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Tax Issues in Consensual Debt Restructuring

The authors present the main Dutch tax aspects of consensual debt restructurings involving Dutch debtors, including consensual debt restructurings by means of amendments of the terms and conditions of debt, debt buy-backs, debt-for-debt or debt-for-equity swaps, and debt waivers.

1. Introduction

With the rise of private equity firms, shareholder activism, globalization and the availability of large amounts of cheap (debt) financing, the years following the burst of the dot-com bubble were characterized by a steep increase of mergers worldwide, reaching its peak in 2006. A large number of Dutch corporations, as well as multinational groups having their corporate holding structures in the Netherlands, have attracted large amounts of debt financing (bank debt and corporate bonds) in this merger wave. The terms and conditions of the debt were based on the relative economic prosperity of that period. Economic and financial markets have in the meantime drastically changed as a result of the global financial crisis. Where the economic downturn has led to a decline in the sales and profits of corporations worldwide, the crash of the financial markets has put a strain on the credit available to corporations. Many corporations are now confronted with the nearing maturity of their debt obligations in the 2013-2015 period, as a result of which the credit markets will be faced with a significant increase in the demand for debt financing over the next few years.

As a result, corporations are on a large scale looking to restructure their debt positions to bring them in line with the current market situation. This article will set out the main Dutch tax aspects of consensual debt restructurings involving Dutch debtors.

If debt restructurings are not properly structured, they may result in taxation at the level of the debtor and/or the creditor. Of particular relevance for Dutch debt restructurings (and these features as such may be typical for the Netherlands only) are the tax exemption for debt waiver gains and the possibility to contribute discounted debt to the capital of the debtor in a tax-neutral manner.

This article will discuss these possibilities and the other tax consequences of consensual debt restructurings by means of amendments of the terms and conditions of debt, debt buy-backs, debt-for-debt or debt-for-equity swaps, and debt waivers.

2. Debt Restructuring in General

There are various circumstances that can cause debt receivables to be discounted, such as increased market interest rates, an increased risk profile of the debtor or, in case of bonds, a decrease in the liquidity of the bonds. Given, among other things, the increasing pressure on, and requirements for, banks to enhance their core Tier 1 ratios and reduce their risk-weighted asset bases, banks may be willing to dispose of receivables at substantial discounts to enhance their balance sheet positions. If there is a reduced supply of credit in second trading lines as well, this could result in even larger discounts. On the other hand, where banks (or lenders in general) have not yet been required to recognize a loss on a distressed asset, they may be less inclined to sell such asset (at a discount), as this would negatively impact their profit figures.

Under Dutch tax law principles,[1] debt is accounted for by the debtor at the (amortized) nominal value of the obligation, taking into account accrued but unpaid interest.

In the case of a fixed interest rate on the debt, any fluctuations of market interest rates are not taken into account in determining the tax book value of the debt at the level of the debtor. For example an increase of the "risk-free" benchmark interest rates (EURIBOR, LIBOR, Treasury bond rates) would reduce the present value of the cash flows of the debt, but would not trigger a write-down of the debt at the level of the debtor. The same applies in the case of an increase of the risk premium in the interest rate: if either the creditworthiness of the debtor deteriorates and/or the pricing for the creditworthiness of the debtor changes, this does not affect the tax book value of the debt for the debtor.

A reduction of the nominal obligation of a Dutch debtor, for instance resulting from a debt amendment, debt buy-back or debt waiver, results in a reduction of the tax book value of the debt obligation and, in principle, a gain for the debtor for tax purposes.[2]

3. Amendments to the Terms and Conditions

3.1. General

An amendment of the terms and conditions of a loan may form an alternative for a debt-for-debt swap (*see* section 5.) to adapt to changed (market) circumstances.[3] Further-

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1. Commercial accounting standards and principles are, in theory, not decisive in Dutch tax accounting. For practical reasons, however, the commercial accounts often form the basis for the tax accounts.
2. Debt waived at non-arm's length terms (i.e. if (and to the extent) the market value of the debt equals its amortized nominal value) by a creditor that is related to the debtor may qualify as an informal capital contribution to the capital of the debtor, rather than a (taxable) gain at the level of the debtor.
3. In this respect, a creditor will take into account that older security, in principle, ranks ahead of newer security. Using a new debt instrument that would affect its priority of the security underlying the debt would thus not be acceptable to such creditor.

more, depending on the relevant law of the contracts, the place of execution and the nationality of the creditor, foreign registration tax or stamp duties may be due upon entering into a new loan.

If the nominal amount of the obligation of the debtor is reduced as part of the amendment of the terms and conditions of the loan, this will require the debtor to account for the debt at the lower nominal amount. Such reduction in principle triggers a taxable gain in the Netherlands, but an exemption for tax may apply if the amendment is properly structured and documented (*see* section 6.).

If the terms of the loan are amended such that the loan should be considered replaced by a new loan (novation), it could be argued that the novation is a taxable event for the debtor. Any gains or losses on the debt would then be realized (e.g. any foreign currency gains on the debt and gains resulting from increased market rates would then be taxable).

3.2. Hybrid loans

Loan instruments with certain equity-like features are treated as equity for Dutch tax purposes. Pursuant to case law, loans will be characterized as equity if the term is more than 50 years, the interest payments on the loan are dependent on the profits of the debtor and the loan is subordinated to all other debt obligations of the company.[4]

Changing the characteristics of a loan may therefore (but only if the new loan meets all three conditions mentioned above, which in practice is fairly unlikely unless expressly structured as such) lead to a conversion of the loan from debt to equity from a Dutch tax perspective. As a result, any interest payments on the loan going forward would no longer be deductible from the debtor's Dutch tax base.

There may be a risk that the loan would also be retrospectively reclassified as equity if the loan has been subordinated and profit sharing in the past and solely the term of the loan is increased to more than 50 years. In such case, past interest deductions may be denied retrospectively, as well. Such retroactive equity reclassification is unlikely to occur in practice, as most debt restructurings will result in either shorter term loans and/or the issue of new shares in the capital of the borrower (*see* section 5.). A taxpayer could defend itself against the tax authorities taking the position that the loan should be reclassified as equity by demonstrating that it was actually able to repay the debt in full at the time of the debt restructuring.

4. Debt Buy-Backs

4.1. General

A company may be inclined to repurchase its own (discounted) debt if it has sufficient cash available. Buying back own (discounted) debt commercially triggers the recognition of the "gain" realized on the debt (e.g. on the increase of the market interest rates). This can boost the company's debt and profit ratios (assuming that the debtor has not been allowed already to report such profit for commercial accounting purposes), possibly aiding it in escaping restrictive debt covenants.[5]

4.2. Buy-back by the debtor

As the tax book value of debt is the (amortized) nominal value of the obligation, a repurchase of discounted debt by the debtor will generate a gain for Dutch tax purposes (subject to the exemption as described in section 6.).

4.3. Buy-back by a related party of the debtor

If the discounted debt is acquired by a related entity of the debtor, however, this will not require the debtor to realize a taxable gain, as the debt continues to exist and the debt remains on the tax balance sheet of the debtor at its nominal value. This would be different only if the acquirer of the loan and the debtor form part of the same fiscal unity. In that case, the debtor and the creditor would be considered a single entity for Dutch tax purposes, and the loan relation would be deemed to have ceased to exist.

After the acquisition of the debt receivable by the group company of the debtor, the loan will continue to exist within the group. This can be undesirable; for example if the loan is (fully) repaid at a later time and the creditor is subject to tax, the creditor will have to realize a (taxable) gain insofar such repayment exceeds the price it paid for the receivable.

Dutch tax law allows for a creditor to contribute a debt receivable to the capital of the debtor without either the creditor or the debtor having to realize a taxable gain (*see* section 5.). Consequently, if the parent company of the debtor purchases the debtor's discounted debt receivables from a third party[6] and subsequently contributes the receivable to the capital of the debtor, this would not normally trigger any Dutch taxes (subject to section 5.3.). A significant advantage of this method over the active debt waiver as described in section 6., is that a debt waiver will eat up any loss carry-forwards, whilst the contribution of the receivable should not lead to a gain in the first place and thereby preserves the loss carry-forwards.

5. Debt-for-Debt and Debt-for-Equity Swap

5.1. Debt-for-debt

An exchange of debt for other debt of the same entity with different terms and conditions can be part of a restruc-

4. Loans may also be treated as instruments the payments under which are non-deductible if (1) they are extended by a related party, have a term of more than 10 years and carry a significantly below arm's length interest rate (or none at all), (2) they are actually equity in substance, but are only given the form of a loan or (3) it is clear from the outset that the loan will not be repaid ("bottomless pit financing").

5. Debt buy-backs may be restricted under debt documentation (possibly subject to majority creditor consent). In determining the debtor's profits, any debt buy-back gains may be excluded from the calculation of the debtor's profits for purposes of testing the covenants under the debt documentation.
6. If such discounted debt receivable were to be acquired from a related company, this could trigger a recapture at the level of the transferring company; *see also* section 5.3.

turing even if the new debt is substantially different from the old debt.

As the debt-for-debt swap includes the termination of the old debt agreement, the debtor will be required to recognize any gains it has realized on the debt. This gain will be the difference between the tax book value of the old debt and the amount of the "repayment" made in respect of the debt. In the case of a debt-for-debt swap, the "repayment" will be the new debt obligation, which will have to be accounted for at its (discounted) value at the time of the swap (*see also* section 3.1.). Effectively, a debt-for-debt swap will thus lock in any (taxable or deductible) currency exchange results and fluctuations in market interest rates and credit spreads.

5.2. Debt-for-equity

As compensation for giving up certain creditor rights, in practice, creditors often receive equity in the (distressed) company so as to be able to benefit from any potential upside if the distressed business recuperates. This can be implemented by converting the debt into new shares of the debtor or making a share premium contribution and netting the corresponding payment obligation to pay up the share premium against the amount receivable under the debt. If properly structured, such a debt-for-equity swap is tax neutral in the Netherlands.

Upon the issue of new shares by the debtor to the creditor, the creditor will be required under Dutch corporate law to pay up (at least) the nominal amount of the new shares in full to the debtor. Such payment can be netted against the debt receivable. Corporate law furthermore requires that the (nominal) value of the receivable be (at least) equal to the total amount that is required to be paid up under the shares (nominal value plus (stipulated) share premium).

To avoid a taxable gain at the level of the *debtor*, the payment obligations under the shares should be (at least) equal to the payment obligations under the contributed debt.[7] The theoretical background is that the debtor "pays off" the full amount of its debt by set-off against the receivable it has on its (future) shareholder. Issuing shares with a lower nominal value than the nominal value of the payment obligations of the debtor is possible as long as the payment obligation under the shares is (at least) equal to the nominal value of the receivable. In the authors' view, it is possible to contribute the receivable as share premium (even without the issue of new shares if the creditor is a current shareholder of the debtor), as long as the payment obligation of such share premium is properly documented (i.e. as stipulated share premium). In combination with the corporate law requirement described above, the nominal amount plus (stipulated) share premium of the shares should thus be equal to the nominal amount of the contributed receivable.

The *creditor* will not realize a taxable gain if the fair market value of the shares obtained by the creditor does not exceed the fair market value of the receivable prior to the netting of the receivable with the payment obligation in respect of the issue of the newly obtained shares.[8]

5.3. Anti-abuse legislation

Certain anti-abuse provisions apply if the debt receivable has been written off and such write-off has been deducted from the *Dutch* tax base of a *related* entity of the debtor. These provisions distinguish, roughly, between the situations whereby (1) the creditor waives the receivable or converts the receivable in equity of the debtor (either through the issue of new shares or by a share premium contribution) and (2) the creditor transfers the receivable to a group entity (or to its foreign branch).

In both situations, the written-off losses are recaptured at the level of the creditor. The difference between both situations is that the written-off losses are immediately recaptured in the latter case (transfer to a group entity), but are recaptured over time in the former case (conversion into equity) depending on the value development of the debtor. These anti-abuse rules should not impact the common debt restructurings, as write-offs by third-party creditors do not trigger these provisions.

6. Full or Partial Debt Waivers

6.1. General

A debt waiver will, in principle, trigger a taxable gain at the level of the Dutch debtor, as its nominal obligations are reduced by the waiver.

The Dutch tax treatment of conditional debt waivers generally follows the Dutch tax treatment of non-conditional debt waivers (whereas in some countries, conditional debt waivers may enjoy special tax treatment).

6.2. Debt waiver exemption

An exemption from Dutch corporate income tax applies if the debt waiver meets the following two requirements:
- the receivable (to the extent it is waived) is not realistically collectable for the creditor; and
- the creditor *actively* (expressly) waives the receivable.

Whether the first requirement is met depends on the specific facts and circumstances of the case at hand. A negative equity on the (tax) balance sheet of the debtor will not always be sufficient to show that the debt is not realistically collectable, as expected future profits may cause the debt to be realistically collectable in the (near) future. Practical indications that a debt is not realistically collectible could be that the debt is purchased from a third party at a discount or simply that the debt has matured and the debtor has defaulted under the loan.

For the second requirement to be met, it is sufficient to have the creditor undertake some sort of action from which it shows that the debt is waived. In practice, includ-

7. *Hoge Raad*, 25 June 1969, BNB 1969/202.

8. *Hoge Raad*, 26 April 1978, BNB 1978/140. The creditor will be required to recognize a taxable gain if the fair market value of the receivable is higher than its tax book value upon contribution. The difference will then be a taxable gain for the creditor.

ing the waiver (as a short paragraph) in an agreement or having the creditor confirm the waiver in a (short) letter to the debtor will suffice.

Vice versa, if there are lenders that are not willing to cooperate in a (largely consensual) debt restructuring, any debt that is not realistically collectible may still have nuisance value for the lenders. Also in case of bankruptcy of the debtor, the debt waiver exemption does not apply if the creditors do not actively waive their receivables. For example entering into a composition should qualify as an active debt waiver. On the other hand, a plan of distribution becoming final (without any further action from the creditor) does not qualify as an active debt waiver, as this does not require an (implicit or explicit) waiver by the creditor.

Such non-cooperating lenders may refuse to actively waive the debt and thereby trigger a non-exempt tax hit for the debtor. A security agent waiving the debt on behalf of the non-cooperating lenders without such lenders explicitly waiving the debt themselves is most likely not sufficient for the debt waiver exemption to apply.

The debt waiver exemption does not apply if and to the extent the debtor has carry-forward tax losses available. In other words, before the debt waiver exemption applies, any tax losses will effectively be lost for the debtor. If the debtor has loss carry-forwards available which it is likely to use in the future, it may be preferable to have a related entity of the debtor buy back the debt and contribute it to the equity of the debtor, rather than having the creditor waive the debt (*see* section 5.).

6.3. Fiscal unity

Under certain conditions, Dutch group entities may elect to form a fiscal unity. Entities included in a fiscal unity are taxed as if they were a single taxpayer for Dutch tax purposes.

Debt waived by a creditor of any of the fiscal unity entities will therefore result in a gain of the fiscal unity as a whole for Dutch tax purposes. The debt waiver exemption as described above applies accordingly, but only if and to the extent that the taxpayer can show that the exemption would also have applied if the debtor had not been part of the fiscal unity.

In practice, as a result of this rule the debt waiver exemption may not be available if the debtor has incurred tax losses that have been set off against the profits of the other fiscal unity entities; if the debtor had not been part of the fiscal unity, it would have had (more) loss carry-forwards available and such losses would have been eaten up by the debt waiver gain before the exemption would apply.

For varying reasons, the entity in a (Dutch) fiscal unity that incurs (substantial) debt may not generate sufficient income to set off its interest expenses. The most common example is the acquisition structure whereby a former acquisition vehicle has incurred bank debt and the former target company generates the operating income. Another example is a group that issues bonds on the market; the issuing group entity will often not be the financing company that on-lends the funds to the group, thereby generating interest income. In those cases, the fiscal unity is used to set off the interest expenses of the parent against the (operating or interest) income of its subsidiary. The debt waiver exemption would then not apply to the extent that interest expenses have been set off against other fiscal unity profits in the past.

7. Conclusion

A (consensual) debt restructuring resulting in a reduction of debt will, in principle, lead to a taxable gain for the Dutch debtor, but there are several exceptions to this principle.

Gains realized by a distressed debtor resulting from an active debt waiver will be exempt from corporate income tax, to the extent the debtor does not have loss carry-forwards (certain special rules apply in the case of tax groupings). Alternatively, a contribution of discounted debt to the capital of the debtor (by either the original creditor or a related entity of the debtor having bought back the debt) can be structured tax neutrally.