Interest deductions in the Netherlands
1 January 2013

1 Introduction

In general, interest payments made by a Dutch corporate taxpayer are deductible from its taxable income. This memorandum sets out the limitations of interest deduction as developed in case law as well as legal limitations included in the Dutch corporate income tax act (the "CITA"). This memorandum does not address transfer pricing adjustments and assumes that the Dutch taxpayer is acting for its own account and not as an agent.

The following steps should be taken to determine whether interest payments are deductible.

First of all, it should be determined whether the loan is indeed debt or that it should be considered equity for Dutch tax purposes (paragraph 2). If the loan is indeed debt, the interest deduction can be denied on the basis of a number of statutory restrictions in the Dutch CITA (paragraph (c)). An overview of these statutory restrictions is included on page 7. Lastly, interest deductions can be restricted on the basis of the abuse-of-law doctrine or the non-businesslike loan doctrine, both developed in Dutch case law. These are briefly discussed in paragraph 4.

2 Debt or equity; case law

According to case law, an instrument's legal form is decisive in determining whether it qualifies as debt or equity. In principle, an instrument that is debt for civil law purposes is treated as debt for tax law purposes as well. However, the Dutch Supreme Court defined three exceptions to this general rule. Debt is re-characterised into equity if:

(i) sham loan - it can be argued that the legal form of a loan is a mere simulation and that in reality the intention of the parties is to provide equity;
(ii) loss financing - the shareholder grants the loan under such circumstances that it was clear from the outset that it cannot be repaid and the shareholder does not have business interest, other than in its capacity as shareholder, to grant the loan; or
(iii) participating loan - the loan is granted under such conditions that the lender, through the loan, participates, to a certain extent, in the enterprise carried on by the borrower. This is the case where:

(a) profit contingent interest - the remuneration, i.e. interest, is dependent on the profits realised by the borrower; and
(b) subordinated - the loan is subordinated to senior obligations of the borrower; and
(c) perpetual - the loan is made for an indefinite period of time, with the understanding that repayment of the loan can be demanded in case of bankruptcy or liquidation. In this respect a term of more than 50 years is considered indefinite.

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1 Hoge Raad 27 januari 1988, nr. 23 919, BNB 1988/217
2 Hoge Raad 11 maart 1998, nr. 32 240, BNB 1998/208
3 Statutory limitations on interest deduction

The following sets out the statutory restrictions on interest deduction as included in the Dutch corporate income tax act.

3.1 Hybrid loans (10-1-d CITA)

Article 10-1-d CITA provides that the remuneration on a loan is not deductible if the loan is granted under such circumstances that the loan in fact functions as equity (a “hybrid loan”). Whether a loan is considered to function as equity should be determined in accordance with the case law as described in paragraph 2 above.

The payments made by the taxpayer on debt instruments re-characterised as equity are not deductible for corporate income tax purposes. In addition, the payments are subject to 15% dividend withholding tax pursuant to article 3-1-f Dividend Tax Act. This rate may be reduced under Dutch domestic tax law or conventions for avoidance of double taxation.

3.2 Anti-base erosion rules (10a CITA)

Based on article 10a-1 CITA the deduction of interest -currency results and other costs included-paid or accrued on debt attracted by the taxpayer directly or indirectly – legally or de facto – from a related party, is denied if the loan is attracted directly or indirectly - legally or de facto - in connection with certain categories of tainted transactions. The fact that the debt is attracted after the tainted transaction does not necessarily prevent it from being connected to the tainted transaction.

Article 10a CITA lists the following categories of tainted transactions:

(i) a distribution of profit or return of capital by the taxpayer (or certain related entities) to a related party;

(ii) a capital contribution by the taxpayer (or certain related entities) to a related entity; and

(iii) an acquisition by the taxpayer (or certain related entities), or expansion of an interest of shares, in a company that is a related entity after this acquisition or the expansion of an existing interest in such entity.

The interest paid or accrued on the debt attracted or created by the taxpayer in connection with a tainted transaction is nevertheless deductible if one of the following exceptions applies:

(i) the taxpayer had valid business reasons both for entering into the transaction and for funding the transactions with debt; or

(ii) the interest on the debt earned by the related party is subject to an effective tax of at least 10% established on the basis of a profit computation in accordance with Dutch tax law, unless:

(a) the debt is incurred in the anticipation of a set-off of the interest against future losses or claims that could be expected to arise after the debt was entered into; or

(b) the tax authorities can reasonably establish that the debt or the transaction was not predominantly entered into for valid business reasons.

3 Related party in this respect is (i) a company in which the taxpayer has an interest of at least 1/3; or (ii) a company that has at least an interest of 1/3 in the taxpayer; or (iii) a company in which a third party has an interest of at least 1/3 whilst this third party also has an interest of at least 1/3 in the taxpayer; or (iv) a company with which the taxpayer forms a fiscal unity (article 10a-4 CITA).
3.3 Long-term, low-yield related party debt (10b CITA)

Article 10b CITA restricts the deductibility of interest and value mutations of loans due to a related party of the taxpayer if the loan:

(i) has no fixed maturity or a term of more than 10 years; and
(ii) is interest-free or carries an interest rate substantially (i.e. >30%) below arm's length interest rate.

The definition of related parties for is significantly broader than the definition of article 10a CITA as described in footnote 3; any direct or indirect joint control, supervision or equity participation can lead to a relation between the borrower and the lender.

The second test is absolute and relates to the stated interest of the debt. This means that zero coupon and other low-yield debt issued with an original issue discount are within the scope of article 10b, even if the effective interest rate is at arm's length.

If the maturity of a loan with an initial term of less than 10 years is extended past the 10th anniversary of the loan, the loan is deemed to have had a term more than 10 years from inception. Consequently, a loan extension may result in interest that was deducted in prior years to become non-deductible with retroactive effect.

3.4 Thin capitalisation rules (10d CITA)

Until 1 January 2013, article 10d CITA contained thin capitalisation rules restricting certain interest due to related parties if the taxpayer was considered to have been excessively financed with debt. While these rules have now been abolished, we include a summary of their scope as they remain applicable to book years started before 2013.

Whether a taxpayer is excessively financed with debt had to be determined on the basis of two tests.

The first test concerns the debt/equity ratio of the taxpayer itself (10d-4 CITA). The debt is considered excessive to the extent the average debt exceeds the three times the average equity and this excess is more than EUR 500,000. Debt is defined as the balance of the loans receivable and the loans payable (the “net debt rule”).

The second test concerns the debt/equity ratio at group level (10d-5 CITA). Each year, this test may be applied upon request of the taxpayer and considers the company excessively financed with debt if its debt/equity ratio exceeds the consolidated group ratio. If the taxpayer's financing ratio is more favourable than that of the group to which it belongs, the deductibility of interest is not restricted at all. The EUR 500,000 threshold and net debt rule do not apply in the second test.
3.5 Excessive participation debt rules (13l CITA)

Until recently the interest on loans used to finance a qualifying subsidiary was, in principle, deductible even if the benefits derived from such subsidiary are exempt under the participation exemption. As of 1 January 2013, article 13l CITA aims to fix this mismatch by restricting the deduction of ‘excessive’ interest on debt of Dutch corporate taxpayers that have invested in exempt participations. Article 13l equally applies to related-party and third-party debt. No grandfathering is provided for, so pre-2013 debt is also affected.

Article 13l CITA disregards any actual relation between a taxpayer's debts and its investments in exempt participations. Instead, it allocates debt to exempt participations through a strictly mathematical formula which can result in counterintuitive and sometimes unfair outcomes, both to the detriment and to the benefit of the taxpayer.

The non-deductible interest is calculated (simplified) as follows:

\[
\left( \frac{\text{Participation Debt}}{\text{Total Debt}} \times \text{Aggregate Interest} \right) - \text{EUR 750,000}
\]

For this purpose:

(a) **Participation Debt** means the Tainted Participation Investments *minus* Equity. The Participation Debt cannot exceed the actual amount of debt of the taxpayer and any debt that is already fully non-deductible based on certain other interest restrictions is disregarded;

(b) **Tainted Participation Investments** means the historic aggregate net investment in the exempt participations. In principle, this includes the historic acquisition cost and additional capital contributions to the exempt participations. However, investments are disregarded (and thus not counted towards the Tainted Participation Investments) to the extent that:

(i) the investment results in an expansion of the operational activities of the taxpayer's group in the 12 months before or after the investment, either by the relevant participation itself or by any other group company; *and*

(ii) certain specific anti-abuse tests are satisfied.

Optionally, investments made before 1 January 2006 can be disregarded for 90%.

(c) **Equity** means the taxpayers equity for tax purposes, but not less than nil and subject to certain adjustments.

By disregarding investments resulting in an expansion of operational activities and allocating all equity to the remaining Tainted Participation Investments first, the scope of article 13l is intended to be limited to truly excessive interest deductions. However, given the strictly mathematical approach and certain complexities not described in the simplified formula above, the outcome of article 13l can be rather unpredictable and vary from year to year.

Article 13l applies to interest but also to (i) related costs and expenses, (ii) costs for hedging interest rate risks and currency risks in respect of the interest only and (iii) currency results on hedging instruments for the hedging of currency risks on the interest only (but not the principal).

Complex rules apply to deal with (i) the overlap between article 13l CITA and other interest restrictions and (ii) intra-group reorganisations.
3.6 Acquisition debt rules (15ad CITA)

Based on article 15ad the interest -currency results and other costs included- on certain 'excessive' acquisition debt cannot be deducted from the taxable profits attributable to a Dutch target company.

For these rules, "Acquisition Debt" is debt attracted in connection with the acquisition of, or increase of an investment in, a Dutch target company that is included in a fiscal unity with the acquisition company. Similar to article 13l, article 15ad is not limited to related-party debt, but also extends to third-party debt.

Whether Acquisition Debt is excessive is determined on the basis of the loan-to-purchase price ratio (the "Loan-to-Purchase-Price Ratio"). In the year of the acquisition, a maximum Loan-to-Purchase-Price Ratio of 60% is allowed; this maximum percentage is reduced by 5%-points annually over the course of 7 years, down to 25% in year 8 and later years. The purchase price for this test is the equity value of the Dutch target company plus acquisitions costs.

The interest of Acquisition Debt is not deductible from taxable profits of the Dutch target, to the extent:

(i) the actual Loan-to-Purchase-Price Ratio exceeds the acceptable ratio (i.e. 60% in year 1 to 25% in year 8); and

(ii) the amount of interest exceeds EUR 1 M.

The Loan-to-Purchase-Price Ratio is determined per fiscal year; i.e. all acquisitions and related funding of Dutch target companies that are included in the same fiscal year within the same fiscal year will be taken together for the purpose of determining the applicable Loan-to-Purchase-Price Ratio.

Article 15ad allows interest on excessive Acquisition Debt to be deducted from the taxable profits that can be attributed to the fiscal unity's parent on a 'stand-alone' basis. These stand-alone profits include profits attributable to other fiscal unity companies in respect of which no Acquisition Debt is outstanding, either because the acquisition was fully equity-financed or any Acquisition Debt is already fully repaid.

If the assets and liabilities of a Dutch target company and the related Acquisition Debt become part of the assets and liabilities of the same entity as a result of a merger, demerger or liquidation, similar restrictions apply.

Interest that is non-deductible based on the Acquisition Debt restrictions can be deducted from the fiscal unity parent's stand-alone profits in future years. This carry-forward is for an indefinite period of time.

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4 A fiscal unity is a consolidated tax group for Dutch corporate income tax purposes. A Dutch parent company can, upon request, include a Dutch subsidiary in a fiscal unity if it holds at least 95% of its nominal share capital. As a result, Dutch CIT is levied as if the Dutch parent company and the Dutch subsidiary were a single taxpayer.
4 Case law limitations on interest deduction

4.1 Fraus legis

If the interest deduction is not restricted on the basis of the case law described in paragraph 2 above or the statutory provisions in the CITA, the deduction can nevertheless be denied on the basis of the Dutch abuse-of-law concept of fraus legis. The concept of fraus legis can be applied if (a) the main purpose of transaction is to avoid taxation and (b) it would be in conflict with the aim and purpose of the Corporate Income Tax Act if the interest deduction would be allowed.

Case law where the deduction of interest was denied on the basis of fraus legis led to the introduction of the earnings stripping rules as described in paragraph 3.2. But even with the existence of specific statutory interest deduction restrictions in the CITA, the concept of fraus legis can still be applied to cases that are outside the scope of the statutory restrictions.

4.2 Non-business-like loans

In 2011, the Supreme Court ruled on the Dutch tax consequences of certain non-business-like loans. The main consequence of qualification of a loan as non-business-like is that the lender cannot claim a tax deduction for the write-off of such loans when the borrower defaults or is likely to default. But the Supreme Court also determined that the lender and borrower of a non-business-like loan must apply interest at a 'guaranteed' interest rate to determine their taxable profits. This means the rate the borrower would have had to pay to an independent lender with a guarantee of the actual lender. As a result, the borrower of a non-business-like loan can only deduct interest up to this 'guaranteed' interest rate.

Non-business-like loans are loans made to a related party under such conditions that independent parties would not have accepted the credit risk under any circumstance. To come to this conclusion, it should first be determined whether the interest rate of a related-party loan is at arm's length terms, considering all other conditions such as the security provided and repayment schedule. If the interest is not at arm's length, then the second question is whether the interest can be adjusted to an arm's length rate – but not to a rate that makes the loan, in fact, profit sharing. If the interest cannot be adjusted to an arm's length rate because no independent party would have been prepared to make the loan regardless of the interest rate, then the lender is considered to have accepted the credit risk because of its relation with the borrower and the entire loan is considered non-business-like.

The above is a concise overview and as such should not be considered as detailed advice. Please contact one of our tax law experts should you have any further questions.
## Overview limitations on interest deduction

<table>
<thead>
<tr>
<th>NO.</th>
<th>ARTICLE</th>
<th>DESCRIPTION</th>
<th>SCOPE</th>
<th>SAFE HARBOURS / ESCAPES</th>
<th>TIMING</th>
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| 1.  | 10(1)(d)| Hybrid loans:  
- Profit sharing;  
- Subordinated; and  
- Perpetual or ≥50 years | All debt | N/A | In force |
| 2.  | 10a     | Avoidance of base erosion by related party debt in connection with tainted transactions:  
Distributions;  
Capital contributions; or  
Acquisitions | Related party debt only | Business motives  
Interest subject to sufficient tax | In force |
| 3.  | 10b     | Long-term, low-yield related-party debt:  
- > 10 years term  
- No or substantially below arm’s length interest | Related party debt only<sup>5</sup> | N/A | In force |
| 4.  | 10d     | Thin capitalisation:  
- 3:1 ratio (default)  
- Commercial group ratio (optional) | Related party debt only<sup>6</sup> | Group ratio  
Netting of related party interest  
Netting of loans | Abolished as of 1 January 2013  
Still applicable to earlier years |
| 5.  | 13l     | Avoidance of base erosion through interest on debt allocated to investments in exempt equity participations, except to the extent:  
- The investment resulted in an expansion of the group’s operational activities; and  
- The structure is not abusive, e.g. no double dip or otherwise primarily tax motivated | All debt | EUR 1 million interest deductible  
Equity participations deemed funded by priority with equity | In force as of 1 January 2013 |
| 6.  | 15ad    | Avoidance of base erosion through a leveraged acquisition followed by tax grouping, merger or split-off | All debt | Standalone profit plus EUR 1 million  
60% -> 25% loan-to-purchase price ratio | In force, applies to tax groups established after 15 November 2011 |

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<sup>5</sup> Including certain third-party debt guaranteed by a related party  
<sup>6</sup> Idem.