

The Netherlands introduces thin capitalization rule for banks

EY Tax News Update: Global Edition

EY's Tax News Update: Global Edition is a free, personalized email subscription service that allows you to receive EY Global Tax Alerts, newsletters, events, and thought leadership published across all areas of tax. Access more information about the tool and registration [here](#).

Also available is our [EY Global Tax Alert Library](#) on ey.com.

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 banks.

Detailed discussion

Basic framework

The new measure is part of an effort by the Dutch Government to treat debt and capital more equally. As banks 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 EBITDA¹). 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.

The interest deduction limitation is calculated based on the leverage ratio at 31 December of the calendar year preceding the relevant fiscal year, as reported pursuant to the European Union (EU) Capital Requirements Regulation (CRR). In short, the leverage ratio is the Tier 1 capital divided by the bank's total unweighted exposure, including both on-balance sheet and off-balance sheet items.

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

A simple example illustrates the working of the rule. Assume a bank with €150 million of interest expenses and a leverage 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 leverage ratio at the group level as reported for CRR purposes is decisive. If no CRR leverage ratio is reported, for example in the case of non-EU banking groups, an equivalent consolidated ratio as published by that group must be used. If no equivalent ratio is available, the stand-alone leverage ratio of the bank must be used.

The new thin capitalization regime also applies to foreign banks 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.

Mixed activities

Although the new thin capitalization rule also applies to insurers, the calculation of the non-deductible interest for insurers is different as it refers to Solvency II rather than CRR definitions. Whether to use the formula for banks or for insurers 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 leverage ratio at the group level. It is of course possible that the individual Dutch bank (entity or branch) has a leverage ratio of 8% or higher, whereas the group has a leverage ratio below 8%. In that case the Dutch bank will be faced with a denial of interest deduction, while it individually complies with the leverage 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 bank has an equity ratio that is below 8%.

Treatment of foreign branches

In the case of Dutch banks 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 a bank to be included in a fiscal unity (consolidated tax group) with non-banking 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-banking 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. As the threshold of 8% is substantially higher than the minimum leverage ratio requirement for prudential supervision purposes, it is expected that many banks will be affected. Therefore, banking 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 bank itself.

Endnote

1. Earnings before interest, taxes, depreciation and amortization.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Belastingadviseurs LLP, Financial Services, Amsterdam

- ▶ Silvain Niekel silvain.niekel@nl.ey.com
- ▶ Arjan van Oostrom arjan.van.oostrom@nl.ey.com
- ▶ Sebastiaan Swaak sebastiaan.swaak@nl.ey.com
- ▶ Benoni Talahatu benoni.talahatu@nl.ey.com

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 004229-19Gbl

1508-1600216 NY
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com