



# Restructuring of indebtedness: Netherlands tax points

This briefing sets out the key Netherlands corporate income tax issues in respect of debt restructurings. In summary, debtors may be faced with material tax consequences if third party debt is guaranteed by a related party, if the principal amount of the existing debt is reduced or if the debtor (or a member of the same fiscal unity) buys back its own debt at a discount. A debt-for-equity exchange can be structured so as to avoid an immediate recognition of profit for the debtor, but may lead to future claw-back of devaluation losses taken by the creditor.

## Introduction

This briefing summarises key Netherlands tax points relating to restructuring of indebtedness.

A key tax principle is that funding that is provided in the form of a debt instrument from a civil law perspective is also considered debt from a tax perspective except in specific exceptional circumstances. Generally speaking, apart from 'hybrid debt' (essentially long-term subordinated debt – with a maturity exceeding 50 years and with profit-sharing features), these exceptions affect related-party situations in which an independent creditor would not have granted a loan under the same circumstances. An exception would also apply if parties have clearly factually intended to provide equity funds but for tax reasons have presented the funding transaction as the provision of a loan (a substance-over-form approach). In these exceptional circumstances, a debt instrument may be wholly or partially recharacterised for tax purposes as equity. This would lead to the denial of interest deduction for the debtor and, if interest would actually be paid, may lead to dividend withholding tax being due. It could also lead to different tax treatment for the creditor.

Under recent case law, if and to the extent that a creditor has accepted debtor's exposure for the benefit of a related party that a third party would not have accepted, although it appears that the character of the instrument otherwise remains unchanged, the creditor may be unable to take devaluation losses on the loan provided.

A key issue in restructuring indebtedness is therefore to establish whether and to what extent a debt instrument for tax purposes is also qualified as regular debt (which would normally be the case) and whether the proposed restructuring could change such qualification.

## Debtor side

### Amendment of the terms and conditions and debt-for-debt exchange

In principle, amendments of the terms and conditions (T&Cs) of a debt instrument based on negotiations between creditor and debtor would mostly be treated in the same way as a debt-for-debt exchange in which one debt instrument is exchanged for another debt instrument with different conditions.

Generally, assuming that creditor and debtor have negotiated such changes on an at-arm's-length basis, relatively minor amendments to a debt instrument's T&Cs should not lead to material tax consequences. In particular:

- deferral of interest payments should in principle not negatively affect deductibility, because interest is normally deducted on an accrual basis;
- adding additional security cover should not by itself affect the tax position of the debt instrument;
- an extension of the maturity term to one that is under 50 years (in total) should also not affect the tax position of the debt instrument by itself; in certain

cases (if the instrument does not carry interest or has an interest rate below market rates), the relevant term is 10 years;

- if covenants have been breached and the creditor agrees not to exercise its right to demand full repayment but renegotiates the applicable interest rate given increased risks, this should also normally be acceptable from a tax perspective; and
- adding conversion rights to compensate the creditor should be possible without material tax consequences for the debtor; however, no deduction is generally allowable for the conversion premium or (future) conversion costs.

However, the following amendments may have material Netherlands tax effects.

- If a third party loan to a distressed debtor would, as a result of the renegotiations, now be guaranteed by a party related to the debtor, the debt instrument will very likely be considered related-party debt. This would mean that the thin capitalisation rules could apply. Depending on the use of the funds and the tax position of the creditor, certain anti-abuse rules applicable to related-party debt may also be triggered. In both cases this could lead to denial of interest deductibility.
- A reduction of the nominal amount of the outstanding debt would in principle lead to profit recognition for tax purposes by the debtor, unless the specific waiver exemption (see below) could be applied.
- An amendment in the currency of the principal amount would probably be considered a realisation of currency exchange results under the old instrument. Note that a debt-for-debt exchange may also lead to a deemed realisation of currency exchange results.
- An extension of the maturity term to a term exceeding 50 years in combination with the addition of a profit-sharing element and subordination would retroactively classify the instrument as hybrid debt. In certain cases (set out above), extension over 10 years will have similar effects for the debtor (also retroactively).

If the creditor and debtor are directly or indirectly related to each other, the key issue will be whether an amendment of the T&Cs will be accepted as being at arm's length. If not, the agreed conditions could

be amended by the tax authorities to arm's-length conditions. This could lead to immediate profit recognition at the time of the amendment or to smaller deductions going forward or, in extreme circumstances, the debt instrument could be considered exchanged for a new instrument that should be qualified as an equity instrument. The debtor may then no longer be able to deduct any 'interest' on the instrument and dividend withholding tax may be due.

### **Debt-for-equity exchange**

Under older case law a debt-for-equity exchange, in which the nominal amount of the shares issued at least equals the principal amount of the debt exchanged (plus accrued interest, if any), should not lead to the recognition of profits for the debtor. In such a case the debt instrument's market value is not relevant for the debtor's tax position.

### **Debt waiver**

A partial or full waiver of the principal amount of a debt instrument (and/or accrued interest) in principle leads to a taxable profit for the debtor. If a waiver occurs (a) because (and to the extent that) the amount waived is no longer realistically recoverable and (b) the creditor expressly waives the obligation to pay for the debtor unconditionally, the debtor may benefit from an exemption for the amount of the waiver exceeding the available tax losses; this means that the profit realised on the waiver reduces the amount of available tax losses, but does not lead to effective taxation.

Statements by the creditor that he will not recover amounts due (without formally waiving the debtor's obligations), long-term de facto lack of collection activities by the creditor, expiry of a relevant statute of limitations on the right to collect, or the clear inability of the debtor ever to repay his debt, all cases resulting in a situation in which it is very unlikely that the debtor will factually ever pay the relevant amounts due, may be considered to qualify as an implicit waiver and this may require profit recognition by the debtor, without the waiver exemption being applicable.

If the creditor is related to the debtor and it can be shown that the waiver would not have been granted by an unrelated third party creditor, the amount waived would be considered for tax purposes an equity contribution

(informal capital) and should not lead to profit recognition or the reduction of available tax losses for the debtor. As there are no capital tax or stamp duties, in these circumstances such a waiver would be without tax consequences for the debtor. In the case of a financially distressed debtor, it will not be easy to show in what capacity the waiver is granted or to provide evidence that a third party creditor would have waived the debtor's obligations in the same circumstances.

There is uncertainty on the tax treatment of conditional debt waivers; a concept that, unlike in some other European countries, is not known as such in Netherlands civil and tax law (although a similar effect can often be created contractually). Subject to the likelihood that the condition will be met, there is a clear risk that this would be treated as a normal debt waiver but without the exemption being applicable.

#### **Debt buy-back**

A buy-back of debt by the debtor (or an entity for tax purposes consolidated with the debtor in a fiscal unity) at a discount to the principal amount would normally lead to taxable profit on the discount for the debtor (or the fiscal unity to which it belongs). Although it could be argued that the waiver exemption should apply to this transaction, there is substantial risk that this exemption is not applicable in these circumstances, given the requirement of a (formal) explicit waiver by the creditor. If the discount is caused by general market circumstances and not by the specific financial distress of the debtor, the exemption will certainly not apply.

A debt buy-back by a party related to the debtor does not by itself trigger the obligation of profit recognition by the debtor. This may be different if the related party is or becomes a member of the same fiscal unity as the debtor, because valuation rules may force parties to use the enterprise value on both the debtor and creditor sides, which may cause profit recognition for the debtor.

Acquisition of debt by a related party may also lead to the triggering of the related-party debt rules, which would mean that the thin capitalisation rules and – depending on the purpose of the loan and the tax position of the creditor – anti-abuse rules could become applicable, potentially leading to the denial of interest deductibility.

#### **Creditor side**

Netherlands creditors generally value loan instruments on the basis of their original cost price or their lower enterprise value. If a financially distressed debtor is unable to repay debt, the creditor will generally be allowed to recognise a tax deductible devaluation loss. There are no specific rules on the level of evidence required for such devaluation. Essentially the creditor needs to make plausible that there has been a material reduction in the market value.

Any material amendment in the T&Cs that affects the market value will generally lead to the same result. Also, a receivable for overdue interest may be valued at its lower market value if the agreed payment date is postponed or the interest due is rolled up. In effect, this means that the creditor is not taxed on interest due that is not paid.

If, after the creditor has taken a devaluation loss, the market value of the receivable increases again, the creditor will have to recognise such increase up to the original carrying value of the instrument.

If creditor and debtor are related, a material devaluation loss claimed on the instrument for the creditor may trigger a discussion with the tax authorities over whether and to what extent a third party would also have provided the loan to the debtor when the loan was granted; under recent case law if that is considered not the case, this may lead to a full or partial denial of the devaluation loss for the creditor (but appears to leave the other tax consequences of the debt instrument for debtor and creditor unchanged).

If the creditor has covered its exposure on the instrument, normally only the net exposure would be recognised for tax purposes.

More complex tax issues will arise in the case of: debt-for-equity exchanges; amendments of the T&Cs of debt instrument between related parties under non-arm's-length circumstances so that part or the full amount of the debt would be treated as equity funds; or an amendment of the T&Cs that would lead to the debt being considered hybrid debt.

As long as the creditor (and parties related to the creditor) does not hold an interest in the debtor that qualifies for the participation exemption, the tax

treatment for the creditor should not materially change. However, if the creditor (or parties related to the creditor) holds such interests, there are specific anti-abuse rules intended to prevent a subsequent upward revaluation of the (deemed) equity instrument benefits from the participation exemption; ie there are claw-back rules for the amount of the devaluation losses earlier deducted from Netherlands taxable profits by the creditor or a party related to the creditor. In essence, the participation exemption will not apply for profits realised on the (deemed) equity stake in the debtor, up to the amount of the devaluation loss deducted from the Netherlands tax base in respect of the (deemed) converted debt instrument; if transactions take place that may have as aim or effect that this tax claim is avoided, an immediate and full claw-back of the tax loss not yet compensated may occur.

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