The Dutch extreme default risk loan - A new dimension in international debt/equity mismatches
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On 25 November 2011, the Dutch Supreme Court shaped the concept of a new kind of loan in a number of rulings. This so-called extreme default risk loan is a high risk loan that has both the marks of equity and debt. The Supreme Court ruled that such a loan must be regarded as a debt, and yet write-downs on these loans are not permitted. Furthermore the Court ruled that the interest stated in the loan agreement is to be ignored for tax purposes and must be replaced by the interest rate that would have been agreed upon had the loan been granted by a third party, but with a guarantee by the creditor. In this article we analyze the rulings and show that in a cross-border setting the fiscal treatment set out by the Supreme Court could lead to undesirable cross-border mismatches. We propose a number of potential solutions to this problem.

1 Introduction

Corporate finance and investment can take the form of debt or equity. Debt investments yield interest income, whereas dividend is the yield on equity. Both are treated differently for tax purposes. As a general rule, dividend payments constitute profit distributions, which cannot be deducted from the distributing corporation’s taxable profits, while interest payments, by contrast, usually reduce the debtor’s taxable profits. While interest payments are included in the profits of the party receiving these payments, dividend income is frequently (objectively) tax exempt. The classification as debt or equity thus determines whether or not the issuer can deduct the remunerations paid for tax purposes and whether or not the income is exempt in the hands of the recipient. From an economic point of view an investor will usually not care whether the investment is debt or equity: both instruments serve to generate profits. But as long as the distinction between interest and dividend is maintained for tax purposes, the fiscal classification of financial instruments and their return is of major importance and therefore disturbs the economically optimal leverage.

At both extremes of the finance spectrum, the distinction between debt and equity is easy. The fundamental difference between debt and equity is that the debtor/creditor relationship is based on a loan agreement, whereas the shareholder/company relationship is based on company law. More specifically, common stock (or equity) does not entitle the holder to any – fixed – return, while he has no assurance whatsoever that he will ever be able to retrieve his initial investment. On the other hand, theoretically there is no limitation to his potential return when the company flourishes. Moreover, the holder of common stock can influence or change the company’s management by exercising his voting rights.

The other end of the spectrum concerns short-term, unsubordinated debts. A holder of debt is entitled to a predetermined fixed return on investment and, at the end of a preset period, to the return of the principal amount. What’s more, if the debtor fails to make the scheduled

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1 That is, if no limitations on interest deduction apply.


7 Helminen 2004, 59.

payments the holder has the right to accelerate repayment of the debt obligation, he can pursue legal means to enforce payments, and, in a worst-case scenario, force the issuer into bankruptcy. In the event of a bankruptcy, the creditor will have preference over most other claimants.

The reality, however, is different from the picture painted above. The actual distinction between debt and equity is less clear cut, as a wide variety of instruments either contain elements of both equity and debt, or features that are alien to both categories. Such instruments can neither be equivocally classed as equity nor as debt and are therefore referred to as hybrid instruments or mezzanine finance.10 In literature,11 a hybrid instrument has been defined as ‘a financial instrument that has economic characteristics that are inconsistent, in whole or in part, with the classification implied by its legal form’. As such, debt obligations can have equity features, for example, conversion rights, participation in profits, or a long or indefinite term. By the same token, equity can have debt characteristics, such as a fixed return not linked to earnings, absence of voting rights, and mandatory redemption after a comparatively short term.12 Using a hybrid instrument is sometimes tax-driven, the most common pattern being the use of a hybrid financial instrument that is treated as debt by the source State and as equity in another jurisdiction.13 The idea is to thus claim deductions (or similar benefits) against the corporate income tax in multiple jurisdictions. Where hybrid instruments are concerned the importance of distinguishing between debt and equity becomes even more apparent. In fact, in most countries hybrid instruments must either be wholly treated as equity or as debt for tax purposes.14 The tax treatment of an instrument, whether hybrid or not, is only rarely split.15 The wide variety of hybrid instruments and the speed at which these instruments evolve render an unambiguous classification of any given hybrid instrument difficult, if not impossible.16 General criteria therefore need be applied, opening up substantial opportunities or risks to tax planning, especially in cross-border situations where both countries involved must classify the instrument. In some cases both countries may decide differently. For instance, when a hybrid instrument is classified as debt in the source State (i.e., the State of residence of the debtor or obligor) and as equity in the residence State (the State of the creditor or obligee), the payment may be deductible as interest in the source State and be exempt as dividend in the State of residence, depending on local CIT regulations and/or national case law. The opposite can be true when the hybrid instrument is equity in the source State and debt in the residence State. The dividend may then be non-deductible and subject to a withholding tax in the former, whereas the receipt of interest could be taxed in the latter.17

In this respect, Dutch case law recently witnessed an interesting development. On 25 November 2011 the Dutch Supreme Court further outlined the Dutch perspective on the distinction between debt and equity in its already infamous judgments on the so-called extreme default risk loan (hereinafter: EDR loan). In these judgments, the Dutch Supreme Court has sketched the characteristics of the EDR loan, stipulating the conditions for qualification of such a loan and outlining its tax consequences. Although such loans would never be agreed on by unrelated parties, the funds provided are, under certain circumstances, still regarded debt, although an interest rate adjustment is required. Moreover, debt write-downs are not permitted for tax purposes. In cross-border situations these elements could give rise to tax arbitrage when the adjustment is only made unilaterally.

From a European perspective the timing of the judgments by the Dutch Supreme Court is remarkable. In recent years the European Commission has announced to investigate hybrid entities and hybrid loans that result in cross-border mismatches. Due to the support by the European Council these announcements have led to the EC consultation on ‘double non-taxation’, which closed on 30 May 2012. The consultation’s results will be published in 2012.

This article proceeds as follows. In paragraph 2 we will provide a brief overview of the Dutch case law on hybrid finance up to 25 November 2011. In section 3 we will subsequently elaborate on the EDR loan and discuss a number of questions that have remained unanswered to date. This discussion will be an introduction to paragraph 4, where the extreme default risk loan will be studied in

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9 Eberhartinger & Six 2009, 4.
10 Ibid.
11 Duncan 2000, 22.
12 Examples of equity and debt features are discussed elaborately by Duncan.
13 C.J.F. Warner, Netherlands Report, Cahiers de Droit Fiscal International LXXXV(2000), 505. It should be stressed that the use of hybrid instruments is not only tax motivated. Regulatory reasons, rating agencies, financial reporting rules and commercial objectives may also compel the issue of hybrid instruments.
14 Eberhartinger & Six 2009, 4.
15 Ibid.
16 Ibid.
17 See also M. Six, Hybrid Finance and Double Taxation Treaties, 63 Bull. Int'l Tax. no. 1, 22 (2009).
an international context. Finally, we will include a brief summary of our findings in paragraph 5.

2 The Dutch Rules on the Requalification of Debt into Equity: Case Law up to 25 November 2011

2.1 The Treatment of Debt and Equity under National Law

As noted in the introduction, debt and equity are treated differently for tax purposes. As a general rule, debtors can deduct interest payments while they are taxed with creditors. Dividend payments, on the other hand, cannot be deducted by the paying corporation and, provided certain conditions are met, they are tax exempt at the level of the shareholder.18 The Netherlands is no exception to this rule. Attempts to find an explicit legal basis for this differential treatment will prove to be futile. The Dutch Corporate Income Tax Act 1969 (hereinafter: CITA) contains no provisions that provide general rules with respect to interest deductions.19 Rather, the question regarding the deductibility of interest and the non-deductibility of profit distributions depends on the context in which these payments are to be situated. In that respect, the Dutch tax system assesses whether payments or interest either relate to capital or profit. Capital-related transactions – between the company and its shareholders – cannot affect a company’s taxable profits. Conversely, profit-related transactions cover any arm’s length transactions of a company and they do affect the company’s taxable profits, even if the shareholder is a party to it. Interest payments represent costs and are, accordingly, profit-related. As such, the interest payments can be deducted from taxable profits.20 While receiving interest constitutes a taxable event, dividend distributions are capital-related and, thus, not tax-deductible.21 Moreover, such distributions remain untaxed due to the participation exemption,22 provided corporate shareholders qualify for this.

2.2 Requalification of Debt as Equity

The difference between debt and equity is especially distinct if funds are distributed between affiliated parties23 and the debtor or obligor incurs losses. Then it basically boils down to whether the funds provided constitute debt or equity. After all, should the debtor appear to be unable to repay a loan, the creditor may write it down for tax purposes. Since loans are profit-related, the creditor’s taxable profits are reduced accordingly. Alternatively, as all benefits from qualifying participations are tax exempt, write-downs of equity provided between affiliated parties will not reduce the shareholder’s taxable profits. The asymmetrical treatment of debt and equity and their respective yields thus creates an incentive to present – whether intentional or not – funds as debt or equity, depending on the facts and circumstances. Obligees will want funds to be labelled as debt if obligors incur losses, as this would be in their interest. In all other cases obligees would rather classify funds provided under capital, as the dividend received will be exempt from corporate income tax. Hence, the frequent legal controversy caused by the classification of financial instruments for tax purposes is hardly surprising. The cases where the Dutch Supreme Court ultimately rendered judgment will be discussed below. It should be noted, however, that most case law on this matter is only relevant for finance among group companies and other related parties (hereinafter: intra-group finance) and not for loans issued by third parties. Third party loans are at arm’s length and by and large the tax authorities24 adhere to the qualifications parties attribute to it. Only in the event of intra-group finance can debt be relabelled as equity for tax purposes.

2.2.1 Civil Qualification

The Dutch Supreme Court ruled in its so-called Unilever judgment25 that when judging whether a financial instrument constitutes debt or equity, the civil law qualification is, in principle, determinative. This qualification can be deduced from the agreement.

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18 This shareholder being a taxable entity, not an individual.

19 The Dutch CITA does, however, contain specific provisions that limit the deductability of interest, such as the provisions of Arts 10a CITA, 10b CITA/Atlas, the thin cap rules laid down in Art. 10d CIT and the recently introduced Art. 15ad CITA. Furthermore, interest deductions can be denied by the application of the ‘abuse of law’ principle.

20 Provided no limitations on interest deductions apply.

21 Moreover, sec. 10(1)(a) CITA explicitly states that dividend payments are not tax-deductible.

22 Under the participation exemption regime (Art. 13 CITA), dividends and other profit distributions, currency gains and losses and capital gains and losses on the disposal of (parts of) qualifying participations are exempt from corporate income tax and dividend withholding tax. Roughly speaking, participations of at least 5% in the nominal paid-up share capital of an active subsidiary, a participation of at least 5% in a mutual fund, and the membership of a cooperative are eligible for the participation exemption regime.

23 The affiliation being the result of direct or indirect shareholder relations. It is submitted that parties can also be related through, for instance, interlocking directorates. However, for the remainder of this article we will assume affiliation through shareholder status, unless explicitly stated otherwise.

24 Local thin capitalization rules or other provisions can nevertheless limit the deductibility of interest.

underlying the funds provided. Almost twenty years later the Court upheld its earlier decision in the so-called Caspian offshore drilling case. These judgments have clearly shown that a loan agreement drawn up by two (related) parties should principally be respected for tax purposes. Situations where the loan agreement is not honoured and instruments that have the legal form of debt are nevertheless treated as equity for tax purposes are limited. Consequently, the remuneration paid to the obligee represents dividend and debt write-downs will not lower the obligee’s taxable profits. Such requalification can only take place in the three situations discussed next (referred to as the ‘three-stage rocket’ in Dutch case law).

2.2.2 Exception No. 1: The Sham Loan

The first exception to the rule that the legal qualification is respected occurs when parties contractually agree to grant a loan, but their actual intent is to provide equity. This phenomenon is called sham loan (schijnlening) in Dutch fiscal literature. Here substance clearly prevails over form. The parties’ true intent can be revealed by considering all relevant facts and circumstances of a specific case. For instance, in its judgment of 3 November 1954 the Supreme Court stated ‘(...) that as a general rule neither the name the transaction has been labelled with nor its form is decisive - rather, it is about what has actually been dealt with between parties, hence, their effective relationship under civil law.’

2.2.3 Exception No. 2: The Profit-Participating Loan

Requalification similarly takes place when a loan is granted under such conditions that the creditor participates in the business of the issuer to a certain degree. It has long been unclear when exactly the creditor could be said to take part in the obligor with the loan qualifying as a profit-participating loan. In more recent case law, the Dutch Supreme Court has provided further guidance on how to interpret ‘participate to a certain degree’. It has since become clear that a creditor takes part in the debtor if the following cumulative criteria are met:

1. the interest is profit-related for 90% or more;
2. the loan is subordinated, and
3. the loan has no fixed term, but only falls due in the event of bankruptcy, suspension of payments, or liquidation. A loan term exceeding fifty years is insignificant and is likewise considered to have no fixed term.

If – and only if – all of the above criteria are met, will the loan be considered equity for tax purposes. Consequently, the debtor cannot deduct the profit-related remunerations paid and receiving the return on an instrument under the participation exemption regime may effectively be tax-free. According to Warner these criteria refer to the factual situation, not to the legal form: ‘It is possible that a return on an instrument does not de jure depend on the profit of the issuer; if, however, de facto the return is dependent on such profit, the factual situation is probably determinative.’

2.2.4 Exception No. 3: The Bottomless Pit Loan

A third and final exception to the rule of the legal qualification prevailing was first mentioned in the Unilever judgment. In this case, the Dutch Supreme Court prescribed (partial) requalification of debt as equity when the investor holds shares in the issuer that qualify for the participation exemption and grants a loan to the issuer under such circumstances that it should have been clear to him from the outset that the debt claim would never be repaid, either in whole or in part. Those funds are then considered to no longer be part of the shareholder’s capital. This may arise when the debtor has been making losses for a while without any profit being anticipated. A third party would never be willing to grant a loan under such circumstances.

3 The Extreme Default Risk Loan

3.1 The 9 May 2008 Judgment

The possible existence of a kind of loan that possesses both the characteristics of equity and debt outside of the three-stage rocket developed in Dutch case law was first noted after a judgment of 9 May 2008. This first judgment raised the question whether the book loss on a loan from a subsidiary to

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26 Dutch Supreme Court Sep. 8, 2006, No. 42 015, BNB 2007/104.
27 Dutch Supreme Court Nov. 3, 1954, No. 11 928, BNB 1954/357.
31 For the dividend to go untaxed at creditor level, it is irrelevant whether the interest payment was tax-deductible in the hands of the debtor or not.
32 Warner 2000, 509.
33 Sham loan, profit-participating loan and the bottomless pit loan.
34 Dutch Supreme Court May 9, 2008, No. 43 849, BNB 2008/191.
its parent company was tax-deductible. No repayment schedule had been arranged, security had neither been provided nor required, and parties concerned had not formalized a written loan agreement. Furthermore, the debtor to this loan (the parent company) had little more assets than the shares in the subsidiary. Therefore, any repayments to the loan would have to be made out of profit generated through the dividends from the subsidiary, the creditor of the loan. The Dutch Supreme Court decided this loan to have an extreme default risk (i.e., it was deemed to be ‘onzakelijk’), arguing that no independent third party would have granted such a loan under such conditions. Therefore, according to the Dutch Supreme Court, any write-down of that loan could not be deducted from the subsidiary’s taxable profit, since the credit risk arose from a shareholder motive. The question as to how to treat the interest paid and received on such a loan for tax purposes had not been raised in this case.

Apparently this loan could not be classified as one of the three loans already known to be requalified as equity (see paragraph 2 above) and, thus, it did not fit the threestage rocket developed in case law up until that moment. So, as the loan in question was not a bottomless pit loan, could not be qualified as a profit-participating loan, and could not be classified under the heading sham loan either, the loan could not be relabeled as equity. It was nevertheless crystal clear that, given the soft conditions of the loan and the financial status of the debtor, the loan was very much tainted by shareholder influences.

This judgment raised many questions about the qualification in respect to the aforementioned case law and the tax consequences of such a loan. For instance, it was unclear how the qualification of what is now known as the EDR loan would affect the fiscal treatment of the arm’s length interest adopted by both debtor and creditor. After all, the question about the tax treatment of the interest on such a loan was not part of the proceedings leading to the judgment of 9 May 2008. The question was raised in literature whether the Supreme Court had created a fourth category of loans that for tax purposes had to be requalified as equity. The judgment created all but legal certainty on the tax treatment of EDR loans. This uncertainty lasted until 25 November 2012.

### 3.2 Clarification on the Main EDR Loan Questions

On 25 November 2011, the Supreme Court answered the majority of the known open questions on the tax treatment of the EDR loan that had until then remained unanswered in three very important judgments. The judgments concerned shareholder loans granted under more of less ‘soft’ conditions, comparable to the conditions discussed in the 9 May 2008 judgment: sometimes no written loan agreement, no repayment schedule or a very friendly repayment schedule and little or no security. These judgments revealed a number of legal rules, which will be elucidated below.

First of all, the Supreme Court stated that the EDR loan does not constitute a new fourth category of loans to be requalified as equity (other than those mentioned in paragraph 2 above). In fact, according to the judgments an EDR loan is to be seen as a debt, even though third parties would never agree to provide funds under the terms and conditions agreed to by the related parties. Therefore, the interest continues to be deductible for the debtor and taxable for the creditor – at least, if and when these parties are within the scope of Dutch CIT. There are, however, some major tax consequences. If and when a loan is qualified as an EDR loan for Dutch CIT-purposes, write-downs on the loan will not be tax-deductible for the creditor and will subsequently not lower the creditor’s taxable profits. In one of the 25 November cases, the Dutch Supreme Court specifically stated that waiving a written down EDR-loan in a downstream situation is to be seen as an informal capital contribution (equity). The consequence is that any waiver of such a loan will not lead to a taxable profit for the debtor. However, the judgments in the EDR-loan cases do not emphasize how a waiver of a written down upstream loan is to be interpreted – to us it would seem to constitute a profit distribution that in most domestic cases will be tax exempt under the Dutch participation exemption and looks to constitute an intelligent equilibrium that works for both downstream and upstream situations: the write-down is non-deductible for the obligor and the waiver is non-taxable for the obligee.

Furthermore, the interest stated in the loan agreement is to be ignored for tax purposes and must be replaced by the interest rate that would have been agreed upon had the loan been granted by a third party, but with a guarantee by the creditor. The actual creditor thus assumes a security, while a fictitious interest rate (hereinafter: the oblige secured interest rate) is to be taken into account for tax purposes. This special condition eliminates any extreme credit risk from the interest rate to be taken into account. The interest rate to be taken into account on an EDR loan thus neither equals the interest rate agreed upon – and if it does, only by chance, nor the interest rate that is stripped of any kind of credit risk (the risk-free interest rate), or the interest rate reflecting the full and actual credit risk. The interest rate on an EDR loan reflects the at arm’s length interest rate that would have been agreed upon had the loan been granted by a third party under a

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35 Dutch Supreme Court 25 November 2011, No. 08/05323, BNBR 2012/37, No. 10/05161, BNBR 2012/38, No. 10/04588, BNBR 2012/78. The latter judgment concerns the Dutch personal income tax but is also very important for CIT purposes.
guarantee from the actual creditor. We stress that such guarantee is assumed and is merely used to come up with an interest rate to be taken into account for tax purposes by both debtor and creditor. Furthermore, no general conclusions can be made concerning interest rates for EDR loans, simply because such interest rates will not only depend on whether the obligor can provide for an actual security, as with regular loans, but also on the obligee’s financial situation and its possibility to provide for the – fictitious – security pointed out by the Dutch Supreme Court. If the obligee has sufficient means to provide for security, the interest rate to be taken into account will approximate the – relatively low – risk-free interest rate. If, however, the obligee has poor or even no means to provide for security, the interest rate to be taken into account will approximate the – relatively high – risky interest rate inherent to a regular arm’s-length approach. The following section will examine some of the consequences this may lead to.

3.3 How to Distinguish an EDR Loan from a ‘Regular’ Loan

The Dutch Supreme Court not only explained how and when to recognize an EDR loan. It likewise showed how to distinguish this odd phenomenon from a regular intra-group loan with some shareholder influence that is not an EDR loan. This section discusses the rather complex rules on how such distinction can be made.

According to the judgments, an EDR loan is a loan that no third party would have granted under such conditions and circumstances, except for the interest rate. Thus, any loans a third party would be willing to grant, given all relevant facts and circumstances, could never be said to carry an extreme default risk. As the Dutch Supreme Court clearly outlines, in finding a third party willing to grant such a loan, only the interest rate can be changed. As a result, all other loan conditions have to remain the same as agreed upon. If such a third party cannot be found, the loan is not qualified as an EDR loan, but as a regular shareholder loan and therefore only submitted to a regular arm’s length adjustment. If such a third party cannot be found, the loan is qualified as an EDR loan. This results in non-deductibility of any write-down, while the aforementioned obligee secured interest rate needs to be taken into account for tax purposes. To complicate things even more, the Dutch Supreme Court ruled that in searching for the fictional third party creditor to distinguish the EDR loan from the regular shareholder loan, the amendment of the interest rate should not result in a loan that would effectively have a profit-participating interest rate. On the surface this limitation seems to be rather logical: if the interest rate were to depend on the debtor’s profit, this would constitute a profit-participating loan. But closer examination will reveal that this is not the case. Case law on profit-participating loans shows that the conditions for such a loan demand more than a mere profit-related interest rate. For instance, according to Dutch case law the expiration period for a profit-participating loan has to be fifty years or more. So, in practice it is possible to enter into a loan with a profit-related interest rate that nevertheless does not qualify as a profit-participating loan.

Since the Dutch Supreme Court’s judgments on the EDR loans do not cover an actual loan with a profit-related interest rate (not being a profit-participating loan according to known case law), the tax qualification of this kind of loan is still very uncertain. Given the Dutch Supreme Court’s limitation on the amendment of the agreed interest rate, it seems unlikely that such a loan with a profit-related interest would constitute an EDR loan.

As to when a loan has to be qualified as an EDR loan, the Dutch Supreme Court states that the time the agreement is entered into is decisive. Subsequent behaviour of the creditor could nevertheless justify a review of the qualification. A practical problem could arise here, as it could become apparent that the loan has been an EDR loan from the start at the moment the creditor wishes to write-down the loan. The interest rate should then be amended retrospectively on the special condition of the fictitious security by the actual creditor.

3.4 Upstream and Downstream EDR Loans

The aforementioned 9 May 2008 judgment dealt with an EDR loan that a subsidiary had granted to its parent company (hereinafter: upstream EDR loan). In one of the cases leading to the judgments of 25 November 2011, the Dutch Supreme Court made clear that an EDR can also arise in a situation where the creditor is the parent company and the debtor is its subsidiary (hereinafter: downstream EDR loan). Although the tax treatment of both loans may initially seem obvious, in fact it is not. As regards an upward loan the parent company clearly has the power to manoeuvre its subsidiary into a high-risk position by forcing it to grant an EDR loan. Whereas the non-deductibility of losses on such a loan can be explained as a profit distribution from the subsidiary to its parent company, a downstream loan carries a theoretical problem. It is probably conclusive that the parent company would grant such a loan with a shareholder motive, but this would not logically lead to non-deductibility of the write-down. Surely in the case of a downstream EDR loan any non-deductibility of the write-down of the loan cannot be based on the existence of a profit distribution, since the parent company cannot distribute profits to its subsidiary. The actual write-down can possibly be seen as an informal capital contribution. Apart from the fact that the Dutch Supreme Court ruled that the EDR loan itself is to be qualified as a loan and not as an informal capital contribution, such an argument will normally only affect
the obligor's taxable income and will not lead to the conclusion that the obligee's taxable income is affected. One explanation for this observation states that the Dutch participation exemption applying to such a loan causes the write-down of the EDR loan to be non-deductible. Up to this moment, we find no indication in Dutch case law that this is the cause of the non-deductibility. Be that as it may, the Dutch Supreme Court simply stated that a downstream loan qualifies as an EDR loan – just as it would if it were an upstream loan – and thus prohibited the deduction of any write-down of the principal of such a loan. Future case law has to point out why this is the case.

3.5 Conclusion So Far

Recent Dutch case law breathed life into the EDR loan. An EDR loan is a shareholder loan with both equity and debt characteristics, making it a hybrid loan. For tax purposes the EDR loan is to be qualified as a loan (not equity). The interest paid and received is, in principle, tax-deductible for the obligor and taxable for the obligee. Any write-down by the obligee is, however, non-deductible. Furthermore, the regular arm’s-length approach in finding the interest rate to be taken into account does not apply. Instead, the interest rate for tax purposes is to be set at the obligee secured interest rate, which rate both depends on the financial situation and on the possibility of the obligor and the obligee to provide for security.

4 The Extreme Default Risk Loan in an International Perspective / Cross-Border Extreme Default Risk Loan

4.1 The Potential for Mismatches

Two kinds of international mismatches could generally occur. The first is an international interest mismatch. The second is a mismatch if and when an EDR loan that has been written down is waived. Both mismatches are now explained.

As pointed out in paragraph 3, only by chance will the obligee secured interest rate equal the actual interest agreed upon and/or paid and received. In most cases, applying the obligee secured interest rate rule will lead to a lower interest rate than according to the regular at arm’s-length approach, since in most cases these loans are high-risk shareholder loans. In purely domestic situations this will not lead to a mismatch, since the Dutch Supreme Court ruled that both the obligee and the obligor have to take into account the obligee secured interest rate.

This will be different in cross-border situations. Since other countries most probably will not acknowledge the Dutch Supreme Court’s very specific at arm’s-length approach, international mismatches could be imminent. This paragraph will be devoted to discussing these possible mismatches and their consequences for the tax treatment of the debtor and the creditor. We will sketch the consequences of an EDR loan between a Dutch domestic company and a company situated in any given foreign country (hereinafter country X).

Although the Supreme Court considers the extreme default risk loan to be a debt, it nevertheless regards the debtor’s risk to be capital-related. Consequently, write-downs of an EDR do not affect the creditor’s taxable profits. This can also lead to mismatches in cross-border situations, as will be explained in paragraph 4.5.

We would like to stress that this article solely discusses the potential interest mismatches of the EDR loan. As stated in paragraph 3.3, from a Dutch perspective the other loan conditions cannot be subject to an at arm’s-length amendment. If it concerns cross-border situations, however, foreign tax regulations could very well open the possibility of an arm’s-length amendment of the other loan conditions, complicating things even more.

4.2 Methodology

4.2.1 Classifications

Before addressing possible mismatches, we first wish to outline a number of assumptions underlying our analysis, to prevent any discussion on semantics and facts and circumstances.

We have assumed that both countries follow only domestic case law and regulations on the tax treatment of the funds. Country X therefore does not acknowledge Dutch case law regarding the EDR loan and the obligee secured interest rate taken into account in the Netherlands. As a general rule, the classification attributed by the other country is irrelevant under national rules.36

It should further be noted that since the EDR loan is not at arm’s length, any country that has uniformly codified the at arm’s-length principle in its national laws is likely to tamper with the loan.37 This is a fortiori true for any treaty that contains a provision like Article 9 of the OECD Model Tax Treaty.38 In this respect we also emphasize that the rules laid down in the judgments of

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37 Brazil being one of the few exceptions.
38 Paragraph 3 of the commentary to this article explicitly mentions the requalification of a loan as equity.
November 25 are sheer folklore. Other countries are free to apply their own transfer pricing rules to adjust the loan to an arm's length level. This leads to three observations. First, it is very well possible that a fixed arm's length interest can be determined in country X. Second, this arm's length interest can by all means be profit-related. Finally, such arm's length adjustments are not restricted to the interest rate. More specifically, in transfer pricing world various roads lead to Rome and in making the necessary adjustments, country X can change the interest rate, adapt the securities provided, or requalify the funds provided. Throughout the remainder of this article we will therefore analyse the situations where country X adopts a fixed arm's length interest rate, a profit-related interest rate or proceeds to requalify the funds provided. Moreover, the profit-related interest and the magnitude and direction of the resulting mismatch depend on the difference between the obligee secured interest adopted by the Dutch tax authorities and the size of the actual profits.

4.2.2 Interest Rate

As the EDR loan in itself is a high-risk loan, the fixed interest rate based on the regular at arm's-length approach that fully reflects the risk is assumed to equal 15%, which is higher than the contractual interest rate, which is set at 12%. The arm's length interest rate can only be adopted by country X since, by definition, no such arm's length interest rate can be found for Dutch corporate income tax purposes. Whereas the obligee secured interest rate would be a lower percentage, for the purposes of this article it has been set at 8%. We will assume that only the Netherlands can take this interest rate into account. Moreover, the profit-related interest and the magnitude and direction of the resulting mismatch depend on the difference between the obligee secured interest adopted by the Dutch tax authorities and the size of the actual profits.

4.2.3 Perspectives Taken

In order to present an overall picture of the tax consequences of the interest on a cross-border EDR loan, two perspectives will be taken: that of an obligee residing in the Netherlands and lending funds to an obligor in country X (paragraph 4.3) and that of a Dutch obligor who takes out a loan from an obligee in country X (paragraph 4.4). In both cases we will analyse an upstream and a downstream EDR loan situation. As stated above, for Dutch tax purposes the EDR loan is regarded as debt, not equity. The only difference with a ‘regular loan’ is that an obligee secured interest rate has to be taken into account and debt write-downs cannot be deducted from taxable profits. The Dutch tax qualification nevertheless tells us nothing about the qualifications adopted by country X. Debt write-downs may also cause cross-border mismatches. This will become apparent in paragraph 4.5, where we will take the perspective of a Dutch creditor granting loans to both a parent and a subsidiary company.

4.3 Dutch Creditor, Foreign Debtor

4.3.1 Upstream EDR Loan

We first analyse an upstream cross-border EDR loan, that is, where a Dutch subsidiary provides funds to its foreign parent company. In our case, the contractual interest amounts to 12%, whereas the obligee secured interest rate equals 8%. Consequently, for Dutch tax purposes, only 8% (instead of 12%) interest will be taken into account and the creditor's tax profits will be lowered accordingly. The Dutch creditor is thus taxed on a smaller amount of interest than he is actually being paid. Depending on the tax treatment in country X, – partial – double taxation or non-taxation may result, as Table 1 illustrates.

<table>
<thead>
<tr>
<th>Tax Treatment of the Dutch Obligee</th>
<th>Tax treatment of the foreign obligor</th>
<th>Mismatch</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligee secured interest taxed under the Dutch CIT: 8%</td>
<td>Deduction of the fixed arm's length interest rate (15%)</td>
<td>Yes</td>
<td>7%-points tax-free</td>
</tr>
<tr>
<td>Deduction of the profit-related interest rate</td>
<td>Yes</td>
<td>Depending on the size of the profits</td>
<td></td>
</tr>
<tr>
<td>Funds treated as equity</td>
<td>Yes</td>
<td>Dividend paid not deductible</td>
<td></td>
</tr>
</tbody>
</table>

Notes

39 As stated before, we regard the obligee secured interest part of Dutch tax folklore, which will only be useful in strictly domestic situations. Hence, it is excluded from the analysis. A case can also be made for applying the risk-free interest rate, as was suggested by Advocate General Wattel. However, as by its very nature the risk-free interest rate is contrary to that of the EDR, this option will not be discussed either. Again, as the contractual interest rate is not at arm’s length, it will not be adopted by any of the countries involved.

40 Note that according to Dutch case law the main characteristic of an EDR loan is that an arm's length interest rate cannot be found.
The first column of Table 1 shows the Dutch tax treatment of the secured interest on the EDR loan. The potential tax treatment in country X is depicted in the second column. As the tax treatment in the latter country is different from that in the Netherlands, mismatches occur, giving rise to double taxation or double non-taxation. The third and fourth columns, respectively, show whether this occurs and what the consequences are.

When adopting the 15% fixed arm’s length interest rate, country X will grant a tax deduction for a larger amount than the sum of interest taxed in the Netherlands, leaving 7%-points of interest untaxed. If country X regards a profit-related interest rate as at arm’s length, the size and direction of the mismatch depend on the total profits made, resulting in partial double (non-)taxation. If the obligor’s profits are such that the total amount of interest paid exceeds the 8% taxed in the Netherlands, the positive difference between the amount of interest actually paid and the obligee secured interest remains untaxed. Conversely, when the obligor incurs losses or his profits are such that the actual amount of interest paid to the obligee is less than the 8% taxed in the Netherlands, double taxation will arise.

Should country X treat the funds provided as equity, the remuneration paid would constitute dividend for local tax purposes. If so, double taxation arises as the obligor in country X is unable to deduct the dividend payments made and the remuneration received by the Dutch obligee is regarded interest income for Dutch tax purposes. What’s more, instruments that are classified as equity according to CIT regulations may be subject to a withholding tax on dividends paid to the issuer. Dividend withholding taxes may also be levied on interest payments that depend on the profits of the debtor or on fixed interest payments.15

4.3.2 Downstream EDR Loan

A downstream EDR loan is provided by a parent company to a subsidiary. Here, too, the creditor is taxed on the basis of a fictitious, 8% obligee secured interest, while the effective interest received is 12%. As discussed before, too, the tax treatment in country X depends on the local transfer pricing regulations. In our opinion this involves the same risks of double (non-)taxation as with EDR loans. This is logical, since this concerns a Dutch creditor, where a correction for the extreme default risk should be made as part of the profit. Therefore, please refer to Table 1 above for an overview of the impact involved.

The tax consequences and risks of double (non-)taxation seem to be largely the same as for cross-border EDR loans16 with a Dutch creditor, bar one noticeable difference: the tax treatment of the difference between the obligee secured interest and the contractual interest. The contractual interest in our example is always higher than the secured interest. In the event of an upstream EDR loan17 this results in the subsidiary/creditor charging too much interest in respect of the EDR loan prior to the correction taking place. Hence, the parent company has always paid too much interest and has, as such, favoured the subsidiary/creditor. This would retroactively indicate an informal capital contribution in the amount of the difference between the contractual and the secured interest. Conversely, a downstream EDR loan according to Dutch standards constitutes a de facto dividend distribution; the parent company has always charged too much interest to its subsidiary and by paying this the subsidiary has favoured the parent company.

Table 2: Dutch debtor, foreign obligee

<table>
<thead>
<tr>
<th>Tax treatment of the Dutch debtor</th>
<th>Tax treatment of the foreign obligee</th>
<th>Mismatch</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obligee secured interest deducted under the Dutch CIT:</td>
<td>8%</td>
<td>Taxation of the fixed arm’s length interest rate (15%)</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Taxation of the profit-related interest rate</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Funds treated as equity</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Notes

41 If, and only if, the profit-related interest rate coincidentally equals the obligee secured interest rate in the Netherlands no mismatches arise. We deem the chances of that occurring negligible.

42 Recall that we have ruled out the possibility of country X adopting the obligee secured interest rate.

43 Compare Warner 2000, p. 517. The Netherlands currently does not levy any withholding taxes on interest. It should also be noted that the rate of withholding taxes can be limited substantially under the application of treaties on double taxation and European Directives such as the Interest-Royalty Directive.

44 So, both for the upstream and the downstream EDR loan.

45 An extreme default risk will usually first be identified when the creditor wishes to write-down its receivable.
4.4 Dutch Obligor, Foreign Obligee

In this section we regard the EDR loan from the perspective of a Dutch debtor that raises funds with a foreign creditor. Clearly the tax consequences of either an upstream or downstream EDR loan are virtually identical for both creditor and debtor. After all, the creditor is liable for tax on interest gains, while – as a rule – the debtor may deduct interest expenses. Solely the hierarchy between creditor and debtor dictates the difference. As we showed before, if a subsidiary favours the parent company by charging too little interest this may constitute a de facto dividend distribution. Alternatively, an informal capital contribution may be identified. We will not discuss this again in this section. As we will restrict ourselves to providing an overview of some mismatches that may arise, the ‘direction’ of the funds provided is irrelevant.

In our example the Dutch debtor is granted a deduction on the interest payments made on the EDR loan. It should be noted that the Netherlands make allowance for the 8% secured interest, whereas the rate actually paid equals 12%. This in itself immediately gives rise to a mismatch. However, because 12% rate is not at arm’s length, it will not be respected by the tax authorities in country X, which – as we have seen above in 4.2 and 4.3 – either tax the 15% arm’s length interest rate or a profit-related interest rate, or regard the payments as a remuneration for equity (dividend). Thus, the Dutch obligor is granted a smaller deduction than what the foreign obligee actually receives. As a consequence, partial double (non-)taxation may arise, as Table 2 also clearly shows. The consequences depicted in this table are the opposite of what is discussed in paragraph 4.3.

4.5 Debt Write-Downs

As stated in paragraph 3.2, any write-down of an EDR loan is non-tax-deductible for the obligor of an EDR loan. In one of its 25 November decisions, the Dutch Supreme Court implied that any future waiver of an EDR loan in downstream situations is to be seen as an informal capital contribution (which constitutes equity). If the obligee is a Dutch resident company, the waiver of a written down EDR loan in downstream situations is considered a capital contribution. Therefore such a waiver will not result in a taxable profit for the obligee. Chances are that foreign domestic tax law will look at the EDR loan differently and not consider this to be a capital contribution. If so, the non-deductability for the obligor of a downstream cross-border EDR loan is not met with a corresponding tax exemption for the obligee if and when the EDR loan is waived.

Such an international mismatch could also very well occur if a written down upstream EDR loan granted by a Dutch resident creditor to a foreign parent company is waived. This will depend on the presence and scope of a domestic participation exemption.

Our conclusion is that any waiver of a written down EDR loan may result in international mismatches, both in upstream and downstream loan situations. This occurs if the obligee of an EDR loan is a non-Dutch resident company. Depending on the national treatment under domestic tax law, a waiver could result in double taxation.

4.6 Solutions

As demonstrated in the previous paragraphs, developments in Dutch case law can frequently lead to interest mismatches in cross-border situations, due to differences between interest deduction and interest inclusion.

The recently published OECD report ‘Hybrid Mismatch Arrangements’ by ‘Working Party no. 10 on Exchange of Information and Tax Compliance’ of the Committee on Fiscal Affairs (hereinafter: the Working Party or the OECD report, respectively) highlights the effects of using a hybrid instrument for cross-border funding of companies. Having outlined the most common ways of using a hybrid instrument to arrange a deduction/no inclusion scheme, the Working Party concludes that these hybrid mismatch arrangements raise a number of tax policy issues, affecting for example tax revenue, competition, economic efficiency, transparency and fairness. Next, the Working Party outlines some policy options, containing domestic tax amendments to ban undesirable mismatches.

The issues raised by the Dutch Supreme Court’s decisions about the EDR loan, are of a somewhat different nature. In the case of an EDR loan, the loan is not marked as equity. Therefore the cross-border mismatches are not caused by a qualification issue, but are due to the Dutch Supreme Court’s different approach to adaptation in accordance with what is at arm’s length and what loan features are subject to at arm’s-length adaptation. The question is whether domestic law amendments are the most effective approach to solve
these mismatches, since they are based in domestic (case) law. While domestic law amendments would solve the problem for the countries involved, a treaty-based provision would perhaps be far more effective. At the moment, the issue raised by Dutch case law on the EDR loan is ‘merely’ a Dutch problem. It is, however, conceivable that in the future other countries start to deviate from the regular at arm’s-length approach. In that case, the most effective solution as regards the interest mismatches seems to be a treaty-based provision. In our opinion, in the commentary on Article 9 of the OECD model convention the OECD should point out that at arm’s-length adaptation of any loan that bears the marks of shareholder influence should not be limited to one or two features of such a loan, but should cover every aspect of the loan. Furthermore, in our opinion it would be recommendable if the commentary were to clearly state that no at arm’s-length adaptation can be based on a fictitious security, thus abandoning the Dutch deviant approach to the at arm’s-length adaptation of an EDR loan.

If international mismatches occur due to the waiver of written down EDR-loans, the latter solution seems to be rather ineffective. Such mismatches are not ‘simply’ at arm’s length mismatches, they seem to be qualification mismatches. Following the aforementioned OECD report, in our opinion this can only be fixed by domestic measures. Rather than asking all other countries possibly involved to make the necessary amendments to their national tax law, the Dutch government initiating tax law amendments to abolish the odd phenomenon of the EDR loan would seem to be more effective, heralding a return to the relatively calm, unwrinkled pond of the rules on requalifying debt into equity.

5 Conclusions

In this article we have examined the possible cross-border effects of a relatively new development in Dutch case law: the extreme default risk loan. In its judgments of 25 November 2012 the Dutch Supreme Court clarified the tax treatment of this kind of loan. The EDR loan is a high-risk loan that clearly bears the marks of shareholder influence, but not enough to designate it as equity. Despite the fact that an EDR loan maintains its loan character, any write-down of such a loan is non-deductible. Furthermore the at arm’s-length adaptation of an EDR differs from the regular at arm’s-length approach on two accounts. First, solely the interest to be taken into account by obligee and obligor is subject to at arm’s-length adaptation and second, in finding the interest to be taken into account there needs to be a fictitious security by the obligee to the loan.

Our investigation shows that this special provision at arm’s-length adaptation will probably lead to undesirable cross-border mismatches. For now, the scope of the problem seems to be limited to situations where a Dutch company is involved. To prevent these problems from expanding, a tax treaty-based provision could be considered. In our opinion, an amendment of the OECD commentary to Article 9 of the OECD model convention, banning out the different Dutch approach to at arm’s length rules, would probably be an effective solution.

If international mismatches occur due to written down EDR loans being waived, a Dutch tax law amendment to abolish the odd phenomenon of EDR-loans seems to be the only possible and practically feasible solution.