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Global Tax Alert

The Netherlands introduces thin capitalization rule for insurers

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Executive summary

On 17 September 2019, the Dutch Government published the 2020 budget proposals, which include legislation to limit the interest deduction for banks and insurers. This thin capitalization rule largely follows the draft legislation that was published and consulted on earlier this year. The measure is due to become effective for financial years starting on or after 1 January 2020.

This Alert addresses the key issues related to insurers.

Detailed discussion

Basic framework

The new measure is part of an effort by the Dutch Government to treat debt and capital more equally. As insurers are typically net interest recipients rather than net interest payers, they are not affected by the general earnings stripping rule (based on 30% of a taxpayer's EBITDA[1]). In order to disincentivize the use of debt in the financial sector, the Dutch Government considers it appropriate to implement a separate measure for this industry.

Building a better working world

The interest deduction limitation is calculated based on the equity ratio at 31 December of the calendar year preceding the relevant fiscal year, as reported pursuant to the European Union (EU) Solvency II prudential framework. In short, the equity ratio is the basic and ancillary own funds, subject to certain adjustments as further explained below, divided by the insurer's total assets.

If the equity ratio is lower than 8%, deduction of interest will be disallowed according to the formula: (8-ER)/100-ER), where ER is the equity ratio rounded to one decimal.

A simple example illustrates the working of the rule. Assume an insurer with €150 million of interest expenses and an equity ratio of 3%. Interest will be denied for an amount of €7.73 million (5/97 of 150 million).

For applying the thin capitalization rule, the consolidated equity ratio at the group level is decisive as calculated based on the group solvency and financial condition report pursuant to Solvency II. If no such report is available, the stand-alone equity ratio of the insurer must be calculated based on its own solvency and financial condition report pursuant to Solvency II. If no such report is available, an equivalent (non-EU) ratio should be determined.

The new thin capitalization regime also applies to foreign insurers with a Dutch branch.

Draft provisions

Interest

The term interest includes all expenses related to money loans and equivalent instruments, for example financial leases.

It only includes the interest expenses that are (potentially) deductible *after* applying the other interest limitation rules in Dutch tax law, but before the application of the general earnings stripping rule. However, a specific anti-double counting rule will prevent the same interest expense from being denied both under the general earnings stripping rule and the specific thin capitalization rule.

Unlike the general earnings stripping measure, and in deviation from the draft bill that was consulted on, foreign exchange results on debts payable and results on hedging transactions with respect to debts payable are not included in the definition of interest.

Adjustments to Solvency II own funds

The equity ratio is calculated using Solvency II principles and includes both basic own funds and ancillary own funds, except those items that have debt characteristics such as subordinated liabilities and guarantees. Tier 3 ancillary own funds are also excluded. In the draft bill that was previously consulted on, net deferred tax assets were not included as equity, but this has been corrected in the final version.

Mixed activities

Although the new thin capitalization rule also applies to banks, the calculation of the non-deductible interest for banks is different as it refers to the Capital Requirements Regulation rather than Solvency II definitions.[2] Whether to use the formula for insurers or for banks will be determined by reference to the activity with the largest balance sheet.

Assessment at group level

The main rule for calculating the interest limitation is to apply the equity ratio at the group level. It is of course possible that the individual Dutch insurer (entity or branch) has an equity ratio of 8% or higher, whereas the group has an equity ratio below 8%. In that case the Dutch insurer will be faced with a denial of interest deduction, while it individually complies with the equity ratio of 8%. The reverse can also be true; no interest limitation applies if the group has a ratio of 8% or higher, even though the individual Dutch insurer has an equity ratio that is below 8%.

Treatment of foreign branches

In the case of Dutch insurers with foreign branches, the thin capitalization rule will effectively only apply to the interest expenses that are attributable to the Dutch head office.

No carryforward

There is no carryforward possible for interest that is non-deductible in a given year.

Fiscal unity

Under Dutch tax law, it is possible for an insurer to be included in a fiscal unity (consolidated tax group) with non-insurance entities. As the thin capitalization measure will be applied at fiscal unity level, all of the interest expenses of the fiscal unity could be at risk, i.e., including the interest that is attributable to non-insurance entities. Because of this potential "tainting" effect, taxpayers should carefully reconsider the composition of their fiscal unity.

Recommended actions

The thin capitalization rule will become effective for financial years starting on or after 1 January 2020. Insurance groups should carefully review the potential financial impact for their Dutch operations. In some cases, it may be possible to take some mitigating measures, such as changing the composition of a fiscal unity in order to limit the impact to only the insurer itself.

Endnotes

1. Earnings before interest, taxes, depreciation and amortization.
2. See EY Global Tax Alert, *The Netherlands introduces thin capitalization rule for banks*, dated 19 September 2019.

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