The provision of funding: loans or capital? Profit participating loans. The Dutch tax view

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Many years ago tax authorities took for granted how tax payers denominated the way they provided funding to group companies. Funding with formal capital is still easy to determine, but as soon as the provision of funding to group companies takes place as informal capital, the analysis can easily get blurred. In addition there are the "funny loans": loan agreements whereby the terms and conditions differ markedly from loans between independent players.

After all, freedom of contract is available in most jurisdictions so parties can on paper agree to anything they want. And if money is provided from the top company in a group to its subsidiaries, the parent will often decide on its own what the terms and conditions should look like. Room for toying around, therefore, sometimes with unexpected consequences. Do it wrong and you end up with non-deductible interest expenses in one group entity but taxable interest income in another group entity. But the opposite is also possible: tax-deductible interest on the one hand but tax free interest income on the other hand.

This occurs because tax authorities, since the mid-eighties of the previous century, have found out that tax courts are willing, depending on the circumstances of each case, to reclassify interest payments into "deemed" dividends. The payer of an interest amount which is reclassified as deemed dividend faces non-deductibility (dividends are not tax-deductible in 99% of jurisdictions) but the recipient of a reclassified interest flow may well be able to claim a tax exemption: if real dividends can be received free form corporate income tax, then deemed dividends should be treated the same way. Many Western-European tax jurisdictions offer such a "participation exemption" nowadays: France, Belgium, the Netherlands, Germany, Spain, Sweden etc. The UK is considering participation exemption too.

"What constitutes a loan for accounting purposes may not be a loan for tax purposes"

During the last three decades or so of the 20th century, the Dutch Supreme Tax Court faced a number of cases whereby tax payers defended a different tax treatment of their interest income or expense than the tax authorities. This usually dealt with interest payment between related entities where conditions were imposed which one would hardly find elsewhere.

In a case where the parent of a group provided a loan to a subsidiary company in the group, but it was clear from the internal documentation that the intention had been to provide equity, but parties wanted to circumvent certain legal disadvantages to a capital contribution so they called the provision of the funds a "loan agreement", the verdict was that this was not a loan but capital for tax purposes despite the wording of the document. The interest income from this loan was subsequently a deemed divided under the Dutch Corporate Income Tax Act (CITA) and remained untaxed (whilst abroad the interest was fully tax deductible).

In a second major verdict, the Supreme Tax Court faced a situation where a subsidiary of a multinational was obliged to redeem a bank loan and asked its parent company to lend her the money to repay the bank. So one loan was replaced by another loan. The verdict here was nonetheless the same. The subsidiary was not doing well at all (which was the reason for the bank to cancel the loan upon expiration date and not refinance the entity via a loan continuation). The Supreme Court held that if a tax payer provides funds to a related party knowing from the outset that the subsidiary will not be able to repay the loan unless circumstances would change dramatically and unexpectedly, the loan is not a loan in a tax sense but the provision of informal capital. If the debtor is Dutch, the interest on such a loan would not be tax-deductible but if the creditor is Dutch, the interest income would be covered by the participation exemption and remain untaxed.

Over the last decade several Supreme Court cases in the Netherlands have dealt with what tax practitioners now describe as "profit participating loans". Multinational enterprises have increasingly provided funding to their subsidiaries through loan agreements which contain a number of "odd" conditions. Generally speaking such loans have three characteristics which differentiates them from third party loans:

a) A relatively long fixed term (25 years or more);
b) A relatively low fixed interest percentage (usually 1%); in addition there is variable interest which is dependent on the net after tax profit of the subsidiary; with good profitability the variable interest percentage can easily exceed 10%;
c) The loan is subordinated: in case the subsidiary goes bankrupt, all other creditors are paid first before the principal of the loan gets repaid.

There are still many jurisdictions where the tax authorities, to determine whether "interest" is really interest in a tax sense, are not allowed to use an economical analysis but have to treat the loan in the same way it is treated for commercial accounting and/or for legal purposes. A reclassification of interest into a deemed dividend will not easily occur there. But in the Netherlands and a few other countries, the tax authorities, either by law or by jurisprudence, are allowed to follow an economical approach. The most far-reaching tax test would be "could the subsidiary have obtained this loan from a bank?" and if not, the loan is no longer a loan for corporate income tax purposes and the interest thereon is a deemed dividend distribution (non-deductible for corporate income tax and perhaps even subject to a dividend withholding tax). This is the approach in the UK, also for transfer pricing purposes.

The Dutch Supreme Tax Court has followed a middle-road when it judged, in a series of verdicts all covering intra-group loans with variable interest rates:

1) That primarily the legal denomination (ie. the denomination under accounting law) of a loan will determine its tax consequences but:
2) In case the loan is granted under such conditions that the creditor, to a certain extent, participates in the business of the subsidiary, the tax treatment of the loan may require reclassification as the hidden provision of informal capital, so the interest payments no longer qualify as such for tax purposes but become deemed dividend income or expense, which is true if the following three criteria have been met simultaneously:

a) The loan has a maturity date of 50 years or more;
b) The interest is highly dependent on the future profitability of the debtor;
c) The "loan" is subordinated to all other debts of the subsidiary.

This Supreme Court verdict was rendered in the case of a French loan which is commonly known in France as a "Prêt Participatif". Interestingly, this PPL contained a clause on an early repayment possibility (which at first sight seems to conflict with requirement a)) which did not bring the judges to a different verdict.

The Dutch tax legislator, at first, did not want to accept that many tax advisers started to use the Supreme Court criteria to create profit participating loans (PPL's) which in the Netherlands would ensure applicability of the participation exemption to the interest income they created whilst knowing that such interest would be tax deductible abroad. For some time the Dutch CITA has therefore contained a special article which made PPL interest income taxable unless the tax payer could prove that the interest was not tax-deductible abroad, but this approach was given up per 1/1/2007 when this anti-abuse article for PPL interest was withdrawn. Consequently, in the Netherlands one may now again apply the old case law criteria to determine whether interest income or expense is also interest income or expense for tax purposes, or a hidden dividend.

With the above explanations in hand one may relatively easily create hybrid intra-group financing structures, via Dutch intermediary holding companies or Dutch group financing companies, from the parent entity in the group to subsidiaries in tax jurisdictions which allow the deductibility of interest on group loans if such loans for commercial purposes are treated as loans, which lead to the tax mismatch described. So one either gets an interest deduction for what in an economical sense is the provision of equity, or a "double dip" (two interest deductions for the same amount) if the group finances the Dutch PPL's from borrowed money in jurisdictions where interest to finance subsidiary entities is tax deductible.

The insertion of a Dutch group entity into such PPL structuring is highly recommended because the interest paid by the subsidiaries should qualify as interest for local corporate income tax, in which case it will likely also qualify for local interest withholding tax. Using the Netherlands in such a set-up implies that one will have access to the Dutch tax treaties which almost invariably imply a zero foreign withholding tax rate. After all, the Netherlands has no interest withholding tax itself so its tax treaties reflect this and the treaty partner is usually willing to give up its own interest withholding tax if the recipient is a resident of the Netherlands. The usual tax treaty requirement that the Dutch entity must be the beneficial owner of the interest income might have to be achieved by taking a final tax planning step (the Beneficial Ownership Booster, BOB) which involves a relatively simple extra step in the set-up which we will gladly explain to anyone who wishes to set up tax effective intra-group financing via PPL contracts with our assistance. In this respect it may be interesting to know that advance tax rulings from the Dutch ruling authority are available for PPL's.

We conclude with an example how a hybrid PPL might bring benefits to a Swedish tax payer with a French subsidiary by inserting a Dutch holding company in the group structure. ■

Exhibit 1