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## TAX NEWS BULLETIN

### AMENDMENTS TO NETHERLANDS TAX LAW IN 2006

#### CORPORATE INCOME TAX (CIT)

##### **1.1. Rates in 2006 and 2007**

As from 1 January 2006, the general CIT rate has been reduced from 31,5% to 29.6%. For profits up to €22.689 the lower CIT rate has been reduced from 27% to 25.5%.

As from 1 January 2007, the general rate will decrease to 29.1%, or even to 26.9% based on the White Paper proposals. The lower rate will decrease to 24.5%, or even to 20% based on the White Paper proposals.

##### **1.2. Tax free conversion of debts into equity**

If a subsidiary of a Dutch company has incurred significant losses, the Dutch company can write down the value of its receivables on the subsidiaries, thus reducing the Dutch taxable base. If next the receivable is converted into equity, and the subsidiary becomes profitable again, the participation exemption applies to the relevant benefits.

Until 9 December 2005, the former Article 12 CIT Act contained an anti-abuse rule to combat this. Adjustments of the prior write-down were made *at the level of the debtor* – except where the debtor was a foreign entity, in which case the adjustment was made at the level of the creditor - and also in non participation exemption situations. Upon conversion of the receivable into equity of the subsidiary, an adjustment was made whereby the former write down was added back to taxable profits of the debtor. Due to the tax consequences thereof, necessary financial restructurings in business life were hardly possible. In TNB March 2004 we discussed draft legislation aimed at improving this situation.

Eventually this took until 9 December 2005, when Article 12 was abolished and anti-abuse rules are laid down in Article 13ba CIT Act. A system has been adopted in which adjustments are only made *at the level of the creditor* and are pinpointed at the abuse of longer existing possibilities of a tax free increase in value of the additional share capital originating from the conversion under the participation exemption. The new provision applies not only in cases of conversion of loan receivables into equity, but also in case of a waiver of loan receivables as well as in cases where a loan receivable starts to function as equity, like under the former Article 12.

More important, under the new regime, the above taxable events of conversion, waiver or function as equity as such need not effectively trigger the profit adjustment. In case of conversion, waiver or functioning as equity, the relevant taxable adjustment can be added to a special tax reserve (*'opwaarderingsreserve'*), equal to the amount of prior write down of the

loan receivable, which next is released from time to time, as and when the fair market value of the relevant participation increases.

### **1.3. Tax deductibility for subsidiaries incurring (starting-up) losses during first 5 years of ownership terminated**

With effect from 1 January 2006, Article 13ca CIT Act is abolished. Under this provision, despite application of the participation exemption, Dutch companies were able to deduct equity losses from loss generating subsidiaries during the first 5 years of ownership, which losses were to be recovered in years 6 to 10, or earlier in case the relevant subsidiary started to earn profits before. Transitional regulations are foreseen for existing situations.

### **1.4. The White Paper**

In our TNB of May 2005, we dealt with the White Paper containing plans to make Dutch corporate income tax more attractive. In the meantime a few adjustment have been made to the plans.

Firstly: From the decision of the Court of Justice of the EC in the Marks & Spencer case, the Ministry of Finance has concluded that there is no reason to adjust the Dutch fiscal unity regime in such a way that it will also permit cross border fiscal unities.

Secondly: The liquidation loss rule forms an exception on the participation exemption i.e. liquidation losses are tax deductible. In the White Paper it was considered to abolish this rule. Now, this idea has been withdrawn following the Marks & Spencer decision.

### **1.5. The Netherlands intends to make it's tax regime for portfolio investment companies more attractive**

On 19 December 2005, the Dutch government has approved the proposal for a Bill which will enable portfolio-investment companies to elect for a regime in which they are fully tax exempt in the Netherlands. Accordingly, such a company will not be subject to Dutch corporate income tax and dividend withholding tax.<sup>1</sup> On the other hand, this company cannot claim the benefits of double tax treaties signed by the Netherlands.

This is one of the measures that should make the Netherlands more attractive and more competitive compared to countries like Luxembourg and Ireland.

The main characteristics of the portfolio-investment company under the proposed regime are:

- Exemption from corporate income tax
- Exemption from dividend withholding tax
- No shareholders requirements
- No financing requirements
- No distribution requirements

But also:

- No right to a refund of dividend withholding tax on dividend income
- No right to double tax treaty benefits

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<sup>1</sup> The 0.55% capital issue tax has been generally abolished as per 1 January 2006.

- Compared to Luxembourg: no *tax d'abonnement*

The contents of the Bill have not been published yet, so that the requirements for applying this new regime are yet unknown. The Bill will first be sent for advice to the Dutch State Council. Upon receipt of this advice, the Bill will be published and presented for discussions in Dutch Parliament.

### **1.6. The advance tax ruling practice**

During 2005, the Netherlands Revenue unveiled the detailed conditions for obtaining an advance tax ruling in respect of financing and licensing activities conducted by Dutch resident companies. This has been welcomed by tax practitioners and gives rise to the expectation that the number of rulings to be granted should increase.

### **1.7. Non-deductibility of bribes**

In our TNB of September 2003, we mentioned proposed legislation about non deductibility of bribes. In case of a condemnation by a Dutch Court in a criminal case, or after a settlement with the District Attorney, the bribes paid are nondeductible. The - still pending - proposal has now been amended, in the sense that *in case of mere suspicion of payment of bribes* the burden of proof is allocated to a larger extent to the Tax Administration;

## **2. Capital issue tax**

The capital issue tax on contributions of capital – recently levied at a rate of 0,55% rate - has been abolished as per 1 January 2006.

## **DIVIDEND WITHHOLDING TAX (DWT)**

### **3.1. DWT to be abolished gradually**

The Ministry of Finance has announced that it is contemplated that gradually the Dutch DWT will be abolished.

### **3.2. DWT limitations in relation to share for share exchange transactions relaxed**

To avoid artificial step ups, recognized (unclaimed) capital for Dutch dividend withholding tax purposes, as allocable to shares which have been issued in return for the acquisition of shares in a target company, is limited to the capital as paid up on the shares of the target company, i.e. any excess value of the target company is ignored. The above rule has lead to much criticism particularly in relation to the contribution of shares of non Dutch target companies as it is suggested that the Netherlands - rather than protecting legitimate tax claims – had introduced claims on earnings which arose in periods it had no taxation rights.

As a measure of improving the attractiveness of the Dutch tax climate the Secretary for Finance has lifted the above claim protection provision in relation to share for share exchange transactions comprising the contribution of shares of non Dutch companies such with the effect as from 1 July 2005. As a result, share for share transactions comprising non Dutch companies as target will lead to an increase of capital as recognized for Dutch dividend withholding tax purposes for an amount equal to the fair market value of the shares

of the non Dutch target company as contributed. The relaxation of the claim protection provision also covers share for share transactions which were effected prior to 1 July 2005.

The above relaxation of the claim protection provision has been made subject to the condition that the share for share transaction may not be mainly effected as to avoid or postpone (dividend withholding) taxation. Further, the claim protection provision will remain equally applicable for share for share transactions comprising Dutch companies as target.

#### **4. Personal Income Tax**

The personal income tax rates applicable the top brackets of Box 1 (income from employment and home ownership) have not been changed (the top rate remains 52%. The tax rate applicable to Box 2 income (income from substantial interests) remains 25%, while the effective rate applicable in Box 3 (income from savings and investments) remains 1,2% of underlying average value of net assets.

### **TAX TREATIES/NETHERLANDS ANTILLES**

#### **5.1. Proposed amendments to Tax Arrangement with Netherlands Antilles (NA)**

On 1 December 2005, an agreement between the NA Minister of Finance and the Dutch Secretary of State for Finance, containing the outlines of amendments to the Tax Arrangement for the Kingdom (TAK), was signed. The current 8.3% rate for dividends paid to a qualifying NA parent company shall be reduced to 5% or even 0% if further conditions are met.

Dividends shall be subject to 0% Dutch DWT if the shareholders are existing or new banks and insurance companies (under supervision), quoted companies or pension funds, provided they meet the usual tests (10% minimum shareholding, beneficial owner etc.).

In all other cases, dividends shall be subject to 0% Dutch DWT only if the NA shareholder meets a non-conduit test. This test shall be met if the NA company receiving the dividends will:

- either invest 100% of the gross dividends into a newly to be incorporated “Recovery Bank” for the NA, for a period of at least four years. After two years 25% of the gross dividends can be released and paid to the shareholders of the NA company.
- or re-invest the dividends directly in local business operations that strengthen the economy of the NA on a long term basis (under strict conditions whereby the substance of the NA company shall be irrelevant).

In cases where the conditions for a 0% DWT-rate are not met, the maximum TAK-rate shall be reduced from 8.3% to 5%. The 5% tax shall be remitted to the NA. This 5% rate shall also be applicable to NA companies which still apply the former NA offshore regime. The minimum shareholding, currently 25% of the share capital in the Dutch company, will be reduced to 10%.

The text of the amended TAK shall be drafted shortly. It is intended to finalise this in the first quarter of 2006. It seems fairly certain that a 5% rate will be available shortly to most Dutch-NA sandwich structures. Whether or not the conditions for a 0%-rate could be attractive is yet uncertain. The favourable exceptions for banks (0% without the requirement of re-

investment) may or may not offer tax planning tools.

## 5.2. Treaty with Isle of Man

A striking development was the recent signing by the Netherlands of agreements with the Isle of Man<sup>2</sup>. These agreements deal, inter alia, with the exchange of information, shipping and aircraft operations and the application of the Netherlands participation exemption to shares held in Isle of Man subsidiaries. It is interesting to note that this agreement includes an assumption that the “subject to tax clause” (one of the conditions for the application of the participation exemption) is considered to be fulfilled, even if the Isle of Man tax rate is zero. This is in line with the plans proposed in the White Paper (see TNB May, 2005). One of these plans is to simplify the participation exemption by eliminating the condition of the “subject to tax clause” for active subsidiary companies.

## CASE LAW

### 6. Supreme Court relaxes criteria for qualification of loan as equity

The Dutch Supreme Court has relaxed the criteria for a loan being regarded as a hybrid loan as it had confirmed these criteria back in 1998. Along the lines of the Supreme Court’s 11th March 1998 ruling amongst others a loan is regarded as an equity alike investment in the borrower, and accordingly qualified as a hybrid loan, if the loan does reflect following characteristics cumulatively:

- (i) the loan interest is dependent on the borrower’s profit,
- (ii) the loan is subordinated to each and all non preferred lenders and creditors, and
- (iii) the loan does not have a maturity date, and is repayable only upon bankruptcy or the liquidation of the borrower or in case of a court order granting suspension of payment to the borrower (*surséance van betaling*).

In its 25th November 2005 ruling, the Supreme Court specifically addressed the characteristics as under (i) and (iii) above in relation to a so-called *prêt participatif* as extended by a Dutch company to its French subsidiary. The *prêt participatif* was interest bearing at a fixed rate of 1% plus further interest depending on the French company’s profit and had a duration of 95 years. Interesting to note is that the French company was in a position to claim relief for interest expenses on account of the *prêt participatif*.

The Supreme Court held that as the instrument’s interest is nearly fully dependent on the borrower’s profits the condition as under (i) above is regarded satisfied. Further, Supreme Court held that the condition as under (iii) above is regarded satisfied if the duration of the loan is more than 50 years. As the second criterion as above was not in dispute the *prêt participatif* was held as forming part of the tax payer’s qualifying investment in the French company.

Loan instruments with the above characteristics are frequently used by Dutch companies to finance investments which do qualify for purposes of the participation exemption as in such

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<sup>2</sup> Signed on October 12, 2005. Yet to be approved in both jurisdictions in accordance with their internal procedures.

case the hybrid loan does form part of the investment and accordingly income and (exchange) gains as allocable to the instrument are covered by the participation exemption as well. The above recent Supreme Court ruling may contribute to the popularity of the instrument as it may have become available for implementation in an increased number of situations.

Rotterdam, February 2006

Should you have any questions or require further information, please do not hesitate to call your regular contact person within our firm (+31 10 436 50 44).

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Detailed specialist advice should be obtained before (refraining from) taking any action as a result of the comments in this paper. This paper is neither intended to be a comprehensive study nor should it be taken as tax or legal advice.