taxpayer holds a participation in a subsidiary that applies a currency other than the taxpayer's. The taxpayer wants to acquire more shares in the subsidiary and a sale and purchase agreement is created for that purpose. In the agreement several contingent conditions that were beyond the control of the relevant taxpayer were included before the shares could be acquired. The taxpayer concluded several hedging instruments regarding the potential contingent payment of the purchase price and did not request prior approval as described above. In the KGP, the Dutch tax authorities hold the view that given the uncertainty as to whether the contingent conditions would be met, the hedging instruments could not be linked to the participation as such and therefore could not fall within the scope of the Dutch participation exemption.

On November 3, 2023, the Dutch Supreme Court issued a decision[13] regarding an international group consisting of a U.S. parent entity and a wholly owned Dutch subsidiary that holds all shares in a Swiss entity. A debt payoff plan was installed to pay off the intercompany debts within the group. A dividend payment from the Swiss entity to the Dutch entity was decided upon on July 1, 2011, and the payment took place on August 4, 2011. The exchange rate of the Swiss franc against the euro increased in that period. The Dutch entity took the position that the dividend should be accounted for in euros on August 4, 2011, and that the profit should fall under the Dutch participation exemption. The Dutch Supreme Court ruled that the dividend receivable on the Swiss subsidiary was created July 1, 2011 (the dividend declaration date) and at that moment a benefit by virtue of participation was received. Any currency exchange results after that date should not be deemed related to the participation and as a result the Dutch participation exemption could not be applicable on the currency gain. Dutch holding companies that are part of an international group in which multiple foreign currencies are involved should carefully consider this decision in order to mitigate potential taxation of foreign exchange results in respect of dividend distributions. This decision is especially relevant if a minority interest is held or if there are listed shares, situations in which the shareholder may have less control of the timing of the dividend (that is, declaration and payment thereof could result in taxable foreign exchange results).

Transaction Costs and Bonuses

In general, transaction costs and bonuses relating to the acquisition or sale of a qualifying participation[14] are not deductible under the Dutch participation exemption. On February 1, 2024, a knowledge group focusing on the Dutch participation exemption published an updated KGP as an aid for the Dutch tax administration (TC document).

The TC document first discusses allocation of transaction costs. Before the tax treatment of transaction costs in light of the Dutch participation exemption can be analyzed, the first question is to whom the costs are allocable. The knowledge group states that the benefit test is important in this regard, and that the question is: Who benefits most from the services that underlie the costs? Two other considerations that should be taken into account are (1) the motive for incurring such transaction costs, and (2) how such costs would be allocated by third parties.

The next step is to determine whether those costs should be qualified as transaction costs. Based on a 2018 Dutch Supreme Court decision,[15] it is important to determine whether there is a direct causal connection with the sale or acquisition of a subsidiary. Costs that qualify as transaction costs include: costs for managing the transaction, costs for due diligence investigations, costs for a virtual data room, legal fees, costs for

[12]KG:023:2024:1.

[13]Dutch Supreme Court, 21/03076, ECLI:NL:HR:2023:1504 (2023).

[14]We refer to footnote 10.

[15]Dutch Supreme Court, 17/01211, ECLI:NL:HR:2018:2264 (2018).

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drafting the transaction documentation, a success fee, and notary costs.

A more recent Dutch Supreme Court decision[16] is also mentioned in the TC document. In December 2023 the Dutch Supreme Court ruled in a case that concerned farewell bonuses granted to an entire staff after the sale of a subsidiary. The Dutch Supreme Court clarified that the required direct causal connection to the transaction includes the condition that costs are incurred because they are, objectively speaking, useful or necessary to achieve or complete the transaction. The required direct causal connection is lacking if there are costs that would not have been incurred if the transaction had not taken place, but which otherwise in no way contribute to the realization of that transaction. Those expenses do not have a direct causal connection to the transaction. The Dutch Supreme Court ruled that, based on the specific circumstances, and mainly because the farewell bonuses were paid after the transaction, the costs should not be qualified as nondeductible transaction costs. However, it is still not fully clear when the payment of bonuses could qualify as having a direct causal connection with the transaction.

The TC document mentions that the deductibility (or nondeductibility) of costs focuses on internal and external costs that are incurred in the course of a transaction, and not only on costs that are incurred as part of the legal transfer of shares by a civil law notary.

The TC document mentions 19 examples of these costs, including:

- costs of conducting a preliminary investigation of assets for acquisition or disposal;
- costs of an information memorandum;
- costs of sales preparation;
- costs of W&I insurance;
- costs of drafting a buyer's long list and shortlist; and
- costs of competition authority approval.

When there are so-called mixed costs, parties could come to an agreement with the Dutch tax authorities regarding an individual distribution key.

W&I Insurance

As mentioned above regarding the TC document, W&I insurance costs are deemed to be transaction costs and are nondeductible for Dutch corporate income tax purposes under the Dutch participation exemption.

A March 14, 2024, KGP addresses the legal costs of making a claim under a W&I insurance policy.[17] The taxpayer issued a claim under W&I insurance after a breach of the seller under the warranties. The insurer dismissed the claim and this led to legal proceedings. Based on the facts in the KGP, the taxpayer was ruled against and was ordered to pay the legal costs of the W&I insurer.

The question was whether the costs for those legal proceedings would also fall under the scope of the Dutch participation exemption and thus be nondeductible. The knowledge group said it is of the opinion that this is not the case, referring to the aforementioned farewell bonus case. The costs for the legal proceedings did not have a direct causal connection to the transaction and the costs were not necessary to complete the transaction. Even though this point of view does not come as a surprise, it is beneficial to taxpayers to have certainty in this respect.

Pillar 2

Pillar 2 has been implemented in the Netherlands as of January 1, 2024. Pillar 2 aims to target both international and domestic groups whose consolidated group revenue exceeds €750 million in at least two of four consecutive years, and introduces a minimum effective tax rate of 15 percent. The basic mechanism is that if an in-scope group is subject to an ETR that does not meet the minimum standard in a country where the group carries out activities, member states will collect a top-up tax by means of (1) the income inclusion rule (the minimum ETR is paid at the level of the ultimate parent entity, in proportion to its ownership rights in subsidiaries that are taxed at a low ETR), (2) the qualified domestic minimum top-up tax (QDMTT) (whereby any top-up tax to be paid by domestic entities with an ETR of less than 15 percent that

[16] Dutch Supreme Court, 22/02219, ECLI:NL:HR:2023:1793 (2023).

[17] KG:023:2024:2.

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are part of an in-scope group will be collected by their own government, instead of by the ultimate parent entity in another jurisdiction), or (3) the UTPR (formerly known as the undertaxed payments rule, which functions as a backstop rule in addition to the IIR and results in a top-up tax at the level of the parent entity if not captured under the IIR or QDMTT, and is applicable as of January 1, 2025).

Pillar 2 may have a significant impact on commercial considerations of M&A transactions. Acquiring a target may result in the acquiring group meeting the minimum revenue level for pillar 2 purposes and could have an impact on the acquiring group's ETR and administrative obligations under pillar 2. However, it could also be an advantage if the target group has a high ETR because this could increase the acquirer group's overall ETR.

According to the Dutch implementation of pillar 2, a sovereign wealth fund (SWF) is in principle not considered (1) to be an ultimate parent entity, (2) part of a multinational enterprise group, and (3) to own a controlling interest in any entity in which it has an ownership interest. The reason is that MNE groups that would not meet the €750 million threshold on their own could be treated as part of a larger MNE group merely because they were owned by a SWF that is required to consolidate the entities in which it has a controlling ownership interest. According to agreed administrative guidance published by the OECD in February 2023,[18] this outcome is consistent with the intention to treat a SWF that qualifies as a governmental entity in the same way as a government under the pillar 2 rules (that is, a government cannot be considered an entity and therefore falls out of scope of pillar 2). Thus, from a Dutch/EU pillar 2 perspective, an SWF (depending on the structuring of the transaction) may not have to deal with pillar 2 consequences when bidding on a target that does not meet the €750 million threshold, while a non-SWF bidder might have to take these consequences into account if the acquirer's group meets the relevant pillar 2 threshold.

Apart from more commercial reasons, the overall process of an M&A transaction will also be affected because for pillar 2, protection in the form of warranties and indemnities may be included in transaction documentation. Furthermore, it requires taking into account more specific pillar 2 due diligence when structuring and documenting the transaction.

But pillar 2 has just been implemented recently, so it will take time to learn how these rules will play out in practice in M&A transactions. ■

[18] OECD, "Tax Challenges Arising From the Digitalisation of the Economy — Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)" (Feb. 2023).

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