ABOLITION OF DUTCH TAX DEDUCTIBILITY OF AT1 AND RT1 COUPONS: WHAT DOES THIS MEAN FOR ISSUERS AND NOTEHOLDERS?

On Friday 29 June 2018, the Dutch government published a letter to Parliament stating that it intends to abolish the specific corporate income tax provision for Additional Tier 1 (AT1)/Restricted Tier 1 (RT1) instruments issued by banks and insurers. In this Q&A we discuss this announcement and the impact this may have on issuers and noteholders of AT1/RT1 instruments.

1. What will be the impact of this abolition?

This abolition means that coupon payments under new and existing AT1/RT1 instruments will no longer benefit from a specific provision under Dutch corporate income tax laws ("Article 29a"). Article 29a allows AT1/RT1 instruments to be classified as a debt (*geldlening*) for Dutch tax purposes. The Dutch government considers that in absence of Article 29a, AT1/RT1 instruments qualify as equity for Dutch tax purposes, and as a result, the coupon may no longer be deductible.

2. What kind of issuers will be impacted?

The abolition will have an impact on Dutch banks that issue AT1 instruments within the meaning of article 52, first paragraph of Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms (CRR) and Dutch insurers that issue RT1 instruments within the meaning of article 94, first paragraph of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

3. What kind of instruments will be impacted?

It is expected that the abolition will have an impact on AT1/RT1 instruments whether issued before or after the abolition of Article 29a. However, so-called "legacy" instruments which were grandfathered under CCR or Solvency II, should in principle not be impacted by the abolition of Article 29a as these instruments should rely on prevailing Dutch case law of the Dutch Supreme Court for deductibility of the coupon (see also under question 5 below).

4. Why does the Dutch government intend to abolish this provision Article 29a now?

The Dutch government informed Parliament that the abolition follows from recent state aid concerns raised by the European Commission ("EC"). In the letters of 30 January 2018 and 22 June 2018, the European Commission has preliminarily expressed concerns that Article 29a is selective because it discriminates between banks/insurers and corporates, as corporates are in a comparable factual and legal situation in the light of the objective pursued by the general Dutch corporate income tax regime. However, there has not been a formal declaration by the EC that Article 29a amounts to state aid. Nonetheless, the Dutch government decided to announce abolition now in order to avoid legal uncertainty for taxpayers which may result from legal state aid proceedings against the EC. The Dutch government's decision to abolish Article 29a is in line with its ambition to pursue a more equal treatment of equity and debt for Dutch tax purposes, which seems to be effectively achieved by limiting the tax deductibility of interest on debt instruments (see also under question 9 below).

5. Is the coupon indeed non-deductible after the abolition of the provision Article 29a?

Legacy instruments which were grandfathered under CCR or Solvency II rely on prevailing Dutch case law of the Dutch Supreme Court for deductibility of the coupon.

Following the implementation of CRR and Solvency II, the Dutch government took the position that AT1/RT1 instruments issued under CRR and Solvency II did not qualify as debt, but as equity for Dutch corporate income tax purposes which would have resulted in non-deductibility of the coupon for Dutch corporate income tax purposes if no specific provision was introduced at that time.

After abolition of Article 29a, this prevailing Dutch case law of the Dutch Supreme Court for deductibility of the coupon may become relevant again for qualification of the AT1/RT1 instruments as debt (or deemed equity). It is not evident that application of the existing case law results in non-deductibility of the coupon of these new generation AT1/RT1. This requires clarification in a legislative proposal and/or should be tested with new case law.

6. Will the coupon become subject to Dutch dividend withholding tax?

The Dutch government confirmed in a letter dated 26 January 2016 that no Dutch dividend withholding tax is payable on the coupons of AT1/RT1 instruments, neither before nor after the introduction of Article 29a. However, this statement of the Dutch government assumed that these instruments would qualify as equity for Dutch civil law purposes. This assumption has been debated in literature and it is doubtful whether it will uphold after the interest deduction rule has been abolished. We expect that existing case law (see under question 5 above) may become relevant for qualification of the AT1/RT1 instruments as debt (or deemed equity) for Dutch tax purposes after the abolition of Article 29a.

Note that the Dutch government announced its intention to abolish the Dutch dividend withholding tax as of 1 January 2020, albeit that it would be replaced by a conditional withholding tax if certain (related party) payments are made to low tax or non-cooperative jurisdictions. The abolition of the Dutch dividend withholding tax is currently subject to strong debate in Parliament.

7. Could the abolition trigger a tax call under existing AT1/RT1 instruments?

The majority of existing AT1/RT1 instruments include so-called 'tax calls' which allow the issuer to redeem the instrument upon the occurrence of a change in law as a result of which (i) interest payable under the instrument is no longer tax deductible and/or (ii) the coupon of the instrument becomes subject to Dutch dividend withholding tax, subject to certain conditions, including regulatory approval and, for certain instruments, a determination that the change in law was not 'reasonably foreseeable' at the time of issuance.

Therefore, the question of whether an issuer has the option to exercise a tax call following the abolition ultimately depends on the exact wording of the relevant tax call and, for certain instruments, whether the regulator deems that the change in tax law was 'reasonably foreseeable' at the time of issuance. Of course, having the option to exercise the tax call does not necessarily mean that an issuer will also choose to exercise the call.

8. When can we expect a is a legislative proposal for the abolition?

The formal legislative proposal to abolish the interest deduction for AT1 instruments is expected on 18 September 2018 as part of the 2019 Tax Plan. We expect the legislative process to be completed by the end of 2018 so that it will enter into force as of 1 January 2019.

9. Are there any other developments in the context of the interest deductibility?

We expect that this abolition of the interest deduction will be enacted in addition to the introduction of a generic thin cap interest deduction limitation for banks and insurers that was announced on 10 October 2017 and will limit the deduction of interest on debt exceeding 92% of the commercial balance sheet total. This thin capitalization rule is expected to enter into force as of 1 January 2020.

The Dutch government's decisions to abolish Article 29a and to introduce a generic thin cap rule are in line with its ambition to pursue a more equal treatment of equity and debt for Dutch tax purposes, which seems to be effectively achieved by limiting the tax deductibility of interest on debt instruments.

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