



The Netherlands: providing financial support to related parties

CORPORATE BENEFIT ISSUES AND TAX POINTS

Providing financial support to related parties that are in financial distress may be in the interest of the group as a whole, but is not necessarily in the direct interest of the individual group company providing such support. This client briefing discusses that issue from a Dutch corporate law and tax law perspective, including the potential consequences if there is a material difference between the financial risks assumed by the Dutch company and the benefits of entering into such a transaction.

Introduction

Groups that are negotiating the restructuring of existing funding arrangements may be faced with requests for the provision of additional security. In that context, group companies previously not party to the funding arrangements may be requested to provide financial support for the benefit of related parties that are party to these arrangements and that may be in financial distress. This support may take the form of accession to existing or new security arrangements by, for instance, providing a guarantee for the obligations of the original obligors, providing a pledge or mortgage on certain assets, or posting collateral by actually transferring assets to the security agent or the creditors.

While there is usually no doubt that the group company negotiating the restructuring of the funding arrangements (often the group's parent) is acting in the best interest of the group, the issue arises, whether, if a Dutch group company (NLCo) provides such financial support, it can rely on the overall group benefit of restructuring the funding arrangements, or whether it should make its own analysis of risks versus benefits on a stand-alone basis. It is assumed that there is not a pre-existing obligation for an NLCo to provide such financial support.

There are two angles to these issues from a Netherlands law perspective:

- the NLCo's corporate benefit analysis under corporate law; and
- the arm's-length analysis under tax law.

Corporate benefit analysis

In its decision-making process regarding the proposed financial support arrangements, the management of an NLCo should consider whether these proposed arrangements fit within the objects clause of the NLCo's articles of association. More importantly, they should consider whether the balance between the financial risks assumed by the NLCo versus the benefits of entering in the proposed financial support arrangements is reasonable. This is a factual and economic analysis to be made by management. Relevant factors for this analysis may include (but are not necessarily limited to):

- whether the NLCo will receive an arm's-length fee for the provision of its support;
- the risk level involved: what is the chance that the financial support provided will lead to a loss of value for the NLCo and how large will that loss likely be;
- whether a right of recourse exists on (other) group companies (under statutory law, contractual provisions, or on the basis of an intra-group counter-indemnity) and the likelihood of effective (partial) recovery of the loss;
- whether the NLCo will, directly (from the creditors) or indirectly (through intra-group funding arrangements with the main debtor under the arrangements), be able to secure funding for itself under the funding arrangements for which it provides support; and
- whether the continued availability of the funding arrangements will have other direct or indirect business benefits for the NLCo (for instance, because the NLCo's business materially depends

on the continued existence of the other companies belonging to the group and the availability of the funding arrangements is essential for that continued existence).

In this analysis, group benefits may play a role, but should be considered taking into account the actual importance thereof for the NLCo. Generally, the stronger the financial position of the NLCo in relation to the financial position of existing obligors under the funding arrangements, the more important the benefits to the NLCo should be on a stand-alone basis, to justify the acceptance of the financial risks involved.

If corporate benefit issues are not sufficiently considered (particularly in the case of a subsequent insolvency of the NLCo):

- the NLCo (or in an insolvency, the administrator) may invoke the nullity of the transaction if it was outside and/or in breach of the objects of the NLCo and the beneficiaries of the financial support were or should have been aware of this;
- (other) creditors of the NLCo (or in an insolvency, the administrator) could invoke the nullity of the transactions on the basis of the rules on fraudulent conveyance or preference (*actio pauliana*); or
- liability issues could arise for management personally on the basis of rules on mismanagement (*onbehoorlijk bestuur*).

Given the potential consequences, it is generally advisable to record carefully the considerations for entering into the proposed transactions in board resolutions or minutes. Needless to say, these considerations need to be based on a sound underlying factual economic analysis. General boilerplate language will not suffice.

Arm's-length analysis for tax purposes

A similar analysis should be made to determine whether the proposed transactions may qualify as being at arm's length for tax purposes. The factors to be considered (as mentioned above) apply similarly for this tax analysis but, in addition, for tax purposes a more financially based underlying analysis is likely to be required. The Dutch tax authorities are less likely to accept general statements on group benefits if these cannot be translated into identifiable monetary benefits for the

NLCo that are in balance with the market value of the financial risks assumed.

If the proposed transaction is not considered to be at arm's length:

- in more extreme cases (eg cases where it is clear that under the specific circumstances no unrelated party would ever have entered into the support arrangements and there is a clear expectation of a resulting loss for the NLCo) and, depending on the place of the NLCo relative to the group companies benefiting from the financial support, the (mere) entering into the arrangement may be considered as a – non-deductible – deemed dividend distribution or informal capital contribution for the value of the likely loss of the NLCo caused by the arrangements. While such informal capital contribution should have no further adverse Netherlands tax consequences, a deemed dividend distribution may trigger dividend withholding tax at the domestic rate of 15 per cent, subject to reduced rates depending on the status, the percentage shareholding and tax residency of the shareholder(s) of the NLCo;
- in other cases (where there is an imbalance between risks and benefits, but there are no clear expectations on the amount of the future loss), case law is not entirely clear on the exact consequences. It is likely that the tax authorities in those cases would, wholly or partly, ignore the entering into of the financial support arrangements and would, wholly or partly, deny the deductibility of a loss claimed pursuant to creditors invoking their rights under the support provided by the NLCo. In that case, in addition, a deemed profit distribution or an informal capital contribution may be considered to have taken place for the amount of the loss actually realised (see above); and
- in cases where it cannot be reasonably maintained that the financial support arrangements are at arm's length, filing a tax return claiming that the arrangements are at arm's length may be considered an offence. In that case, in addition to corrections of reported taxable profits, penalties (up to 100 per cent of the amount of additional tax due) may be imposed on the NLCo and, in more extreme cases, on the responsible members of management as well.

There is also an obligation to document intra-group transactions for transfer pricing purposes. The NLCo will be required to have documentation on file from which it can be identified how the terms and conditions of such transactions have been determined and whether such terms conform to arm's-length standards. Failure to do so may result in a shift of the onus of proof, to the detriment of the taxpayer, and in penalties being imposed. The underlying analysis for determining the corporate benefit for the NLCo mentioned above may provide a good starting point for the preparation of the transfer pricing documentation if it is based on a sound factual economic analysis.

Timing

As a general point, it is advisable to discuss the proposed arrangements and the underlying economic analysis with the NLCo's management at an early stage to avoid discussions potentially preventing closing on the planned date.

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