

June 2009

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## TAX NEWS BULLETIN

### IMPROVEMENT OF THE DUTCH INVESTMENT CLIMATE AND INTEREST DEDUCTION RESTRICTIONS

#### **Topics in this Tax News Bulletin:**

The proposed measures include:

- 1) a notional base reduction for group financing income, resulting in a 5% effective corporate income tax (CIT) rate on group financing income,
- 2) a partial limitation on the deduction of group and third party interest expenses,  
and
- 3) simplification of the conditions of the participation exemption.

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## ***Introduction***

On 15 June 2009, a Consultation Document with the lay-out of draft legislation and commentary was published on the website of the Ministry of Finance, including proposals to improve the investment climate in the Netherlands, and measures to restrict deduction of interest expenses. Interested parties are invited to submit their comments before 1 August 2009, after which a legislative proposal will be drafted. The legislative proposal is expected to be published after the summer recess of Parliament, and is currently expected to enter into effect as law on 1 January 2010.

### ***1. Reduced effective CIT rate for group financing income***

Under this proposed measure a notional base reduction (of factor 20.5/25.5) is applied to group financing income. As a result, a positive balance of group interest income and expenses is effectively taxed at 5%; likewise a negative balance results in an effective tax saving of 5%. In determining which companies form part of the “group”, the power to control is the relevant test. In this respect it is intended to follow the commercial criteria for having to prepare consolidated annual accounts (IAS 27). The scope of the measure is fairly wide: group financing income includes interest from, as well as changes in value of, group loans (including “hybrid loans”) and “war chests”, the interest component in group financial lease and hire purchase installments, and results on financial instruments to hedge interest and currency risks in relation to group loans. The mandatory (non-selective) character of this measure should ensure that it can not be considered prohibited state aid by the EC Committee.



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## **2. Simplification of existing provisions restricting interest deduction**

Currently, interest deduction is restricted by both provisions covering statutorily defined base erosion transactions and by thin capitalization rules.

The Government does not rule out that the provisions covering statutorily defined base erosion transactions will be abolished, but emphasizes that the abuse of law doctrine would continue to play a role in such cases.

Under the proposal, the existing thin capitalization regulations are abolished and replaced by one of the following alternative measures:

### **a. Earnings stripping rules**

Interest is not deductible if and to the extent that the (negative) balance of group and third party interest exceeds 30% of EBITDA and € 250,000.

Based on a counter evidence provision, the earnings stripping rules would not be applicable if the debt to equity ratio of a taxpayer does not exceed the debt to equity ratio of the group of which the taxpayer forms part.

Tax payers will be allowed to carry forward their excess interest expense for a period of nine years.

### **b. A combination of two specific restrictions:**

#### **i) Restriction aiming at acquisition holding companies**

In practice, when a Dutch target company is acquired, often an acquisition company is used. Typically, a fiscal unity between the acquisition company and the target company is requested, allowing the acquisition company to offset the acquisition interest expenses against the profits of the target company (a similar result can be achieved through a legal merger or legal demerger). Under the proposal, such group or third party interest expense related to the acquisition of a target company is deductible only if and to the extent that the (business of the) acquisition company itself generates sufficient taxable profits.

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However, the proposal provides for a safe harbor: the restriction does not apply:

- (1) if and to the extent the disallowed interest expenses do not exceed € 250,000,  
or
- (2) if the average debt of the tax payer (the fiscal unity) does not exceed three times the average equity. For the purpose of this safe harbor rule, equity that is used for the financing of qualifying participations is disregarded.

ii) Restriction aiming at financing of subsidiaries

Under the current law, interest expense relating to the financing of participations are in principle deductible, while the income from the participations is exempt. Upon the introduction of the reduced CIT rate on group financing income, a similar “imbalance” situation would arise in case group loans are financed by third party debt: the interest income would be taxed effectively at 5%, while the interest expense would be deductible at 25.5%.

Under the proposal, interest expense relating to participations would no longer be deductible. In addition, the amount of participations is increased by 20.5/25.5 (approximately 80%) of the amount of all group receivables. In this respect, the exempt part of the group receivables are treated similar to participations.

A specific allocation rule should determine which part of a tax payer’s debts relates to participations and group receivables, and consequently which part of the interest expense is non-deductible. Starting point would be the – favorable – assumption that the participations and the (exempt part of) group receivables are financed by equity (as adjusted and increased by the tax loss carry forward available at the beginning of the year, if any). To the extent the average amount of participations and group receivables exceeds the average amount of equity, participations and group receivables are deemed to be financed by debt.

Since group interest expense would effectively be non-deductible for 20.5/25.5 (approx. 80%), group debts are effectively treated as equity to that same extent. Therefore, for purposes of determining the debt relating to participations and group receivables, the equity is increased by 20.5/25.5 of the group debts.



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### 3. Improvements of the participation exemption

The purpose of the Dutch participation exemption is to avoid double taxation of business profits. The participation exemption is specifically not intended for passive portfolio investment income, which is often mobile and simple to (re)locate to low taxed jurisdictions. Following the introduction of the 'low taxed passive portfolio subsidiary' provision in 2007, the Ministry now acknowledges that investigating this test can be time consuming. In addition, the outcome of this test is often uncertain, because it depends on a qualification of assets, the nature and composition of which may change regularly.

Therefore, under the proposal the participation exemption applies if the tax payer can demonstrate that the participation is not held as a passive portfolio investment. This test is almost identical to the test that applied until 2007. It is intended as an improvement, as the term has crystallized in (the ruling) practice and case law as having a relatively broad scope.

Note that even if the shareholder is considered to be holding the participation as a passive portfolio investment, the participation exemption may nevertheless be applicable if the subject to tax test (at least 10%), or the asset test is met. Under the proposal, both tests are relaxed, the latter also implying a relaxation of the test for so-called real estate participations.

Should you have any questions or require further information, please do not hesitate to contact one of the Tax Advisers mentioned below.

Hans Drijer	<a href="mailto:hans.drijer@ohp.nl">hans.drijer@ohp.nl</a>
Jos Hellebrekers	<a href="mailto:hellebrekersj@ohp.nl">hellebrekersj@ohp.nl</a>
Hans Keijzer	<a href="mailto:keijzerh@ohp.nl">keijzerh@ohp.nl</a>
Willem J. Otterspeer	<a href="mailto:otterspeerw@ohp.nl">otterspeerw@ohp.nl</a>
Peter Priester	<a href="mailto:peter.priester@ohp.nl">peter.priester@ohp.nl</a>
Eric van der Stoel	<a href="mailto:eric.vanderstoel@ohp.nl">eric.vanderstoel@ohp.nl</a>
Jeroen van der Wal	<a href="mailto:vanderwal@ohp.nl">vanderwal@ohp.nl</a>

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