April 2011

TAX NEWS BULLETIN: DUTCH MINISTRY OF FINANCE PUBLISHES "FISCAL AGENDA"

On 14 April 2011, the Dutch Ministry of Finance published its "fiscal agenda". The fiscal agenda translates the long term policy objectives of the current government to proposals to change and improve the current Dutch tax system. The government aims at further strengthening the Dutch investment climate and the competitiveness of the Dutch economy, at rewarding entrepreneurship, and at reducing the government body. The starting points will be simplicity, solidity, and fraud immunity of the tax system. The first and foremost purpose of taxation will once again be the financing of government expenses. The complexity which has resulted from using taxation as an instrument for government policy has resulted in inefficiency and "deadweight loss".

This summary aims to highlight those proposed measures which may be relevant to foreign taxpayers and foreign tax practitioners.

1. A general shift from direct taxation to indirect taxation

Indirect taxes are thought to be more solid, and less distorting to the economy than direct taxes, which is why the government considers a general shift from direct to indirect taxation. The current "standard" VAT rate is 19%. The reduced rate (applicable to specific basic goods and services such as food & drink, medication) is 6%. Several options for increasing VAT revenue will be explored:

- *A limited increase of the reduced VAT rate to 8%*
- *Partial abolition of the reduced VAT rate. Reduced rate to continue to apply to food only*
- *Full abolition of the reduced VAT rate, resulting in a single VAT rate on all goods and services*

The number of tax base reductions in the personal income tax is to be reduced. The increase in personal income tax revenue and VAT revenue would be used to reduce personal income tax rates. Also, a substantial number of "smaller" taxes, including certain environmental taxes such as packaging tax are to be abolished. These legislative proposals concerning these changes are expected in the first half of 2012.

2. Changes to the corporate income tax act

The two proposed changes to the corporate income tax act are:

- *Restricting excessive interest deduction by acquisition holdings*
- *Leveling the playing field for foreign permanent establishments and foreign participations*
- *Corporate income tax rate reduction to 24%*

The legislative proposals concerning these changes are expected in the third quarter of 2011. The government also intends to restrict the deduction of interest expenses on the financing of the acquisition of (exempt) participations ("Bosal expenses"). More guidance on the measures to be proposed in this respect is expected on June 14, 2011.

The tax base increase resulting from the above changes would be used to reduce the corporate income tax rate from 25% to 24%.

Excessive interest deduction by acquisition vehicles

Interest expenses incurred by Dutch acquisition vehicles in relation to the financing of the acquisition of the Dutch target company can be offset against the taxable profits of the Dutch target company by including the Dutch target company in a fiscal unity with the acquisition vehicle. The proposed restriction on interest deduction is intended as a disincentive for excessive acquisition financing. Based on the proposed measure, interest expense incurred in relation to both intercompany and third party acquisition financing will be deductible only from the stand alone profit of the acquisition vehicle. Furthermore, the restriction will only apply in case of excessive debt financing. A maximum debt-to-equity ratio is yet to be determined (the ratio is 3:1 under the current thin cap provision), whereby the equity will be reduced by the amount of participations held by the taxpayer (if any). In order to reduce administrative burdens and to spare small acquisitions, a threshold amount of annual interest expense is set at €500k. The so called “goodwill gap” (the decrease in tax equity which occurs when the goodwill paid for shares of the target company is set off against the tax equity of the fiscal unity, upon consolidation of target and acquisition vehicle into fiscal unity) will be taken into account by allowing an increase of tax equity, for a period of 10 years, equal to a linear depreciating amount of goodwill gap.

Foreign permanent establishments

As a result of the current exemption for foreign p.e. profits being a tax exemption rather than an object exemption, losses of a foreign p.e. are included in the taxable base and therefore offset the taxable profit of the Dutch head office, subject to a recapture provision which defers exemption on future profits until the loss has been compensated. This system provides for a timing benefit, which is not available to participations since profits and losses from participations are excluded from the taxable base entirely (object exemption).

The proposed measure for foreign p.e.’s is to replace the tax exemption with an object exemption. The subject-to-tax requirement contained in the provisions for avoidance of double taxation can therefore be removed. Foreign p.e. losses which have become permanent (e.g. ceasing or transfer of activities to a third party) may be deducted from the taxable profit of the Dutch head office, provided that the p.e. country does not allow any form of loss relief. For foreign passive p.e.’s, the existing (partial) credit method will continue to apply.

3. Dividend withholding tax

In spite of repetitive calls for abolition of dividend withholding tax, the Dutch government does not intend to abolish the dividend withholding tax for the following reasons:

- The revenue of dividend withholding tax is (too) significant
- Abolition of dividend withholding tax would subsidize foreign budgets, as most taxpayers affected by Dutch dividend withholding tax are able to fully credit the tax against their income tax liability
- The dividend withholding tax plays an important role in obtaining balanced results from tax treaty negotiations

4. Foreign taxpayer liability

The fiscal agenda also announces changes to the taxation of foreign taxpayers on substantial (>= 5%) passive interests in Dutch companies. Under the current corporate income tax act, dividends from and capital gains on the sale of shares of a Dutch company are subject to 25% corporate income tax if the foreign shareholder owns a substantial passive interest in such Dutch company. The tax also applies to interest paid on loans payable to a foreign substantial passive interest holder. Although the fiscal agenda provides no further information on the possible changes, it is expected that such changes will entail making the substantial passive interest tax compliant with EU law in the sense that the tax will only apply to EU shareholders in case of abusive situations. Changes to the substantial passive interest tax are said to be included in the legislative proposals which are expected in the third quarter of 2011.