House Ways and Means Committee Hearing

"How Other Countries Have Used Tax Reform to

Help Their Companies Compete in the Global Market Place and Create Jobs"

May 24, 2011

Response to Questions Submitted to Frank Schoon by Reps. Rangel, Stark, and Blumenauer

The following written submission responds to an August 17, 2011 letter from Chairman Dave Camp (R-MI) requesting my response to a series of questions relating to controlled foreign corporation (CFC) rules in the Netherlands as they would apply to several specific fact patterns.

Overall Comment

In my written testimony the key elements of the Dutch tax system are described. Before responding to the specific questions I first will reiterate some relevant passages from my written testimony.

Dutch tax law does not include special provisions for "controlled foreign companies" (i.e. there are no controlled foreign corporation or Subpart F rules). Dutch resident entities are subject to corporate income tax on their worldwide profits, and non-Dutch resident entities are subject to corporate income tax in the Netherlands on income derived from certain specific sources within the Netherlands, but with provisions to prevent double taxation of business profits.

With respect to the questions raised, the Dutch participation exemption is the relevant provision incorporated in Dutch tax law that deals with the prevention of double taxation. Under the application of the participation exemption all income (i.e. dividends, capital gains (or losses), currency gains (or losses) and other profit distributions) realized by a taxpayer with respect to a qualifying participation is fully exempt from Dutch tax. To qualify for the participation exemption the "ownership test" and one of the "motive test", the "asset test" or the "subject to tax test" must be met. If the participation exemption is not applicable because the required tests are not met, the taxpayer is required to mark to market its investment on an annual basis if the taxpayer holds an interest of 25% or more in the investment, the investment is not subject to a reasonable level of tax according to Dutch tax principles and 90% or more of the investments assets consist of low–taxed portfolio investments.

In general a foreign tax credit of 5% or the actual underlying tax under EU Parent-Subsidiary Directive is available on income (grossed up with a factor of 100/95) derived from an investment that does not qualify for the participation exemption unless that investment is not subject to corporate income tax.

Specific Questions and Answers

In the absence of CFC rules in the Netherlands, I will respond to the questions from the perspective of the application of the Dutch participation exemption.

a. *P, a domestic corporation, owns 100% of a CFC in X, a country with no income taxation. The CFC earns income from manufacturing and selling widgets back to P.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

b. *Same as (a), except that the CFC earns interest income from lending funds to unrelated parties outside X*.

The participation exemption should apply at the level of P on its investment in the CFC if the finance activity 1) is in line with the business of P, 2) is part of the business of the CFC, or 3) is considered 'active' for Dutch tax purposes, because the ownership test and either the asset test or the motive test should be met. In those cases, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

c. *Same as (a), except that X has a generally applicable corporate income tax at a rate identical to that imposed by the country on P, but the CFC is entitled to a 10 year tax holiday.*

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

d. *Same as (a), except that the CFC earns royalties from the active conduct of a trade or business.*

If the royalty income is earned from a license provided to a related party which qualifies as 'active' for Dutch tax purposes, or from a license to an unrelated party, the participation exemption should apply at the level of P on its investment in the CFC, because the ownership test and either the asset test or the motive test should be met. In those cases, all income

derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

The participation exemption would not apply at the level of P on its investment in the CFC if the only activity of the CFC is licensing to related parties which does not qualify as 'active' for Dutch tax purposes. In such a case where the participation exemption is not applicable, P would be required to mark to market its investment on an annual basis because P holds an interest of 25% or more in the CFC, the CFC is not subject to a reasonable level of tax according to Dutch tax principles, and 90% or more of its assets consist of low–taxed portfolio investments. Given that the CFC is not subject to corporate income tax, no foreign tax credit would be available.

e. Same as (a), except that the CFC earns interest derived from another CFC controlled by P.

If the second CFC is a subsidiary of the first and less than half of the aggregated assets of both CFCs consist of low taxed passive assets (e.g. low-taxed receivables from the second CFC), or generally if the finance activity is considered 'active' for Dutch tax purposes, the participation exemption should apply at the level of P on its investment in the CFC, because the ownership test and either the asset test or the motive test should be met. In those cases, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

If the second CFC is not a subsidiary of the first, the participation exemption would not apply at the level of P on its investment in the CFC if lending funds to related parties is the only activity of the CFC, unless the finance activity of the CFC is considered 'active' for Dutch tax purposes. In such a case where the participation exemption is not applicable, P would be required to mark to market its investment on an annual basis because P holds an interest of 25% or more in the CFC, the CFC is not subject to a reasonable level of tax according to Dutch tax principles and 90% or more of its assets consist of low–taxed portfolio investments. Given that the CFC is not subject to corporate income tax, no foreign tax credit is available.

f. Same as (a), except that the CFC buys widgets from P and resells them to another CFC controlled by P in a third country.

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

g. Same as (a), except that the CFC is predominantly engaged in the banking business and conducts substantial activity with respect to such business.

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. Therefore, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

h. Same as (a), except that the CFC is an insurance company.

If the CFC is comparable to a true third party insurance company, the participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met. In that case, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.

i. Same as (a), except that the CFC lends its earnings from the sale of the widgets to P.

The participation exemption should apply at the level of P on its investment in the CFC because the ownership test and both the motive test and the asset test should be met, provided that the finance activity does not exceed the manufacture/sales activity of CFC. In that case, all income derived from the CFC at the level of P is fully exempt. The income earned at the level of the CFC is not included in the worldwide income of P.