KPMG Meijburg & Co
Tax & Legal

Important judgment on tax classification of financial instrument

On May 17, 2024 the Dutch Supreme Court rendered an important judgment on the tax qualification of a financial instrument that was issued by a company established in France in 2007. It concerned the 'obligation remboursable en actions' (hereinafter: ORA). The question was whether the instrument had to be regarded as equity (capital) or debt capital (loan) for the purposes of the Corporate Income Tax Act 1969. Although the dispute focused on the question whether the costs related to the issue of the instrument were allocable to a Dutch permanent establishment of the French company, the Supreme Court judgment potentially has a much broader scope.

Characteristics of the ORA

The ORAs had the following characteristics: they typically had a term of 50 years. After 50 years the ORAs would be converted into ordinary shares of the company. The nominal amount of an ORA was the same as the issue price of a new share in the company at the time the ORAs were issued. After a period of 12 years following the date of issue of the ORAs had passed, the company could each year demand that the ORAs be exchanged for ordinary shares in the company. After a period of three months after the issue of the ORAs had passed, holders of ORAs could ask to exchange them, but only for shares in the company. At the time the ORAs are exchanged for ordinary shares, the ordinary shares may have a lower value than the nominal value of the ORAs. In that situation the difference would not however be reimbursed. The ORAs do not have any shareholder rights, such as voting rights. The payment on the ORAs was, in principle, the same as the dividend distributed by the company, with a certain minimum and maximum payment. It was possible that the payment would not be paid out by the company, but would remain outstanding. It was not possible to repay the ORAs in cash. Only by voluntary or involuntary liquidation of the company would the holders of ORAs be able to claim payment in cash; a claim that would have precedence over all shareholders and holders of participating loans provided to the company. Most of the ORAs were converted into ordinary shares in the French company by the holders shortly after they were issued.

The Supreme Court judgment

The Amsterdam Court of Appeals had ruled that the ORAs must be regarded as capital for tax purposes, because the hallmark of the instrument was that it would be repaid in shares of the company that had issued the ORAs. The Supreme Court began its explanation with the well-known rule that to answer the question whether, for the purposes of tax law, the lending of funds must be regarded as a loan or as the provision of capital, the civil-law form of that lending of funds is generally decisive. If the lending of funds is assessed according to civil-law standards as the provision of share capital, it must, in principle, be regarded as the provision of capital for the purposes of tax law. The Supreme Court then dealt with the question when is there a loan under civil-law? According to the Supreme Court and in line with previous rendered judgments, relevant in this respect is that there is a repayment obligation. The Supreme Court subsequently ruled that the Court of Appeals had not disregarded those rules and that the ORAs must be regarded as capital under tax law.

KPMG Meijburg & Co comments
For us, a number of things about the judgment stand out.

The first is: until May 17, 2024, previous Supreme Court case law required that if the lending of funds was assessed according to civil-law standards as a provision of share capital, then for the purposes of tax law it must be regarded as the provision of capital. What stands out about the judgment of May 17 is that the Supreme Court has added the words ‘in principle’ to that formulation. That addition raises the question whether it can be inferred from this that the Supreme Court believes it is possible to deviate from this rule under certain circumstances. In practice, that could, for example, have consequences for the application of the participation exemption. If it were possible to nuance the general rule formulated by the Supreme Court in the past, that would lead to legal uncertainty about where, in the case of public limited companies and private limited liability companies, the line should be drawn between the provision of risk capital and the provision of a loan. In case law rendered before May 17, that legal uncertainty was described as undesirable by the Supreme Court. We therefore assume that the addition of the words ‘in principle’ cannot be read as a restriction of the rule formulated in the past that capital under civil law is also regarded as capital under tax law.

Secondly, we find the following noteworthy. It had been established that the ORAs were regarded as debt capital for French civil law purposes. This was not reflected in the considerations of the Court of Appeals; it had left the civil-law classification open. It is unclear how the Supreme Court reached the conclusion that the ORAs must be regarded as capital for tax purposes. Is that because the ORAs must be regarded as capital for civil law purposes? Is that because the ORAs do not qualify as a loan under civil law due to the absence of a repayment obligation and therefore can only qualify as capital under tax law, or is it because although the ORAs qualify as loans under civil law, this qualification cannot however be followed for tax purposes, just as, based on current case law, this is not the case for sham loans, loans with no expectation of repayment and participating loans? However, we consider the latter unlikely. In that case we would have expected another or a more comprehensive substantiation of the conclusion reached by the Supreme Court.

We interpret the Supreme Court judgment as meaning that, in light of the characteristics of the instrument, for civil law purposes there is no repayment obligation, because when converting the instrument only shares in the company are issued. The fact that, in the event the company unexpectedly defaults on the instrument before the end of the instrument’s term, the holders have a right to a cash claim against the company, does not alter this. It is all about the characteristic of the instrument in normal settlement. That characteristic is that, at any given time during normal settlement, the holder can only become a shareholder in the company. There is then no loan under civil law. In that case, the only qualification possible under tax law is that of capital. That there is debt capital for French civil law purposes is then apparently irrelevant, due to the absence of the repayment obligation deemed as crucial by the Supreme Court. That interpretation does not change the existing assessment

framework. On the other hand, in the case of loans under civil law, the current exceptions to the general rule (re-qualification for tax purposes to capital in the case of sham loans, loans with no expectation of repayment and participating loans) remain unchanged.

In our view, it is now clear that the mere fact that by a default of the company that issued the financial instrument, a claim arises for the holders of the instrument that takes precedence over any claims by shareholders, is insufficient to be able to speak of a loan.

The Supreme Court's ruling that the ORAs must be regarded as capital under tax law, will also have consequences for the holders of such and comparable instruments. However, it is currently unclear whether they also have the status of shareholder and how their interest should, for example, be qualified for the purposes of the participation exemption. Does an interest in an ORA or a comparable instrument qualify as a share in the nominal paid-in share capital or is there an interest comparable to an option? Is a payment made on such an instrument a dividend for the purposes of dividend tax or a payment for a capital provision as referred to in Section 10(1)(c) Corporate Income Tax Act 1969? The present judgment does not provide answers to all these questions. In our view, at the time of the issue there is a capital provision by the holders of the instrument, not being share capital. We do not expect this judgment to be the last word on the distinction between capital and debt capital for the purposes of the Corporate Income Tax Act 1969.

If you would like more information about this matter or have other questions about the tax classification of financing instruments, feel free to contact your Meijburg advisor.

KPMG Meijburg & Co
May 22, 2024

The information contained in this memorandum is of a general nature and does not address the specific circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.