taxnotes® international

Volume 116, Number 4 ■ October 28, 2024

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Reprinted from *Tax Notes International*, October 28, 2024, p. 649

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In this installment of In Step With Stibbe, Peeters and Molenaars examine a recent tax ruling of the Dutch Supreme Court regarding the qualifications of instruments as debt or equity for Dutch tax purposes and a recent ruling of the District Court of Amsterdam that also touches upon this subject.

The Dutch Supreme Court issued an important ruling on May 17 regarding the qualification of instruments as debt or equity for Dutch corporate income tax purposes (the ORA ruling).[1] The court discussed the qualification of French *obligations remboursables en actions* (ORAs). ORAs are convertible bonds with a term of 50 years, in which the repayment takes the form of company shares instead of cash.

First, we discuss the general Dutch tax rules regarding the qualification of an instrument as debt or equity. Then we discuss the ORA ruling and a recent District Court of Amsterdam ruling published on June 13 (the court ruling)[2] that addressed the question of whether a receivable should be qualified as a so-called sham loan (*schijnlening*) and thus qualify as equity. We conclude with some remarks about both rulings.

Debt vs. Equity

In general, whether an instrument should qualify as debt or equity for Dutch corporate income tax purposes depends on the corporate law qualification of the instrument. This characterization is important for Dutch corporate income tax purposes because it helps to determine, for example, whether losses on that loan would be deductible (if the instrument is qualified as debt) and whether interest should be considered at the level of the debtor (to the extent the instrument is qualified as debt). As a general rule, for Dutch corporate income tax purposes, we follow the corporate law qualification subject to certain exclusions that have predominantly been developed through Dutch case law.

Based on Dutch Supreme Court case law, a loan may be recharacterized as equity for Dutch corporate income tax purposes in the following situations:

1. The parties deliberately intend to create an equity instrument instead of a loan (a sham transaction).[3]

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[1] Dutch Supreme Court, 21/00415, ECLI:NL:HR:2024:706 (May 17, 2024).

[2] District Court of Amsterdam, 23/488, 23/489, 23/490, ECLI:NL:GHAMS:2024:1619 (June 13, 2024). This is a different ruling than the ruling of the District Court of Amsterdam against which cassation was instituted and that lead to the ORA ruling (District Court of Amsterdam, 18/00688 and 18/00689, ECLI:NL:GHAMS:2020:3634 (Dec. 22, 2020)).

[3] Dutch Supreme Court, 11 928, ECLI:NL:HR:1954:AY3410 (Nov. 3, 1954).

2. The creditor (owns a shareholding in the debtor and) provides a loan under such conditions that the debt claim, at the time the loan is extended, is effectively wholly or partly without value because of the creditworthiness of the debtor; although the creditor intends to provide a loan, it is immediately clear at the time the loan is provided that it can never be repaid, making the funds effectively an equity contribution to the debtor (loss financing, or *bodemlozeputlening*).[4]
3. The creditor extends a loan under such conditions that the creditor effectively participates, to a certain degree, in the enterprise of the debtor (a participation loan, or *deelnemerschapslening*).[5]

Based on case law, a participation loan is only present if the following three cumulative conditions are met:

1. The interest payable on the loan is (entirely or nearly entirely) contingent on profits.
2. The debt obligation is subordinated to all *pari passu* ranking creditors.
3. The debt obligation has no fixed term (or a term greater than 50 years) and is payable only in cases of bankruptcy, suspension of payments, or liquidation of the debtor.

Apart from the characterization as debt or equity, the Dutch tax authorities may also challenge an interest rate agreed upon between related entities if the authorities deem it not to be at arm's length. If this occurs, the authorities will first attempt to commercialize and adjust the loan to arm's-length conditions. However, if an arm's-length interest rate cannot be established without it resembling a profit-sharing remuneration, the loan may be classified as uncommercial or not at arm's length. As a result, any potential loss on the loan cannot be deducted from the creditor's profit. In addition, a fictitious interest rate must then be calculated to be the rate that the debtor would have provided to a third party with the surety of the related party from which the monies are actually borrowed. Interest received above this fictitious rate will not be deductible, while interest received below it is, in principle, deductible, but could still be subject to other specific interest deduction limitation rules.[6]

ORA Ruling

The ORA ruling concerned a French *société anonyme* (a listed entity, hereinafter French SA) whose activities consisted of letting real estate. As of 2007 there was a permanent establishment in the Netherlands. The only asset of the Dutch PE was the shares in a Dutch NV (*naamloze vennootschap*). The shares were acquired after a public trade offer. As part of this trade offer, the previous shareholders of the Dutch NV could either choose to receive shares in the French SA or ORAs. Figure 1 is a schematic overview of the structured trade offer based on the facts and circumstances as described in the ORA ruling.

The ORAs were issued at nominal value equal to the issue price of the new shares in the French SA at the moment of issuing the ORAs and had a term of 50 years. After 12 years, the French SA could convert the ORAs into shares in the French SA and, three months after the issuance, the holders of ORAs had the option to convert their ORAs into shares in the French SA. Repayment in cash was, in principle, impossible, and could only be made through conversion to shares in the French SA, and only in the case of an involuntary or voluntary liquidation of the French SA could the ORA holders receive cash as payment. The ORA holders were subordinated to all creditors of the French SA, but had a preferential right to shares and participating loans (*prêts participatifs*) and had no shareholder rights. From a French corporate law perspective, the ORA was qualified as debt.

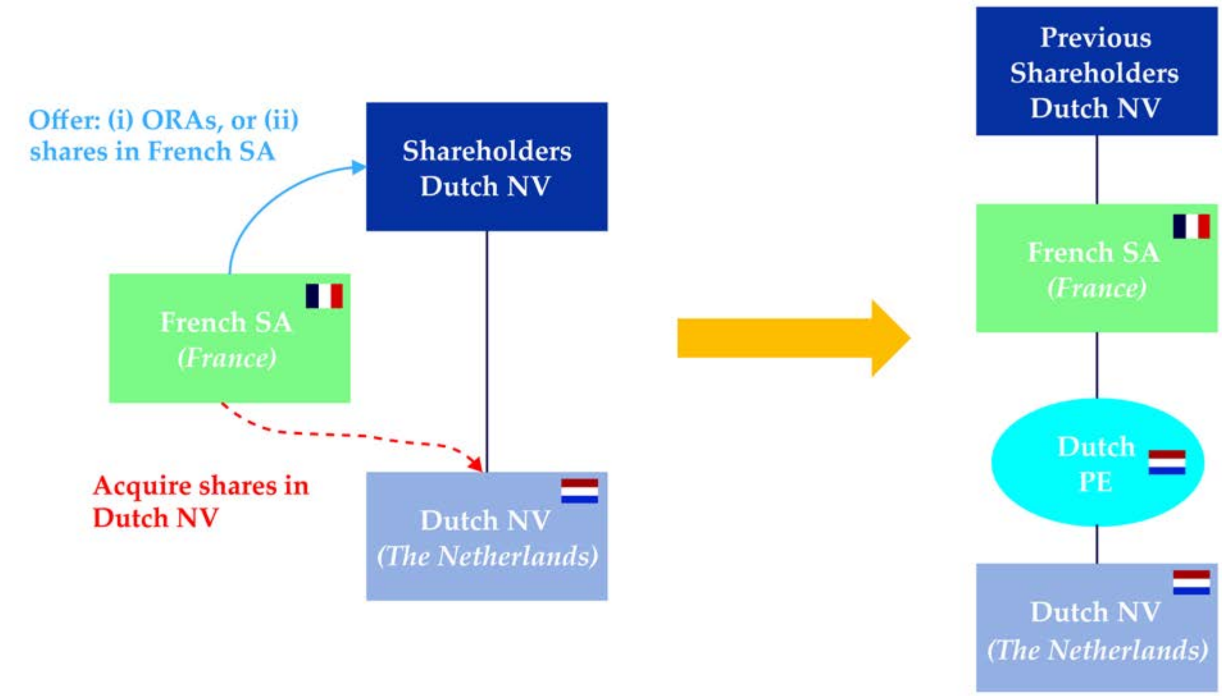
For the structured trade offer of the ORAs, certain emission costs were made at the level of the French SA to issue the ORAs. One of the questions was whether these emission costs would qualify as costs associated with the company's legal form (and be attributable to the French SA) or whether emission costs would be costs connected to a financial instrument

[4] Dutch Supreme Court, 23.919, ECLI:NL:HR:1988:ZC3744 (Jan. 27, 1988).

[5] *Id.*

[6] Please note we will not discuss further the subject of interest that is not at arm's length or the specific antiabuse interest deduction limitation rules.

Figure 1. Schematic Overview: Facts and Circumstances of ORA Ruling



Source: Information derived from facts and circumstances as presented in the ORA ruling (Dutch Supreme Court, 21/00415, ECLI:NL:HR:2024:706 (May 17, 2024)).

attributable to, and most likely deductible at, the level of the Dutch PE. In short, the Dutch Supreme Court ruled that the costs should be allocable to the French SA because they should be seen as costs associated with the company's legal form. Based on the tax treaty between France and the Netherlands, the right to levy is allocated to the Netherlands. Only to the extent the emission costs are allocable to the PE are they deductible (subject to whether the ORAs are debt or equity).

Below we discuss why the Dutch Supreme Court ruled that the ORAs should be qualified as equity for Dutch corporate income tax purposes. The court applied the following reasoning for doing so.

First, following earlier case law,[7] the Dutch Supreme Court stated that *in principle* (*in beginsel)* the corporate law qualification of an instrument has to be followed for these purposes. The emphasized "in principle" has been newly added by the Dutch Supreme Court in this case compared with previous case law. A repayment obligation (*terugbetalingsverplichting*), according to earlier case law,[8] is the relevant criterion to determine whether providing money (*geldverstrekking*) qualifies as debt. An instrument is still debt when the repayment obligation is conditional and uncertain or when the creditors in case of a liquidation or bankruptcy rank equally to preferent shareholders.

Second, the Dutch Supreme Court held that, regardless of the French corporate law qualification, the ORAs are equity for Dutch tax purposes because there is no enforceable right for the holders of the instruments to be paid back in cash. The fact that cash is payable in case of a (voluntary) liquidation is, according to the Dutch Supreme Court, such an extraordinary

[7] Dutch Supreme Court, 18/03178, ECLI:NL:HR:2020:874 (May 15, 2020).

[8] Dutch Supreme Court, 42015, ECLI:NL:HR:2006:AV2327 (Sept. 8, 2006).

circumstance that this does not alter the base commitment between the ORA holders and the French SA to convert the instrument in shares (and no cash repayment).

The Dutch Supreme Court added the words "in principle" when discussing the rule that the corporate law qualification must be followed when qualifying for tax purposes an instrument that qualifies as equity for corporate law purposes. Based on previous case law it has always been clear that the starting point should be the corporate law qualification, and only in specific circumstances (as described in the previous section of this article, "Debt vs. Equity") can one deviate from this qualification. Adding "in principle" seems to open the door for more exceptions to this general doctrine that have not been clearly defined in either legislation or case law, as opposed to the exceptions mentioned earlier. Therefore, this seems to imply that in some situations the corporate law qualification will be followed as a general rule, but it is unknown in which situations one should or could deviate from that rule. The exact intention of the Dutch Supreme Court is unclear, and it is also surprising that neither the district court nor the Dutch Supreme Court have considered that, from a French perspective, the ORAs are qualified as debt for tax purposes. The reason for not following the French corporate law qualification is not discussed in the ORA ruling.

From the ORA ruling, it can be derived that instruments similar to ORAs may also qualify as equities for Dutch corporate income tax purposes. For example, instruments that contain a mandatory conversion into shares may — because there is no repayment in cash — be qualified as equity for Dutch corporate income tax purposes. And what about a reverse convertible? The ORA ruling shows that it depends on all facts and circumstances to qualify an instrument as debt or equity. The supreme court did not discuss other consequences of an instrument qualifying as equity, such as the application of the Dutch participation exemption (whereby the main condition is that the interest in the subsidiary represents 5 percent or more of the nominal paid-up capital), whether holders of similar rights would be able to apply that exemption, and whether payments on those instruments would be deemed dividends for Dutch tax purposes.

Court Ruling

The June 13 court ruling by the District Court of Amsterdam considered the possible application of the sham transaction principle. As discussed above in the section "Debt vs. Equity," a sham transaction might be present if the parties intend to create an equity instrument instead of a debt instrument.

Figure 2 shows the schematic overview of the taxpayer's structure, as provided by the taxpayer to the court.

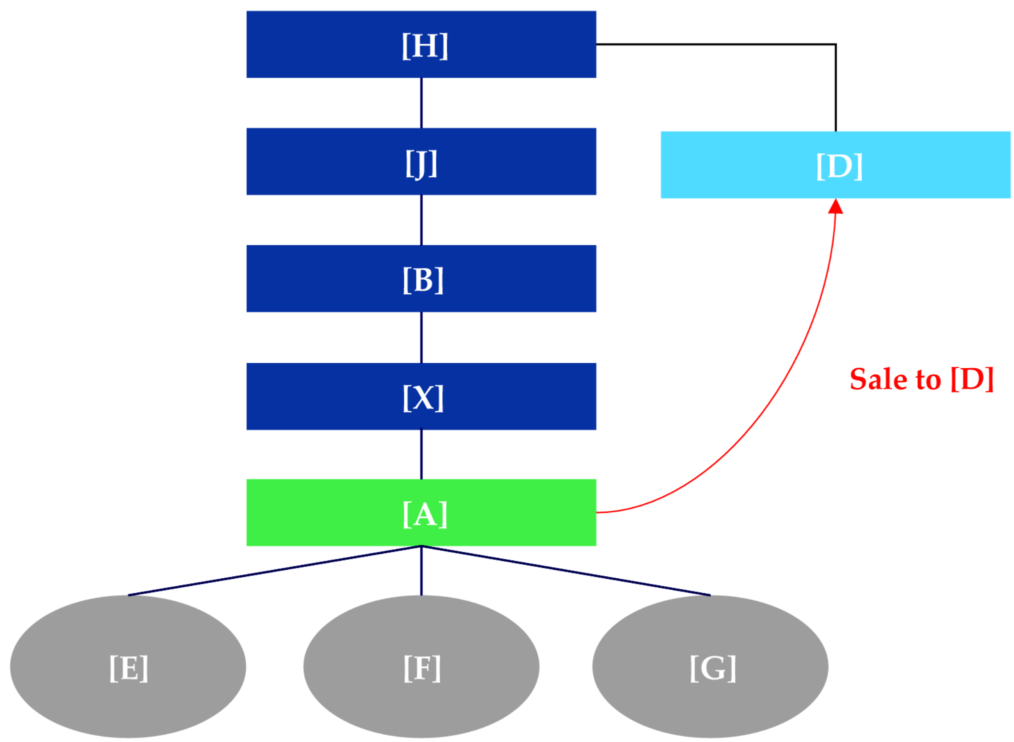
The court ruling concerned [A], a Dutch taxpayer, that sold three of its subsidiaries ([E], [F], and [G], or "the subsidiaries") to an indirect sister entity, [D], a Mauritian taxpayer, for USD 62,300,000 (the purchase price). [D] never paid [A] the purchase price and the question arose whether the nonpayment of the purchase price should be qualified as a receivable on which interest would be payable. Later, the receivable on [D] was distributed to [H] as a deemed dividend distribution. Several agreements were entered into between [A] and [D] in which the parties agreed on the transfer of the subsidiaries and that the purchase price would remain outstanding, but it was also clear from the agreements that the purchase price was due and payable by [D] to [A].

If the nonpayment of the purchase price were deemed a sham loan, this would be seen as equity and therefore no taxable interest on the amount would have to be imputed at the level of [A].[9] Therefore, taxpayer [A] tried to reason that it should be seen as equity to prevent an extra taxable amount of imputed interest. The Dutch tax authorities believed it should be qualified as debt and that [A] was supposed to impute interest in the relevant tax years.

The district court thought that the nonpayment of the purchase price should be qualified as a receivable (*vordering*) on which taxable interest should have been imputed. As

[9]Please note that we will discuss only the relevant considerations regarding the qualification of an instrument as a sham loan and will not discuss the other considerations of the court ruling. The entities [J], [B], and [X] as shown in Figure 2 were not relevant for these considerations and are therefore not mentioned here.

Figure 2. Schematic Overview of the Taxpayer's Structure



Source: Reprinted from the court ruling (District Court of Amsterdam, 23/488, 23/489, 23/490, ECLI:NL:GHAMS:2024:1619 (June 13, 2024)).

mentioned, taxpayer [A] argued that this was not the case because the receivable that should be requalified as equity qualifies as a sham loan. The reasons [A] gave were mainly that there was no loan agreement, no agreements regarding the terms and repayment, no interest had been taken into account, no action was undertaken to have [D] pay the amounts that are due, and according to [A], there was never an intention or expectation that the amounts would be paid back. Therefore, the receivable should be requalified as equity because the parties had no intention of repaying the amounts.

The court held that the nonpayment of the purchase price qualified as debt for tax purposes and that the sham loan principle (because of which the debt would be qualified as equity) did not apply. The court did not discuss the reasoning for why the facts were not enough to have the loan qualify as a sham loan for Dutch corporate income tax purposes, but it can be derived from this ruling that the burden of proof regarding the requalification of a loan as equity is high and that it may be difficult to prove the intention of the parties based on the sham loan principle after the fact (at least in the situation in which the taxpayer tries to apply the sham loan principle to their advantage, as was the case in this court ruling).

Final Remarks

The ORA ruling shows that the last word regarding the qualification of instruments as debt or equity for Dutch tax purposes has not yet been said. Apart from the fact that the ORA ruling gives some clarity on how certain characteristics of financial instruments translate into the qualification analysis for Dutch tax purposes, it remains a factual analysis. The exact consequences of the qualification of instruments as equity is also unclear for purposes of the Dutch participation exemption. The Dutch Supreme Court opened the door for some uncertainty for taxpayers by adding that, in principle, the corporate law qualification should be followed when an instrument that is capital for corporate law purposes is to be qualified for tax purposes.

The court ruling shines some light on how the underlying facts and circumstances affect the discussion of whether a receivable should be requalified as equity because it qualifies as a sham loan. The court ruling proves that the burden of proof in this respect is high and so it might be difficult to prove the intention of the different parties in hindsight.

We expect that more case law will be issued regarding the debt and equity question and hope that it provides more answers for taxpayers. ■