BUDGET PLAN 2012 RELEASED

On September 20, the Budget Plan 2012 was officially published by the Dutch Ministry of Finance. The Budget Plan contains tax measures that should become effective from 1 January 2012. The tax measures which are most important to the international corporate tax practice are the corporate income tax and dividend withholding tax measures, which are summarized in this Tax News Bulletin.

CORPORATE INCOME TAX

1 (Non-)deductibility of Interest (deferral) for debt financed acquisitions of Dutch target companies ("Acquisition Interest Provision")

Background

In case a foreign or domestic acquirer uses a debt-financed Dutch acquisition company ("Acquisition Company") to acquire a Dutch target company and includes such target company into a fiscal unity with its Acquisition Company, or merges such target company with the Acquisition Company, the interest expense on the acquisition debt ("Acquisition Debt", and "Acquisition Interest") reduces the taxable profit of the fiscal unity. Effectively, the acquisition is financed by the target company's profit.

Proposed measure

Following the proposed Acquisition Interest Provision, aimed at avoiding erosion of the Dutch taxable base, Acquisition Interest (including associated expenses and positive and negative fx results) will be deductible only to an amount equal to:

- the fiscal unity profit before application of the Acquisition Interest Provision, less
- the amount of fiscal unity profit attributable to the acquired target(s), plus
- the amount of Acquisition Interest.

Effectively, under the Acquisition Interest Provision, Acquisition Interest will be deductible only to the amount of the stand alone profit of the Acquisition Company (or, in case the Acquisition Company forms part of a fiscal unity, and under certain conditions, Acquisition Interest will be deductible against the fiscal unity profit excluding the profit of the acquired target(s)). However, this restriction applies only to the lower of:

(i) Acquisition Interest in excess of € 1 million ("First Limitation")
(ii) Interest on the excessive part of Acquisition Debt (i.e. interest on debt which exceeds two times the amount of equity of the fiscal unity; "Second Limitation")

The value of participations, held by any of the fiscal unity companies, that qualify for the participation exemption, reduces the amount of equity for purposes of the Acquisition Interest Provision. Goodwill or bad will related to the acquisition of a target (i.e. the difference between the price paid for the shares of the target and the net asset value of the target) reduces the equity of the fiscal unity upon consolidation of the target. To mitigate this affect, an amount equal to the goodwill or bad will is added to, respectively deducted from, the equity of the fiscal unity and depreciated over a ten year term.

Acquisition Debt includes both intercompany debt (internal debt) and third party debt (external debt) used for the acquisition of Dutch target companies. The Acquisition Interest Provision applies only if the tax debt-to-equity ratio of the fiscal unity exceeds 1:2 (i.e. max 2/3 debt financing allowed).

The Acquisition Interest provision is aimed primarily at high-leverage buyers, such as private equity and hedge funds. However, corporate acquisitions may also be affected. As a result of the € 1 million threshold amount, smaller acquisitions are spared.

Under the transitional regime, pre-2012 debt-financed acquisitions of Dutch target companies are grandfathered indefinitely, provided that the consolidation into fiscal unity or merger took place before 1-1-2012. It appears that post-2012 refinancing of pre-2012 Acquisition Debt used to finance pre-2012 acquisitions is not affected by the Acquisition Interest Provision (provided that the consolidation or merger took place before 1-1-2012).

2 Deduction of permanent establishment ("PE's") losses repealed

Background

Under current law, PE results are included in the Dutch taxable base. Subsequently, a deduction from Dutch tax, equal to the Dutch tax attributable to the PE results, is granted, effectively exempting the PE results. However, as a result of this relief mechanism, PE losses are immediately deductible from the Dutch taxable base (i.e. can be used to offset head office profits). Such deduction is however subject to a recapture: future PE profits are first reduced by past PE losses, and consequently are not exempt from Dutch tax until the past losses have been fully recovered.

Proposed measure

Under the proposed Object Exemption, PE results are still included in the Dutch taxable base, but subsequently the Dutch taxable base is reduced by the positive and negative PE profits determined by Dutch standards. The effect of the Object Exemption is essentially the same as the current system, *except* that PE losses will no longer be deductible against head office profits. Under the Object Exemption, the subject-to-tax requirement (in non-treaty situations) relating to the PE profit will no longer apply.

The Object Exemption will not apply to low taxed passive PE's. A PE will be deemed passive if its activities consist for more than 50% of:

- Passive investment, and/or
- Direct/indirect financing of the head office or companies related to the head office, and/or
- Direct/indirect financing of assets (including the right to use, or assets made available) used by the head office or companies related to the head office.

A PE will be deemed low taxed if its profits are not included in a profits tax which results in a real levy according to Dutch standards. In stead of an Object Exemption, profits from low taxed passive PE's are eligible for a fixed 5% credit. In case the profits of a low taxed passive PE have (directly or indirectly) been subject to a local profits tax in excess of 5%, a credit equal to such higher tax rate may apply (capped at the amount of Dutch tax levied over the PE profit). Under certain (mostly older) tax treaties, profits from low taxed passive PE's may continue to be fully exempt.

PE losses which have become permanent due to the fact that the PE activities have been terminated, and which have not been subject to local loss relief in the PE country, are deductible from the Dutch taxable base in the year in which the PE activities are terminated. PE activities are not considered terminated if continued by related companies. However, PE losses are deductible if the activities are sold to a third party, unless the PE losses carry over to the third party buyer under the laws of the PE country. Commencement of activities in the same country within three years after termination of prior PE activities are considered a continuation of the old activity and trigger a recapture of the PE termination loss.

3 Non-resident corporate income tax liability ("substantial interest tax")

Non-resident taxpayers are subject to 25% corporate income tax on dividends and capital gains in relation to 5% or larger shareholdings in Dutch companies ("substantial interest tax") if such shareholdings are not attributable to the capital of a business enterprise (i.e. if such shareholdings are held as a passive investment).

Under the 2012 Budget Plan, and following scrutiny from the European Commission, it is proposed to narrow the scope of this non-resident tax liability. The substantial interest tax will apply only if the main purpose or one of the main purposes for holding the substantial interest is to avoid Dutch income tax or Dutch dividend withholding tax being levied from another taxpayer (i.e. from the (ultimate) beneficial owner of the Dutch company). For purposes of this “main purpose test”, guidance can be found in relevant ECJ case law, which speaks of “wholly artificial constructions”.

A wholly artificial construction is deemed to exist, inter alia, if:

- a non-EU shareholder holding a substantial interest in a Dutch company interposes an EU company in order to avoid Dutch income tax or Dutch dividend withholding tax, without the EU company or the establishment of that company in the EU having real (economic) meaning, or
- Dutch portfolio investments of foreign shareholders are pooled in a foreign entity in order to avoid Dutch dividend withholding tax where that foreign entity does not dispose of sufficiently qualified with adequate authority in respect of the (pooled) investment in the Dutch company.

Objective elements to take into account in the main purpose test are (i) the place of effective management, (ii) (economic) substance, and (iii) commercial risks borne by the company. The applicable tax rate is reduced from 25% to 15% in case the substantial interest is held only to avoid Dutch dividend withholding tax (and not also to avoid Dutch income tax).

4 R&D investment deduction (DIB/RDD)

Current applicable tax incentive schemes for innovation

Currently the following fiscal stimulation of innovation and R&D exist:
- “WBSO-incentive”; i.e. the reduction of wage tax liability on wage costs of innovation and R&D, and
- Dutch innovation box (***DIB***) incentive; the 5% effective corporate income tax rate on all profit from innovation and R&D

Proposed measure

In the Budget Plan 2012, a deduction for capital expenditures (e.g. research facilities and technical installations) associated with innovation and R&D is proposed. The so-called Research & Development deduction (***RDD***) At the time of issuing the Budget Plan, the R&D investment deduction had not been fully elaborated yet. However, based on prior publications from the Dutch Ministry of Economic Affairs, it is currently expected that the deduction for R&D capital expenditures will be shaped in the form of a levy discount. Under the proposed measure, an amount equal to 25% (equal to the applicable CIT rate) of the amortization/depreciation of R&D capital expenditures and of the R&D operating expenses would become deductible from the annual (corporate) income tax liability. The tax liability is not reduced below zero (i.e. no refund). Any unused deductions may be carried back/forward. A combination of the DIB and RDD incentives appears to be possible.

5 Deduction of interest on debt used to finance acquisition of participations (“Bosal interest”)

The Budget Plan does not mention the previously announced proposal to restrict deduction of interest on loans used to finance the acquisition of participations that qualify for the participation exemption (so called “Bosal interest”. The Ministry of Finance is still considering this proposed measure. A proposal may be issued later this year.

DIVIDEND WITHHOLDING TAX

1 The Dutch Cooperative

Background

Over the past seven years, Dutch Cooperative Associations ("Coops") have become an increasinly popular alternative Dutch holding company, as they are not subject to Dutch dividend withholding tax, while being eligible for participation exemption and treaty benefits. Reason for not being subject to Dutch dividend withholding tax lay in the fact that Dutch dividend withholding tax only applies to proceeds from shares or profit certificates (or comparable equity rights) issued by companies with a capital divided into shares, and the Coop does not have a capital divided into shares (in stead it has capital accounts attached to membership rights).

Proposed measure

The Budget Plan 2012 intends to curb the abuse of Coops for purposes of avoiding Dutch dividend withholding tax. The general rule will remain that members in a Coop are not subject to Dutch dividend withholding tax, and that a Coop is not subject to a withholding obligation. However, in abusive situations, members of a Coop will become liable to Dutch dividend withholding tax. Abusive situations may exist where a foreign company owning a participation in a Dutch company interposes a Coop in order to avoid Dutch dividend withholding tax, or where a foreign company owning a foreign participation interposes a Coop to avoid the foreign withholding tax, without the Coop having real (economic) meaning.

The liability for Dutch dividend withholding tax is a two step test:

1. First, at the level of the Coop it will have to be determined whether there is a "wholly artificial construction" aimed at avoiding Dutch or foreign dividend withholding tax.
2. Second, if there is indeed a wholly artificial construction aimed at avoiding Dutch or foreign dividend withholding tax, members will become liable to Dutch dividend withholding tax - and the Coop will become subject to a withholding obligation - if their membership rights in the Coop are not attributable to the capital of a business enterprise (i.e. if they hold their membership rights as a passive investment)

If the Coop directly or indirectly holds shares, profit certificates (and comparable equity rights) in a Dutch company, the Dutch Coop becomes subject to a withholding obligation *even if* the membership rights are attributable to the capital of a business enterprise. In such case, the Coop will be liable to withhold Dutch dividend withholding tax if and to the extent the proceeds from the membership rights includes a proportional part, attributable to the membership right, of the profit already present in the Dutch company on the moment immediately before the Coop obtained its interest in the Dutch company. A first-in-first-out approach will be applied in this case.

Avoidance of Dutch dividend withholding tax will be deemed to exist in case of an internal transfer of a Dutch company subject to a Dutch dividend withholding tax claim to a Coop.

The withholding obligation is created by equating a Coop with company with a capital divided into shares and by equating a membership right to a profit certificate. This equation does not apply to the exemption from withholding the Dutch dividend tax, as a result of which the Dutch divided withholding tax can also be effectively levied from the foreign members.

2 Refund of Dutch dividend withholding tax on portfolio investments for tax-exempt investors in non-EU member states

Dutch resident tax-exempt investors, such as pension funds, are eligible for a refund of Dutch dividend withholding tax on dividends from their investment in Dutch shares. As of 1 January 2007, such refund was made available also to EU member state resident tax-exempt investors. Pursuant to the Budget Plan 2012, refund of Dutch dividend withholding tax will also be available to tax-exempt investors established outside the EU, but in relation to dividends *from portfolio investments only,* and provided that such tax-exempt investor:

1. Would not have been subject to Dutch corporate income tax, if they had been resident in the Netherlands (e.g. pension funds, Sovereign Wealth Funds, and exempt government bodies),
2. Is resident in a designated country with which the Netherlands has concluded adequate arrangements for the exchange of information (designated countries yet to be appointed by Ministerial Decree).

It is not entirely clear where the threshold of "portfolio investment" lies. From ECJ case law, it could be derived implicitly that share interests of less than 10% of the capital of the investee company are portfolio investments. Further, it is not yet clear which countries will be designated but it can be carefully assumed that countries with which the Netherlands has concluded a tax treaty which contains an exchange of information provisions in accordance with the OECD standard should be among the designated countries. It remains to be seen whether countries with which the Netherlands has concluded Tax Information Exchange Agreements (TIEA's) will also be among the designated countries. At present, the more likely outcome would appear to be that TIEA countries will not be among the designated countries.

Refund claims can be submitted up to three years after the end of the year in which the Dutch divided withholding tax has been levied. Non-EU tax-exempt investors who have incurred Dutch dividend withholding tax on Dutch portfolio investments in the last three years are recommended to file refund claims from 2008 onwards, on the basis that denying such refunds is an unjustifiable violation of the EU freedom of capital.

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