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# Key Elements of the Dutch Corporate Income Tax System

**Statement of Frank M. Schoon**

Mr. Chairman, Mr. Ranking Member and other Members of this distinguished Committee, it is an honor to participate in these hearings on international tax reform. I would like to thank you for the invitation to appear before you today to provide information on key international elements of the Netherlands corporate income tax system. I am Frank Schoon, a Netherlands tax partner with Ernst & Young, based in Chicago. I appear before you today on my own behalf and not on behalf of Ernst & Young or any client of Ernst & Young.

In this testimony, I will provide you with a brief overview of (i) the Netherlands corporate income tax system, (ii) the history of the Dutch participation exemption regime, (iii) the current Dutch participation exemption regime, (iv) the treatment in the Netherlands of foreign branch income and other foreign source income and (v) the transfer pricing rules, advance agreements and main anti-abuse/base protection rules in the Netherlands.

## The Netherlands corporate income tax system

Corporate income tax is imposed in the Netherlands on the worldwide profits of Dutch tax resident entities and on the income derived from certain specific sources within the Netherlands of non-resident entities, but with provisions to prevent double taxation of business profits. The Dutch participation exemption described more fully below generally exempts most active foreign source income earned through foreign subsidiaries.

The following types of tax-resident entities are subject to corporate income tax in the Netherlands: NV (*naamloze vennootschap*, a public limited company); BV (*besloten vennootschap*, a private limited company); companies with a capital that is, wholly or partly, divided into shares; "open" limited partnerships; cooperative associations; mutual insurance companies and associations and certain mutual funds and public bodies. Furthermore, all other types of associations, foundations and non-public bodies are subject to corporate income tax in the Netherlands to the extent that they are engaged in a trade or business. Whether an entity is tax resident is determined by reference to all relevant facts and circumstances, such as the seat of the board, the location of the head office and where the shareholders' meetings are held. Entities incorporated under Dutch civil law, such as the BV and NV, are deemed to be resident in the Netherlands for corporate income tax purposes, except for the application of a limited number of articles included in the Dutch Corporate Income Tax Act.

As mentioned, Dutch resident entities are subject to tax on their worldwide income with provisions to prevent double taxation. The taxable amount equals the taxable profit minus any losses carried over from other years. Taxable profit is equal to profit minus gifts. Profit is defined as "the total income derived from a business, in whatever form and under whatever name." This profit is then allocated to the appropriate financial years by reference to sound business practice ("*goed koopmansgebruik"*) and consistent accounting conduct. The concept of sound business practice is predominantly developed in case law. The broad definition of profit allows all expenses to be deducted, unless the expenses do not qualify as business expenses (for example, if triggered by the shareholders' relationship) or a specific provision disallows deduction. One of the exceptions relates to finance costs of a certain category of "tainted transactions" (as described below), which are not deductible. Tax levied on profits is not deductible either. Distributions of profits, except for those specifically listed, whether made directly or indirectly under whatever name or form, are not deductible.

As of January 1, 2011, the Dutch corporate income tax rate on taxable profit is 20% on the first €200,000 and 25% on the remainder, regardless of whether the profits are distributed. It has recently been announced by the Dutch government that this rate may be further reduced to 24% as early as January 1, 2012. No distinction is made between capital gains and other income. In certain cases, capital gains are exempt (e.g., under the participation exemption regime) or a deferral of taxation of such gains is available based on case law or under a reinvestment reserve.

Over the last three decades the corporate income tax rates have decreased gradually from 45-48% (1980), to 40-35% (1990), 30-35% (2000), to the current rate. From parliamentary history it can be seen that the motivation for this decrease generally has been to lower the tax burden on companies, to stimulate investment and to create jobs. In later years, aligning with developments in other (EU) jurisdictions also played a role.

Resident taxpayers may claim relief for the avoidance of double taxation in respect of foreign source profits earned directly under the applicable Dutch tax treaties and the domestic Unilateral Decree rules.

**Brief overview of the history of the Dutch participation exemption regime**

One of the pillars of the Dutch corporate income tax system is the participation exemption regime, which aims to prevent double taxation of business profits at different corporate levels (the "*ne bis in idem*" principle) in both a foreign and a domestic context. The origins of the participation exemption regime go back to 1893. Over the years a number of amendments were made to the participation exemption regime. The latest amendment as per January 1, 2010 modifies the regime by incorporating a so-called "motive test" (as described below). This motive test aims to secure a stable approach which provides for certainty regarding application of the participation exemption.

In 1992, the Dutch State Secretary for Finance stated during parliamentary proceedings that the exemption method (for income of subsidiaries and Foreign Branches) as provided under the Dutch corporate income tax system is the most suitable system for the Netherlands considering its many international relations and its open economy.[1]

**Current participation exemption regime**

The participation exemption regime fully exempts income, such as dividends and other profit distributions, currency gains (or losses), and capital gains (or capital losses), realized with respect to a qualifying participation held by a taxpayer. The participation exemption also applies to profit shares owned by a taxpayer in certain debt issued by a qualifying participation that is treated as equity, as well as to options on shares of qualifying participations and earn-outs. Subject to prior approval of the Dutch tax authorities, a taxpayer can apply the participation exemption to the foreign-exchange results relating to financial instruments that hedge the foreign currency exchange rate exposure on qualifying participations.

Subject to certain very strict requirements, losses realized as a result of the liquidation of a subsidiary are not covered under the participation exemption and may as such be deducted at the level of the taxpayer.

<u>Eligibility for participation exemption.</u> Dutch tax resident entities and non-resident entities with a permanent establishment in the Netherlands may benefit from the participation exemption regime with respect to qualifying interests in a subsidiary.

To qualify for the participation exemption, an “ownership test” and a “motive test” generally must be satisfied with respect to the Dutch taxpayer’s shareholder’s interest in a subsidiary. If the “motive test” is not met, the participation exemption nevertheless applies if either the “asset test” (i.e., on an aggregated basis generally less than half of the assets of the subsidiary and its underlying subsidiaries consists of low taxed passive assets) or the “subject to tax test” (i.e., the directly held subsidiary is subject to a profit tax that results in a reasonable levy of profit tax in accordance with Dutch standards) is met.

Under the “ownership test” the taxpayer is required to hold at least 5% of the nominal paid-up share capital of a company with a capital divided into shares. Any interest that does not meet this 5% threshold in principle does not qualify for the participation exemption. There are, however, certain exceptions to this rule. The above capital test can be replaced by a voting rights test (i.e., the shareholder is required to hold at least 5% of the voting rights), if the subsidiary is established in an EU Member State with which the Netherlands has concluded a tax treaty that provides for a voting rights test (rather than a capital test) for the reduction of dividend withholding tax. There is no minimum requirement as to the term for which an interest in a subsidiary must be held by the Dutch shareholder in order to qualify for the participation exemption.

Under the “motive test”, an interest in a subsidiary cannot be held as a portfolio investment. Effective as of January 1, 2010, this non-portfolio requirement or “motive test” is primarily based on prior legislation

[1] Reference is also made to Paul Vlaanderen, Why Exempt Foreign Business Profits, Tax Notes International, 11 March 2002, p 1095-1103. The author states that the exemption method allows internationally operating companies to compete on an equal footing with companies in all markets of the world.

(pre-2007) and long-standing Dutch case law. Extensive parliamentary history provides an explanation of this concept and also lists some examples of when the motive test is generally satisfied. The motive test is generally satisfied if the shares in the subsidiary are not held merely for a return that may be expected from normal asset management. Some types of subsidiaries, such as fiscal investment institutions or exempt investment institutions (or foreign companies subject to a similar regime), due to their nature, cannot qualify as a non-portfolio interest. Furthermore, in a limited number of specific situations (e.g., in the case of a foreign group finance company), an interest in a subsidiary can be deemed to be held as a portfolio investment, which is generally determined based on the function and assets of the subsidiary. As noted above, if the motive test is not satisfied, the participation exemption nevertheless is available if either the asset test or the subject to tax test is met.

<u>Non-qualifying participation exemption income.</u> If an interest in a subsidiary does not qualify for the participation exemption under the above tests, dividends on such interest may be taxable when repatriated. In the case of income that is not eligible for the participation exemption, a foreign tax credit system applies. Under this system, a general credit is allowed for income (including capital gains) derived from such non-qualifying portfolio investment. The credit is set at 5% of such income. Alternatively, the taxpayer can choose to credit the actual underlying foreign tax, for income derived from a low-taxed portfolio investment that qualifies under the EU Parent-Subsidiary Directive.

A company that together with associated companies holds an investment of 25% or more in a non-qualifying portfolio investment which is not subject to a reasonable level of tax according to Dutch principles and 90% or more of the assets of which consist of low-taxed portfolio investments is required to mark to market this investment on an annual basis. Income derived from a non-qualifying portfolio investment is grossed up with a factor of 100/95 to subsequently apply the 5% tax credit.

<u>Expense deductions</u>. Prior to 1994, expenses incurred with respect to an interest in a foreign subsidiary that qualified for the participation exemption were not deductible for Dutch corporate income tax purposes, unless the expenses were instrumental in generating Dutch taxable income. The expenses to which this non-deductibility rule applied were determined using a tracing approach. Effective from January 1, 2004, this limitation on the deduction of expenses was eliminated pursuant to the ruling of the European Court of Justice in the *Bosal* case which found the limitation to be incompatible with EU law. Under the participation exemption regime as amended, expenses relating to interests that qualify for the participation exemption are deductible, such as costs for management or administration. However, expenses related to acquisition and disposal of a qualifying interest in a subsidiary, such as lawyers' and notary fees, are not deductible. Moreover, there are applicable anti-abuse and base protection rules related to interest expense, which are discussed below.

In addition, several anti-abuse measures apply to limit deductions in specified circumstances:

- If a loan to a subsidiary, which has been written off, is sold to a related person or a group company, the amount that had been taken into account as a deduction is treated as taxable income for Dutch corporate income tax purposes.

- If a loan to a subsidiary, which has been written off, is converted into an interest that qualifies for the participation exemption after the conversion, the amount that had been taken into account as a deduction is treated as taxable income for Dutch corporate income tax purposes. The write-off can be added to a revaluation reserve that is released (through a taxable recapture) as the value of the interest increases.

- Other anti-abuse measures relate to the incorporation of a permanent establishment and the treatment of losses on the liquidation of an interest that qualifies for the participation exemption.

**Foreign Branch Income**

If a Dutch tax resident has a foreign permanent establishment ("Foreign Branch"), the income (positive and negative) of the Foreign Branch will directly be included in the worldwide income of the Dutch tax resident. As a result, Foreign Branch losses are deductible, albeit subject to recapture. Foreign Branch income is, in principle, exempt from corporate income tax in the Netherlands under tax treaties and/or under the Dutch Unilateral Decree. According to the Dutch Unilateral Decree rules, profits derived from a business carried on through a permanent establishment or permanent representative within another sovereign country are exempt from Dutch corporate income tax provided that the foreign income is included in the resident's taxable worldwide income and that the foreign income is subject to income tax in the state from which the income is derived. The foreign income should, in principle, be taxable in the state where the income is sourced. It is not relevant whether or not the taxpayer benefits from a tax holiday for a certain period of time or whether foreign tax has actually been imposed or paid. In the absence of double tax relief, the foreign tax can be deducted as a cost at the level of the Dutch tax resident.

The Dutch Ministry of Finance is currently considering moving to a full territorial tax system for Foreign Branch income. If this system is adopted, Foreign Branch results will no longer be included in the worldwide profit of the Dutch tax resident. Furthermore, losses incurred by the Foreign Branch will no longer be deductible from the taxable income of the Dutch tax resident. Note that losses incurred by a Foreign Branch will, however, remain deductible if there is a final discontinuation of the Foreign Branch (comparable to liquidation loss rules under the participation exemption regime) and no compensation is granted by the foreign jurisdiction.

**Other foreign source income**

Other foreign source income like interest and royalties received by a taxpayer is in principle subject to the current statutory Dutch corporate income tax rate of 25%.

However, net earnings from qualifying intellectual property may effectively be taxed at a rate of 5% under the "innovation box". The predecessor of the innovation box, the "patent box", was introduced in 2007 and amended in 2008. Subsequently, in 2010 the regime was further modified and re-named to the innovation box. The regime was introduced in 2007 to stimulate employment and innovation in the Netherlands. A taxpayer may opt for this innovation box regime for each intangible asset that individually meets the following cumulative requirements:

- The intangible asset is self-developed by the taxpayer
- The intangible asset is patented in the Netherlands or abroad
- It is expected that the patent will contribute at least 30% of the earnings generated from the intangible asset, and
- The intangible asset did not form part of the taxpayer's business assets prior to 1 January 2007

Agriculturists' rights in respect of newly developed plant varieties qualify as a patent. Intangible assets developed by another party for the risk and account of the taxpayer (contract R&D) can also be within the innovation box by the taxpayer.

In addition to patented intellectual property, certain designated and pre-approved assets (so-called "WSBO assets"), e.g., software, qualify for the innovation box as well. Such assets are eligible only if they did not form part of the taxpayer's business assets prior to January 1, 2008.

Self-developed trademarks, logos and other similar assets are excluded from the innovation box.

If a taxpayer opts to apply the innovation box regime, the benefits derived from a qualifying asset are taxed at an effective tax rate of 5%, to the extent that the net earnings of qualifying assets in the innovation box exceed the total amount of development costs of these assets.

Development costs of an intangible asset can be charged directly through the profit and loss account, without prior capitalization. Before the innovation box regime can be applied, the total amount of relevant development costs must be recaptured by offsetting these costs against the net earnings of all intangible assets in the innovation box. The taxpayer is required, therefore, annually to determine the amount of development costs that still needs to be recaptured.

Any losses incurred with respect to qualifying assets in the innovation box are deductible at the statutory corporate income tax rate (i.e., at 25% instead of 5%). Such losses are, however, considered development costs for innovation box purposes and are, therefore, also subject to recapture (against the statutory corporate income tax rate of 25%) before the 5% effective tax rate applies to profits derived from the qualifying assets in the innovation box. In other words, the 5% effective tax rate applies only to positive net income that falls within the innovation box.

The amount of "net earnings" is the balance of all revenue, including capital gains, less the costs of amortization and other costs connected to the qualifying intangible assets and WBSO assets within the innovation box. In other words, the earnings are not merely limited to formal royalty income but basically all benefits connected to the qualifying assets could be within the innovation box (i.e., an economic concept of earnings). The total amount of net earnings from qualifying assets which could be taxed at the 5% rate is unlimited.

Foreign withholding taxes borne by a resident taxpayer can under the available tax treaty, in principle, be credited against the Dutch corporate income tax irrespective of whether the income is taxed in the innovation box (subject to a two-tier limitation).

**Transfer Pricing Rules**

As of January 1, 2002, the arm's length principle was codified following the OECD Transfer Pricing Guidelines. This principle ensures that related-party transactions must be agreed on the same terms and conditions as third-party transactions. Before 2002, this principle originated from the basic concept that taxable profit comprises all income derived from a business, in whatever form and under whatever name. As a consequence of this principle, any payment or benefit made or paid directly or indirectly to a person in his or her capacity as shareholder, or made or paid to related persons under conditions that are not at arm's length, will be construed as distributions of profit in full or in part to the shareholder. However, such a distribution of profit is not deductible and dividend withholding tax may apply.

Conversely, if a related company grants a benefit to a Dutch company, which originates from the shareholders' relation as opposed to deriving from a business, such a benefit does not fall within the scope of the Dutch corporate income tax. Such a benefit is construed as a capital contribution in disguise or "informal capital contribution," which must be excluded from the taxable profit of the company.

The relevant rules refer to a broad set of relationships with respect to which the arm's length principle must be satisfied. It also covers a board relation or a control relation. In this respect, it is of importance whether the shareholder, board member or supervisor is able to influence the transfer pricing of the companies involved.

For taxpayers, it is mandatory to document intercompany transactions. The documentation has to be available as of the moment of the first intercompany transaction. If a taxpayer is not able to submit the documentation, the burden of proof is reversed, and the taxpayer must demonstrate, to the satisfaction of the tax authorities, that the transfer pricing is at arm's length.

**Advance agreements**

Often taxpayers discuss their tax position in advance with the Dutch tax authorities in order to settle any uncertainties and avoid disputes. In many cases this leads to an advance pricing agreement ("APA") or other agreements.

**Anti-abuse/base protection rules**

Anti-avoidance measures are incorporated throughout Netherlands tax law, applicable EU Directives and tax treaties concluded by the Netherlands.

The most relevant anti-base erosion rules as stated in the Dutch Corporate Income Tax Act of 1969 are the thin capitalization rules and the interest deduction limitation rules, which are briefly described below.

The thin-capitalization rules are designed to avoid the erosion of the Dutch tax base within corporate groups. Under the rules, interest expenses (and other costs) with respect to related-party loans (or deemed related-party loans) may be partly or completely disallowed if the taxpayer is part of a group, as defined in the Dutch Civil Code (in general, comparable to the definition under Dutch generally accepted accounting principles [GAAP]/international financial reporting standards [IFRS]) and if the taxpayer's debt level exceeds specified thresholds.

Under the rules, if the average fiscal debt of the company exceeds three times the company's average fiscal equity plus €500,000, the excess interest is in principle disallowed. However, as an alternative, the company may look at the commercial consolidated debt-to-equity ratio of the (international) group of which it is a member. If the company's own commercial debt-to-equity ratio does not exceed the commercial debt-to-equity ratio of the group, the tax deduction for interest on related-party loans is allowed.

In principle, deductions for interest on external (bank) debt directly obtained by the taxpayer are not disallowed. However, if such external debt is formally granted by a third party but is in fact owed to a related party, the thin-capitalization rules apply.

Under the interest deduction limitation rules, the deduction of interest paid, including related costs and currency exchange results, by a taxpayer on a related-party loan may be disallowed if the loan relates to one of the following transactions:

- Dividend distributions or repayments of capital by the taxpayer or by a related Dutch company to a related company or a related individual

- Capital contributions by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands into a related company

- The acquisition or extension of an interest by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands in a company that is related to the Dutch tax resident after this acquisition or extension

However, this interest deduction limitation does not apply, and the deduction is allowed, if either of the following conditions is satisfied:

- The loan and the related transaction are primarily based on business considerations; or

- At the level of the creditor, the interest on the loan is subject to tax on income or profits that results in a levy of at least 10% on a tax base determined under Dutch standards. In addition, such interest income may not be set off against losses incurred in prior years or benefit from other forms or types of relief that were available or anticipated when the loan was obtained. Effective from January 1, 2008, even if the interest income on the loan is subject to a levy of at least 10% on a tax base determined under Dutch standards at the level of the creditor, interest payments are not deductible if the tax authorities can demonstrate it to be likely that the loan or the related transaction is not primarily based on business considerations.

For purposes of applying this interest deduction limitation, interest expenses are traced on a historic basis. A mathematical method of allocation is not used for this purpose.

Finally, it has been announced by the Dutch government that deduction of excessive interest expenses incurred by a Dutch acquisition company which is subsequently joined in a fiscal unity (i.e., a tax consolidation) with the acquired Dutch target company will be limited. This provision would apply to both related party and third party debt. In addition, it has been announced that the deduction of interest costs related to the acquisition of interests qualifying for the participation exemption will be reviewed.

**Absence of controlled foreign corporation rules**

There are no special provisions in Dutch law for "controlled foreign companies" (i.e., there are no controlled foreign corporation or Subpart F rules). In the Dutch tax system as described above, the relevant question therefore is whether or not the participation exemption or the branch exemption applies, which along with the anti-abuse and base protection rules address the issue of mobile and passive foreign income.

Thank you for giving me the opportunity to share this information on the Netherlands tax system. I would be happy to answer any questions from Members of the Committee.