



Dutch government publishes proposals for 2007 tax system

On 19 February 2004, the State Secretary of Finance announced plans for overhauling the Dutch corporate income tax system in an address at the Free University in Amsterdam. After getting input from various sides in the first phase of this project, the Dutch government published a memorandum with preliminary plans formed on the basis of the ideas suggested in the first phase. The memorandum was published on 29 April 2005 and is discussed in a separate annex to this newsletter.

Proposed bill on converting branches to participations

On 12 May 2005 the government filed a bill with the Second Chamber to close a loophole in an anti-abuse measure concerning the participation exemption. Under Dutch law the losses of a permanent establishment (“p.e.”) can be offset against the other taxable income of a Dutch resident. However, future gains from the p.e. are only exempt once these p.e. losses have been recaptured. In order to prevent such a recapture, taxpayers used to convert their p.e.’s into subsidiaries before such a recapture took place (future income would then be exempt under the participation exemption). However, as of 1990, income and gains from such a foreign subsidiary would only be exempt after a recapture of the p.e. losses took place. To circumvent this, a Dutch taxpayer (ABV) would interpose a foreign holding company (BCo) between the Dutch company and the p.e. converted into a company (CCo).

The proposed bill, which was announced in our [March 2004 newsletter](#) introduces the following measures. It applies the recapture of foreign losses through deferral of the participation exemption to a participation holding an interest of at least five percent in a loss making branch which was converted into a company. This happens to the extent that income from this participation stems from income from the converted branch. The rule furthermore only applies to the qualifying participation closest to the converted branch. E.g. ABV, holds BBV which holds CBV which holds a foreign subsidiary, DCo. ABV has a loss making branch which is transferred to DCo before the branch becomes profitable. When it does become profitable, DCo distributes the profits to CBV, CBV to BBV and BBV to ABV. The recapture of the foreign losses only takes place at the level of CBV by denying it the benefits of the participation exemption on the DCo dividends. The denial takes place up to an amount equal to the branch losses. The subsequent distributions from CBV to BBV and BBV to ABV are exempt under the participation exemption.

Should DCo dispose of the former enterprise or should CBV dispose of the shares in DCo whereby the above anti-abuse legislation can no longer apply, then the participation in the disposed subsidiary must be marked to market directly before the disposal in order to recapture any undistributed profits from the former branch at that time.

Probably one of the most noteworthy aspects of the proposed bill is the taxpayer friendly attitude reflected among others through the generous grandfathering regime. Under this regime any realised but undistributed profits from the former branch at the time the law enters into force will be sheltered from the new recapture rule. In order to realise this, participations affected by the proposed bill may be marked to market (tax free under the participation exemption) directly before the law enters into force. The law will enter into force on the first day after the date of issue of the Government Gazette in which it is placed. The proposed texts are available on our website under [“Proposed laws”](#).

Dutch / Chinese treaty on air tax in groundbreaking format

On 18 April 2005 the Dutch Ministry of Foreign Affairs informed the Dutch parliament that the Netherlands concluded an agreement with China on an exemption for Dutch airlines from Chinese air taxes. It requested the parliament’s approval of the agreement.

According to the accompanying explanation to the treaty, China levies a “Business Tax”, which essentially is a turn over tax, on Dutch airlines. The tax is not covered by the Chinese/Dutch tax treaty since it is not a tax on income but on turn over. However, airlines from other countries are not subject to the tax since China concluded bilateral agreements with those countries on the Business Tax. The Netherlands has now concluded an expedited agreement with China to rectify this situation. The agreement has been expedited by not making it a formal treaty but actually concluding the agreement in the form of an exchange of letters between the Dutch and Chinese governments in the English language. The exchange of letters took place between 14 and 21 December 2004 and, according to the accompanying memorandum, took effect immediately.

Probably one of the most note-worthy aspects of the proposed bill is the taxpayer friendly attitude reflected in it

Valuation of bonds acquired above par value

On 29 March 2005 the High Court of the Hague decided on how a taxpayer may value its bonds. This protracted case started with a decision of the High Court of Amsterdam on 30 January 2002 in which the appeal of the taxpayer against the inspector's refusal to follow its system of valuation was upheld. Subsequently, the Dutch Supreme Court rejected that decision by on 17 September 2004 and referred the case to the High Court of the Hague.

The exact facts of the case are some difficult to trace since the High Court refers to the previous decisions, neither of which have been published. Based on similar cases decided by the same courts on the same days it can be assumed that taxpayer, an insurance company, valued its bonds under a depreciation method according to which the difference between the purchase price paid for the bonds and the par value of the bonds (the "Premium") is written down against the taxpayer's profit over the remaining lifetime of the bonds. E.g. if the market interest rate is 5% and the bonds pays 6%, bonds with a par value of 100 may trade for 102 due to the higher interest received. In that case, the taxpayer would spread the Premium of 2 out over the remaining lifetime of the bond. The Supreme Court rejected this method of valuation and referred the case to the High Court of the Hague.

The taxpayer informed the High Court that following the Supreme Court decision it now valued some of its bonds at the lower of the acquisition price or their fair market value and others at the depreciation value, but only if this exceeded the fair market value and then never higher than the acquisition price (the 'taxpayer' was a consolidated group and one subsidiary in the group used the former and another subsidiary the latter method of valuation). The tax inspector attacked the second form of valuation arguing that the taxpayer was bound by an agreement made with the tax authorities by a representative body of insurance companies in 1969. However, since the Supreme Court determined that this agreement did not apply to the Premium, the High Court rejected the tax inspector's argument. The taxpayer was thus allowed to amend its system of valuation and to value bonds on a basis of depreciating the Premium annually provided that the resulting value is not lower than the fair market value of the bonds. For being right, the taxpayer got awarded Euro 483 as compensation for litigation fees.

Supreme Court on treatment of cash settled convertibles

On 20 May 2005 the Supreme Court decided on the tax treatment of cash settled convertibles (and missed an opportunity to rectify its previous case law). The facts were as follows. A taxpayer issued convertible bonds in US Dollars. The bondholders could convert the bonds into shares of the taxpayer and taxpayer had the right to then settle the conversion either in cash or in shares. Due to the conversion right acquiring an intrinsic value (i.e. the purchase price of the share were lower than the market price of the shares), the bondholders did offer the bonds for conversion during 1994. The taxpayer settled some of the conversions in shares and others in cash.

In earlier decisions the Supreme Court determined that since the right of conversion could not be traded separately and since the holder of the convertible – an individual investor in that particular case - was not subject to tax on the conversion right, the right of conversion (the difference between the interest due on a loan without a conversion right and a loan with a conversion right) itself was not deductible for the corporate debtor either. Naturally this created double taxation for corporate convertible bond holders who are taxed on the conversion rights and the subsequent gains on those conversion rights. In 2001, a new Dutch individual income tax act came into effect in which capital gains also became taxable for individuals, albeit at a fixed deemed return on investment basis. During the parliamentary debates on the new act, it was pointed out that since individuals are now also taxed on their conversion rights and capital gains, convertible bond issuers should be allowed to deduct the conversion rights and losses. However, instead of doing this, the earlier case law became legislation.

In the current case the taxpayer argued that its losses on the cash settled conversions should be deductible. The Supreme Court denied this, referring to its own case law from 2001 on employee stock options. There the Supreme Court determined that "the holder of a call option on shares in the company that wrote the call option, is in a relation to the that company which so closely resembles a shareholder's relationship, that all transaction between him and that company must be treated like the shareholder and must be completed outside the profit realm of the company." I.e. the issuer's conversion losses are not deductible. The Supreme Court determined that this doctrine applies even if the convertibles were cash settled (and the creditors therefore never became shareholders).

Dutchtax.net regrets this decision for various reasons. First, the original case law never looked at the double taxation that ensues when a convertible holder is a company instead of an individual. Second, there are various instances in Dutch law where the law itself creates a disparity between Corporate Income Tax and Personal Income Tax (i.e. where something will be taxable for the one side of a transaction but not deductible for the other). There is therefore no reason for the Supreme Court to uphold this balance, especially not after the government started taxing individual investors for capital gains in 2001 and bluntly ignored the Supreme Court's reasoning in this respect. Finally, the notion that the option holder is like a shareholder is devoid of economic reality, not only because option holders have no voting power, but also because the option holder generally only has a very limited economic downside compared to a shareholder and a highly leveraged upside.

Pending publication on Dutch international tax law

Dutchtax.net is proud to announce the pending publication of Johann Müller's book on Dutch international tax law. The book will be published by the International Bureau of Documentation in Amsterdam. [More information](#) on IBFD site.

The Supreme Court determined that there was no difference between cash settled conversions and conversions into share capital

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EU related tax developments

Foreseeable emigration of BV's and waiving their pension liabilities

It has been a good month for decisions on the tax treatment of BV's emigrating from the Netherlands and foreseeably being relieved from their pension liabilities..

It has been a good month for decisions on the tax treatment of BV's emigrating from the Netherlands and foreseeably being relieved from their (pension) liabilities shortly after emigration. First, the High Court of Arnhem ruled in a case where an employee set up a Netherlands Antilles NV in the Netherlands. The NV took over the employer's pension liabilities (valued at NLG 1.7 mio) after which the NV emigrated to the Netherlands Antilles and the employee waived his pension rights. The High Court of Den Bosch determined that the waiving of the pension rights was foreseeable prior to the NV's emigration and therefore most of the profit from the waiving was taxable in the Netherlands. The taxpayer appealed to the Supreme Court, which decided in July 2004. The Supreme Court followed the taxpayer's argument that if the waiving of the pension rights was foreseeable at the time of emigration, it also was foreseeable at the time of the taxpayer taking over the pension liabilities. Therefore, the taxpayer only acquired liabilities with a very low value, leading to a very low profit prior to emigration, if any. The Supreme Court referred the case to the High Court of Arnhem. This court decided on 13 April 2005 that since the employee never would have accepted the pension liability acquired by the NV being practically nil, the pension must have had its full value upon transfer to the NV and that the full profit was therefore only realised upon the subsequent waiver.

Things went better for a taxpayer who moved himself and his pension holding BV to Belgium instead and did not waive his pension rights. On 13 May 2005 the Supreme Court determined that the Netherlands was not able to levy extra corporate income tax, personal income tax or wage tax on the emigration. In the particular case at hand the tax authorities tried to levy a 60% corporate income tax on the BV. The 60% tax is an anti-abuse measure introduced to levy tax on pensions from pension holding companies when it may not be possible to get hold of the "abusive" pension beneficiaries anymore.

On 18 March 2003 the High Court of the Hague already determined that such a levy constituted an unjustifiable restriction on the BV's freedom of establishment. It was a restriction since the establishment of the BV in a different place inside the Netherlands would not have led to the 60% levy. The restriction was not justifiable by abuse of law, since the Court determined that it was not foreseeable at the time of BV's emigration that the pension rights would be waived or that BV would be liquidated (Taxpayer argued that it was liquidated in connection with a professional liability claim on a former partner of the pension beneficiary). It was also not justifiable as a necessity for the cohesion of the Dutch tax system since the Belgian Dutch tax treaty elevates the cohesion existing between the deduction of pension premiums and the taxation of pension distributions to a bilateral level between the Netherlands and Belgium and the Belgian Dutch tax treaty.

The Advocate General of the Supreme Court advised on 14 July 2004 to reject the tax authorities' appeal. However, unlike the High Court he argued that the 60% tax was already prohibited by the Belgian/Dutch tax treaty, whereby it became unnecessary to apply EU law. To the extent the treaty allowed such a levy, the levy could nonetheless be prohibited under EU law. However, this would ultimately be on the grounds that the law does constitute a restriction and that any justification there is would not be allowed since the anti-abuse character of the law is disproportionate since the law applies in all cases regardless of whether there is or is not any factual abuse. The Supreme Court avoided the EU aspects of the case and determined, along with the Advocate General that the levy was already disallowed under the Belgian Dutch tax treaty, since it would testify of bad faith among treaty partners if the Netherlands levied a tax on the BV in lieu of the income tax on the pension payments of which the right of levy is allocated to Belgium in this case.

Bill allows occupational pension policies from other member states

On 4 May 2005 the Dutch government filed a proposed bill of law with the Dutch Second Chamber to implement [EC Directive 2003/41](#) on cross border occupational pensions. Neither the Directive, nor the proposed law says anything about the cross border deductibility of pensions. We assume that taxpayers and their employers are going to have to continue to rely on the ECJ's case law in this respect, in particular cases like Skandia ([Case C-422/01](#)), Jessica Safir ([Case C-118/96](#)) and Rolf Danner ([Case C-136/00](#)).

Disclaimer

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2 day EU law course in New York: Last minute registrations

On 9 and 10 June 2005 Dutchtax.net will be offering a two day EU training course in New York in co-operation with the [European American Tax Institute](#). Learn where to find what and how to avoid professional negligence. [More details](#). There are still a few places left.

Do not miss this opportunity to learn how Marks & Spencer or Cadbury Schweppes can influence your US foreign tax credit, or to learn how EU state aid rules can potentially annul your tax benefits (plus interest).

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Introduction

On 19 February 2004, the State Secretary of Finance announced plans for overhauling the Dutch corporate income tax system in an address at the Free University in Amsterdam. Rather than setting details of the changes, the State Secretary set out a process which should lead to the implementation of the overhauled system by 1 January 2007. The process will be divided into three phases. During the first phase until mid 2004, all parties are invited to come with their own proposals of what needs to be done and how it should be done and to discuss their ideas in an online forum which will be launched at the end of March. In the second phase the Ministry would draft a memorandum with their preliminary plans on the basis of the ideas formed in the first phase; this would have been concluded in the second half of 2004, however, the memorandum was filed on 29 April 2005. The memorandum would be filed with parliament and discussed before a formal proposal of law will be prepared. This phase should be completed by approximately mid 2005, however, in view of the late filing of the draft memorandum, this process too will suffer some delay. In the final phase a proposal of law will be filed (end 2005) which should be discussed, amended and adopted in 2006.

The primary reasons given for the overhaul is the improvement of the Dutch investment climate and the necessity to make the Dutch corporate income tax act EU compliant where necessary. The State Secretary did give some indications of the measures he envisions. These are:

- ❖ to only changes those aspects of the Corporate Income Tax (“Corporate Income Tax Act”) which needs changing, rather than starting from scratch;
- ❖ to keep the changes revenue neutral;
- ❖ to keep things practical;
- ❖ to find national solutions for problems rather than trying to fix them through the EU or the OECD;
- ❖ to introduce specifically tailored measures rather than a broad reduction of the general tax rate, without creating regimes which can be qualified as illegal state aid in an EU context;
- ❖ to find reasonable solutions for changes required under decisions from the EU Court of Justice (e.g. should the outcome of the Marks & Spencer case force the Netherlands to allow cross border consolidations).

Memorandum filed with parliament

As said here above, a memorandum has been filed with the Dutch parliament on 29 April 2005. The main recommendations of relevance for the international corporate tax practice are:

- ❖ a further reduction of the Corporate Income Tax rate to 26.9 percent;
- ❖ the abolishment of capital duty. This measure has already been announced and will take effect as of 1 January 2006 already;
- ❖ the possible introduction of a separate box for group financing (lending and borrowing) where the net interest income will be subject to tax rate of 10 percent. Taxpayers will have the right to choose whether or not to make use of this box;
- ❖ a slight possibility of the introduction of a separate box for group royalties;
- ❖ introducing cross border tax consolidation;
- ❖ amending the participation exemption by:
 - ❖ eliminating the possibility to deduct certain losses from the liquidation of a subsidiary;
 - ❖ replacing the current activities test (referred to as “portfolio investment test”) and subject to tax test by a simpler system of excluding passive tax haven companies from the participation exemption;
 - ❖ making the minimum interest requirement of 5 percent applicable without any exceptions for lower strategic interests;
 - ❖ eliminating the possibility to write down participations during the first five years after their acquisition;
- ❖ the slight possibility of a territorial system;
- ❖ the possible reduction on the number of various legislative instruments for limiting interest deductions;
- ❖ limitation of loss carry forward and carry back rules to one year carry back (currently three years) and eight years carry forward (currently indefinite);
- ❖ limiting the depreciation of real estate to its free market value.

Hereafter, some of the above measures will be described in further detail.

Possible introduction of group interest box

On 9 February 2005, the Dutch government filed a bill to abolish the Dutch group finance company regime ultimately per 1 January 2011. During the parliamentary discussions of 7 April 2005 of the bill the Christian Democrats (CDA) and the Liberal Party (VVD) both asked for an alternative to the group finance company regime which is neither qualified as a harmful tax regime nor as illegal state aid. The Christian Democrats suggested a box system within the corporate income tax in which interest and maybe royalty income are taxed in separate (low rate) boxes. It seems as though their wish has been (partially) granted by the introduction of a box system.

The memorandum describes the features of the box system as follows.

- ❖ The group interest box will be optional; i.e. taxpayer should also be able to opt out of the group interest box regime and to apply the general Dutch tax rules instead.
- ❖ All members of a group must choose the same option. I.e. all must apply the group interest box, or none should.

- ❖ The box will consist of the net total of the group interest paid and received by a company.
- ❖ The box will only apply to the extent that the net group interest received exceeds the net interest paid to third parties. E.g. ABV is a group finance company, its net group interest income is 100. This is partially financed through third party debt of which the interest costs were 60. The low tax rate will only apply to 40 of the net group interest received.
- ❖ Interest received on short term investments held as war chest are also treated as group interest. Although the literal text does not say so, I assume that this includes interest on short term investments with third parties.
- ❖ Any corporate taxpayer can opt for this facility.
- ❖ The income will be subject to rate of 10%. I quite frankly think that most multinationals will find 10% too high, considering the other group financing alternatives available. Maybe the government will have to choose between a higher rate (10%) and a few customers, or a lower rate (e.g. 5%) and many more customers. In terms of maximising tax revenue, the latter seems the route to go.

The government will confirm with the Commission whether this facility is EU compliant and does not constitute illegal state aid. It will also ensure that it does not constitute harmful tax competition.

Cross border consolidation and territorial systems

In anticipating that the EU Court of Justice may rule in favour of Marks & Spencer in Case C-446/03, the government is considering the choice between the introduction of a territorial tax system or the introduction of cross border tax consolidated groups. It most fortunately believes that a territorial system is less compatible with the open Dutch economy and therefore chooses for cross border consolidation instead. I say that this is most fortunate, since I do not believe that a territorial system is EU compliant: how can having a headquarter in Amsterdam with a branch in Rotterdam of which losses are deductible and a branch in London of which losses are not deductible, ever be?

With regard to cross border loss compensation the government is on the one hand contemplating the introduction thereof, whilst at the same time, considering measures for limiting the import of foreign losses into the Netherlands as much as possible. The latter consideration seems excessive. Afterall, what better way is there to force taxpayers to bring profit generating activities to the Netherlands, than to allow them to import foreign losses.

The main features of the contemplated regime are:

- ❖ the current tax consolidated group regime will be made available for non-resident subsidiaries as well. These subsidiaries will effectively be treated as branches;
- ❖ as is the case with foreign branches, foreign losses of subsidiaries will be deductible while profits will be exempt;
- ❖ using foreign tax collection as motive, the cross border consolidation regime will only be available to EU member states (one may wonder whether this is EEA compliant. It may well be acceptable under foreign tax treaties, since their non-discrimination clauses tend to concern inbound investments only);
- ❖ to prevent consolidation only taking place during loss making years, limitations will be introduced on when a foreign subsidiary can enter a consolidated group. E.g. it may well be that foreign subsidiaries can only enter during a certain period after qualifying for being consolidated, and that there will be a minimum period of consolidation. I understand that this is a real problem that needs to be addressed, but think that the solution is searched for in the wrong direction. First, it will not be possible to set different conditions to foreign subsidiaries than local subsidiaries. Second, the real solution already exists and should be the application of the anti-abuse rules under the participation exemption, preventing loss making branches from being turned into subsidiaries when they become profitable.
- ❖ an all in or all out system will be applied per country, including the Netherlands. E.g. if ABV has three subsidiaries in the Netherlands, two in Germany and two in France, then either all four Dutch companies and/or ABV and both German subsidiaries and/or ABV and both French subsidiaries could form a consolidated tax group. This system is better than the Italian or the recently proposed Danish systems which use a worldwide all in or all out consolidation;
- ❖ losses of foreign subsidiaries will not only be carried forward to limit the exemption of future foreign profits, but will also be carried back to recapture past exemptions of foreign profits. E.g. ABV has a consolidated subsidiary in Germany, BGmbH. In year one BGmbH makes a profit of 100 and pays 30 tax in Germany on that profit. The profit is exempt from taxation in the Netherlands. If ABV made a profit of 200 in year 1, then the total Dutch tax due would be $((300 \times 30 =) 90 - (100/300 \times 90 =) 30 = 60)$. In year 2 BGmbH makes a loss of 100. In Germany BGmbH can (partially?) carry back this loss to offset against its profit from year 1. Under the proposed system, the exemption of BGmbH's profit from year 1 is reversed. If ABV again made a profit of 200 in year 2, I assume that this rule means that ABV will pay $(200 \times 30 =) 60$ in tax again in the Netherlands, in spite of the fact that its worldwide income for year 2 is only $(200 - 100 =) 100$. This would mean that on a combined worldwide profit for two years of $300 + 100$, ABV will have paid 120 in Dutch tax.
- ❖ There will be instances in which past foreign losses will be recaptured immediately. I refer to the announced legislation on branch conversion discussed on the first page of this newsletter.
- ❖ The Netherlands currently uses a per country exemption method. This means that if ABV has a loss making branch in Germany and a profit making branch in Italy, then the full Italian profit is still exempt, since the profit does not first have to be offset against the German loss. The government is considering a return to a worldwide system where the Italian profit would first have to be offset against the German loss before obtaining an exemption on the net amount of foreign profit only.

Amendments to the participation exemption: Dropping the subject to tax and activities tests

These tests will be dropped for applying the participation exemption. The idea is to make the application of the participation exemption more simple and predictable.

However, income and gains from passive foreign subsidiaries will only be exempt if the profits of those subsidiaries have been subject to a reasonable tax judged by Dutch standards. Should that not be the case, a credit instead of an exemption system will apply. According to the memorandum the new subject to tax test will continue to allow the participation exemption to apply in “normal” EU relations. I assume that this means that income from a passive subsidiary in Ireland, taxed at 12.5% or Cyprus, taxed at 10% will still be exempt under the participation exemption. Not doing so, could constitute a breach of EU law.

Group finance activities will also be treated as passive, unless the current criteria for qualifying as an active group finance company are fulfilled. A company is an active group finance company if the following conditions are fulfilled:

- ❖ the entity's normal activities consist of the arranging and execution of financing activities for the benefit of members of the group;
- ❖ the actual funds acquired from third parties constitute at least 20 percent of the fair market value of the entity's assets;
- ❖ the entity does not manage excess liquid assets larger than 10 percent of the total paid up capital of the entity for more than 12 consecutive months; the war chest is ignored;
- ❖ the entity is independent in its management and daily business; normal interference by shareholders or group management is ignored;
- ❖ the number of people working for the entity, their powers and responsibilities are compatible with the nature and function of the entity and the entity has its own offices, supplied with facilities which are common to the financial sector; and
- ❖ the entity performs the transactions relevant to this regulation through its own bank accounts..

A company will also be treated as being passive if it is an investment company. It is not clear whether the criteria for being an investment company will be the same as those applying currently for the Dutch CFC regime, and if so whether the current CFC regime will continue to exist. Under current legislation a CFC is an interest of one quarter or more in an entity resident outside the Netherlands. That interest must be marked at market value if the assets of that entity consist exclusively of investments - including assets used for passive group financing activities.

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