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Internet consultation on introduction of interest deduction limitation (thin cap rule) for banks and insurers launched

On March 18, 2019 the Dutch government launched an internet consultation offering interested parties the opportunity to respond to the draft bill that introduces the thin cap rule for banks and insurers. The internet consultation closes on April 15, 2019. If approval is granted, the responses will be published during the course of the consultation. The bill is discussed below.

Background to the bill

The government wishes to encourage the use of equity to carry on a business by limiting the tax benefits for debt. This has resulted in the introduction of a generic interest deduction limitation (earnings stripping measure) ensuring that the amount of net payable interest that can be deducted will be limited as of January 1, 2019. Because businesses in the financial sector (at the fiscal unity level) usually, on balance, receive interest, they will not be affected by this general deduction limitation.

The introduction of a thin cap rule for banks and insurers, effective as of January 1, 2020, has therefore been proposed. With this measure the government also wishes to ensure that the financial sector contributes to the reduction of the corporate income tax rate.

Main features of the bill

The thin cap rule will limit the interest deduction for tax purposes if banks and insurers have excessive debt.

Banks and insurers are defined as banks and insurers with a license issued under the Financial Supervision Act (*Wet op het financieel toezicht*) or that have received a notification from the Dutch Central Bank (*De Nederlandsche Bank N.V.*) This means that a large number of banks and insurers will be affected. It not only concerns licensed banks and insurers with a registered office in the Netherlands, but also foreign banks and insurers (both inside and outside the EU/EEA) with a permanent establishment in the Netherlands.

Initially, the interest deduction was to be limited to that part of the debt exceeding 92% of the balance sheet total for accounting purposes. The government has now abandoned this by not linking this percentage to the balance sheet total for accounting purposes, but by aligning it as much as possible with variables familiar to the sector. According to the government, this is because of the existing regulatory frameworks for banks and insurers. As banks and insurers are already familiar with various variables within those regulatory frameworks, this means that for the purposes of calculating the deductibility of interest under the thin cap rules that are now being introduced, different rules are used for banks and insurers.

A closer look at the rules for banks

With regard to banks, the consolidated leverage ratio in the Capital Requirements Regulation has been used. The thin cap rule for banks and banking groups limits the deductibility of the interest expense for loans (interpreted in accordance with the definition used for the generic interest deduction limitation), if there is a shortage of equity.

There is a shortage of equity if the leverage ratio of a bank or banking group is less than 8%. Insofar as there is a shortage of equity, a (8-L)/(100-L) part of the annual interest expense payable on loans is excluded from deduction. L represents the percentage of the leverage ratio rounded-off to one decimal point. The fraction's numerator (8-L) is the shortage of equity, expressed as a percentage. The fraction's denominator (100-L) is the percentage share of the debt in, briefly put, the adjusted balance sheet total. The outcome of the fraction, multiplied by the interest expense on the loans, is the non-deductible part of the interest expense on those loans.

A closer look at the rules for insurers

Insurers do not have a leverage ratio. This means that insurers use the 'equity ratio' in the Solvency II Regulation when determining whether there is a shortage of equity. The ratio is, in principle, determined at the group level, but there are two exceptions: when the equity ratio cannot be determined on the basis of the group report or in the case of an insurer with limited risk exposure.

The thin cap rule for insurers and insurance groups limits the deductibility of the interest expense for loans (interpreted in accordance with the definition used for the generic interest deduction limitation), if there is a shortage of equity.

There is a shortage of equity if the equity ratio of an insurer or insurance group is less than 8%. Insofar as there is a shortage of equity, a (8-ER)/(100-ER) part of the annual interest expense payable on loans is excluded from deduction. In this fraction, ER stands for equity ratio. The equity ratio is the equity expressed as a percentage, rounded off to one decimal point, of the, according to the rules of the Solvency II Directive, consolidated balance sheet at the level of the insurance group of which the taxpayer is a member. The fraction's numerator (8-ER) is the shortage of equity, expressed as a percentage. The fraction's denominator (100-ER) is the percentage share of the debt in the adjusted balance sheet total. The outcome of the fraction, multiplied by the interest expense on the loans, is the non-deductible part of the interest expense on those loans.

Other points to note

Lastly, the bill provides for rules if both a bank and an insurance company are members of a fiscal unity for corporate income tax purposes. In addition, the bill addresses how the thin cap rule must be applied at permanent establishments of foreign banks and

insurers. The bill also covers the overlap between the interest deduction limitations in the earnings stripping measure and those in the thin cap rule.

Meijburg & Co comments

This will further increase the tax burden on the financial sector. In addition to Section 29a Corporate Income Tax Act 1969 having been abolished as of January 1, 2019, which means the remuneration on additional Tier 1 capital instruments is not automatically deductible, an interest deduction limitation will now also be introduced for banks and insurers as of January 1, 2020. This is not surprising, given that the government had already announced this and in 2016 the OECD recommended that an interest deduction limitation specifically for banks and insurers be incorporated into national legislation. It appears that the Netherlands is the first OECD Member State to act on this recommendation and this could lead to a deterioration in the competitiveness of the Netherlands.

We are currently analyzing the impact of this bill and will get back to you shortly about this.

Meijburg & Co
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