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The taxation of foreign passive income for groups of companies

General

The Netherlands has an open economy with a relatively small domestic market. Consequently, it is important to give employees and entrepreneurs access to foreign markets without comparative tax disadvantages (i.e. to create a level playing field for Dutch entrepreneurs abroad). The Netherlands therefore applies the basic principle of capital import neutrality for active income. This is manifested through the application of a participation exemption to qualifying shareholdings and an exemption for profits attributable to active permanent establishments. For passive income[3] the argument of a level playing field is not applicable, since passive income is in practice highly mobile and not dependent on local infrastructure, market conditions, etc. For passive income the principle of capital export neutrality is leading, generally resulting in the application of the credit method for passive income. These general principles are, amongst others, expressed in a policy document on the Dutch tax treaty policy that has been submitted to the Parliament on 11 February 2011.[4]

The Netherlands applies a worldwide income tax system and has a classical system which taxes corporate profit at the statutory rate of 25% and in principle taxes these profits again with (corporate) income tax as income and capital gains from a shareholding at the level of the ultimate shareholders. The withholding tax rate on dividends is 15%, but an exemption is applicable in case the participation exemption applies. It is Dutch treaty policy to aim for a 0% withholding tax on non-portfolio dividends. The Netherlands does not levy withholding tax on interest and royalties.

The Dutch CITA contains several provisions concerning the taxation of foreign passive income within groups of companies.[5] These provisions have the nature of anti-abuse provisions and seek either to prevent that passive income is shifted to low-tax jurisdictions or repatriated from low-tax jurisdictions to or via the Netherlands without (additional) taxation, or to prevent erosion of the Dutch tax base.

A. General anti avoidance rules (GAAR)

A.1. Fraus legis and *richtige heffing*

The general anti-avoidance rule in the Netherlands is the *fraus legis* doctrine, which has been developed by the Supreme Court. Furthermore, Netherlands tax law contains a general

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[3] The Netherlands does not have a general definition of passive income. In general income from passive investments e.g. dividend, interest, royalties, rental income will be regarded as passive income. The legislation contains deeming rules which qualify interest, royalty and rental payments between related entities as passive income under certain circumstances.
[4] TK, 2011/2012, 25087, no. 7 (appendix).
[5] These rules will usually apply if entities are considered as related entities. A related entity is defined as “(i) an entity in which the taxpayer owns at least a one third interest, (ii) an entity that owns at least a one third interest in the taxpayer, or (iii) an entity in which a third party owns at least a one third interest while this third party owns at least a one third interest in the taxpayer. The term "interest" refers both to the paid in capital (financial interest) and the issued capital (voting interest) and includes direct and indirect relations.

anti-avoidance rule called *richtige heffing*.[6] Both general anti-avoidance rules serve as an *ultimum remedium*, which means that they, in principle, should only be applied after all normal interpretation methods have been considered without these methods leading to an outcome in accordance with the purpose and intent of the tax law. The conditions for application of *fraus legis* are as follows:[7] (i) tax avoidance should be the predominant motive for the transactions; and (ii) the tax effects of the transactions should be contrary to the purpose and intent of the tax law.[8]

In relation to the relocation of passive income within groups of companies, *richtige heffing* and *fraus legis* have not been very effective targeting instruments.[9] They have, however, successfully been used to challenge certain international restructurings resulting in Dutch base erosion due to interest payments to low-taxed creditors. An example is the case law of the Supreme Court of 10 March 1993, 27 992, BNB 1993/195. In this case, B NV, an entity resident in Curacao, incorporated C BV, an entity resident in the Netherlands. Upon incorporation of C BV, B NV transferred the shares in three Dutch resident operating companies to C BV. C BV remained indebted for part of the transfer price and subsequently incurred interest on the debt, which it effectively deducted, after forming a fiscal unity with the Dutch operating companies, from the taxable profit of the Dutch operating companies. The Dutch tax inspector invoked *richtige heffing* and on this basis ignored the existence of the debt at the level of C BV. The Supreme Court decided in favor of the tax inspector and consequently, denied the deduction of the interest expense. Its decision was based on the following reasoning: (i) the predominant motive of the transactions was tax avoidance since no real changes in the factual circumstances between B NV and the operating companies was intended; and (ii) the effects of the transactions were contrary to the purposes and intent of the tax law since the debt had no purpose for the business enterprises of the operating companies and the structure leads to a more or less arbitrary and unlimited deduction of interest. It is important to note that in relation to international Dutch base erosion structures and the application of *richtige heffing* and *fraus legis* thereto, the Supreme Court has introduced a compensating levy test in, *inter alia*, its decision of 20 September 1995, 29 737, BNB 1996/5. In this case with a fact pattern closely resembling that in BNB 1993/195, the Supreme Court – in short – decided that when the interest income at the level of the recipient (in this case a UK group company) is subject to a reasonable taxation according to Dutch standards, the deduction of interest should not be contrary to the purpose and intent of the law.

A.2. Relationship with specific anti-avoidance rules

In general, it is assumed that where the legislator has enacted specific anti-avoidance rules, such rules restrict the scope for using *fraus legis* to challenge similar kinds of perceived abusive transactions.[10] In this respect, an interesting case was decided on by the Supreme Court on 11 July 2008, 43 376, BNB 2008/266. As a background, it should be noted that since 26 December 1996, a specific anti-avoidance rule targeting Dutch base erosion through interest payments to low-taxed creditors has been included in the CITA (article 10a CITA). This rule was *inter alia* intended as a codification of the Supreme Court case law discussed in paragraph A.1. above.

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[6] Article 31 Dutch General Tax Act (*Algemene Wet inzake Rijksbelastingen)*.
[7] We note that *richtige heffing* has not been invoked since the late 1980's due to the evolution of the *fraus legis* doctrine (*fraus legis* is generally regarded to encompass *richtige heffing*).
[8] From recent Supreme Court case law can be inferred that if a transaction or a series of transactions can be regarded to be wholly artificial, this may more easily lead to the conclusion that such transaction or series of transactions is contrary to the purpose and intent of the tax law (Supreme Court, 10 February 2012, 08/05317, BNB 2012/127).
[9] See, for instance, Supreme Court, 3 July 1991, 25 942, BNB 1991/255.
[10] See e.g. IJzerman, R.L.H., IFA Cahiers 2002, Volume 87a, Form and Substance in Tax Law, p. 453.

In BNB 2008/266, in short, the shares in a group company were transferred to the taxpayer against debt, which debt was subsequently converted into a life annuity. The taxpayer wanted to deduct its contributions to the life annuity (mainly consisting of interest accrual on the obligation under the life annuity) from its taxable income. Since a life annuity does not qualify as a loan, the fact pattern did not fall under the text of article 10a CITA. At issue, *inter alia*, was whether *fraus legis* could be applied to the fact pattern given the existence of article 10a CITA. The Supreme Court held that article 10a CITA has its own purpose and intent and that consequently *fraus legis* can be applied if the transaction is predominantly aimed at tax avoidance and is contrary to the purpose and intent of article 10a CITA itself.

It follows from BNB 2008/266 that in case of restructurings resulting in Dutch base erosion through interest payments to low-taxed creditors, a taxpayer has to be aware of both the specific anti-avoidance rules in this respect as well as the general anti-avoidance rule *fraus legis*.

B. Specific anti-avoidance rules (SAAR)

B.1 The participation exemption and participation credit

The participation exemption in principle fully exempts dividends and capital gains derived from domestic and foreign subsidiaries that qualify as a “participation” (deelneming).

A participation is defined in article 13, paragraph 2 CITA as, *inter alia*, an interest of at least 5% in the nominal paid-up capital of a company with a capital divided into shares.[11] An exception applies to “low-taxed non-qualifying portfolio investment participations” to which the credit method applies.

The application of the credit instead of the exemption method (switch-over) is the principle anti-avoidance rule in relation to foreign passive income. The background of the switch-over is to prevent the allocation of passive income to low tax jurisdictions and the possibility to repatriate this income to or through the Netherlands without additional taxation. The anti-avoidance rule does not make a distinction between domestic and foreign subsidiaries.

The definition of “low-taxed non-qualifying portfolio investment participation” is complex. As a general concept, the exemption will not apply if the income from the participation is predominantly passive and not taxed at a realistic level according to Dutch standards. This concept is worked out in a motive test, an asset test and a subject to tax test. If one of these three tests is met, the participation exemption will apply. If not the participation credit applies. Below we will discuss the three tests in more detail.

B.1.1. Motive test

Under the motive test, the motive for holding the participation has to be determined. This is a qualitative criterion. If the predominant motive is not portfolio investing, this test is met. Based on long standing case law, it can be noted that in general, a participation is not held as a portfolio investment if it is being held for a return that exceeds the return that can be expected from normal asset management. Extensive parliamentary history provides general guidance to the question when participations are held or not held as portfolio investment. When making the assessment, the nature, functions and activities

[11] Pursuant to article 13(2) CITA, certain other interests also qualify while pursuant to article 13(3) and 13(4) CITA certain interests and instruments can be dragged along with a participation of the taxpayer or a related entity of the taxpayer.

of both the taxpayer and the participation should be taken into account.

A participation is not considered to be held as portfolio investment if it is engaged in the same line of business as the taxpayer. If the taxpayer is a holding company, it is considered to conduct an active business if it has an essential function for the entire group. This can be either a top holding company that has a financial, managerial and strategic coordinating function for the entire group, or an intermediate holding company that creates a business link between the business of the (ultimate) parent company and activities of the subsidiaries within a group.[12] A participation is generally held as portfolio investment if the participation primarily invests in e.g. shares, bonds, derivatives or real estate.

If a subsidiary, for instance, conducts an active trade or business (creation of a business link between the business of the (ultimate) parent company and activities of subsidiaries within a group is regarded to be an active business), but also directly or indirectly holds portfolio investments the motive has a mixed character. According to parliamentary history, the nature of the direct and indirect turnover, profit, activities and assets are in such case relevant factors that should be taken into account.[13] Not surprisingly, in practice discussions often arise on the weighing of these factors. In this respect, we note that if the assets are predominantly attributable to the passive activities, in light of the aim of the switch-over, the profit attributable to the passive versus operational activities seems the most relevant factor in such case.

In addition to the above guidance, the motive test also contains two deeming rules:

- A participation is deemed to be held as portfolio investment if the assets of the subsidiary, on a consolidated basis predominantly (>50%) consist of interests in companies of less than 5% of the nominal paid-up capital.
- A participation is deemed to be held as portfolio investment if the functions of the participation together with the subsidiaries in which the subsidiary directly or indirectly holds a participation of >5%, predominantly (>50%) consists of the direct or indirect financing of the shareholder or a related entity or business assets that are used by the shareholder or a related entity, including making the use or right to use of business assets available.

The second deeming rule ensures that subsidiaries predominantly engaged in group financing or intra-group deployment of assets are considered to be held as a passive investment, irrespective of the fact whether the participation is held for a return that exceeds a return that can be expected from normal asset management. This follows from the anti-abuse purpose of the switch-over clause, which is to avoid that groups of companies route income from highly mobile assets to low-tax jurisdictions. From parliamentary history can be derived that the function is determined on the basis of a combination of the nature of the turnover, activities and assets and liabilities attributable to the financing activities and business activities respectively.[14] There is no clear guidance as to when the passive functions are deemed to outweigh the operational functions but it seems that the guidance described in relation to the mixed character above can be used in this respect.

It follows from the above that if a group of companies, for instance, wants to structure its group financing activities through a low-tax jurisdiction, it can mix these activities with activities of operational subsidiaries. Provided that the operational functions outweigh the passive functions, the participation exemption should in such case apply to all the

[12] TK, 2009/2010, 32 129, no. 3, p. 58-60.
[13] TK, 2009/2010, 32 129, no. 8, p. 25-30.
[14] TK, 2009/2010, 32 129, no. 3, p. 60-61.

income from the participation, including the passive income.

If a participation does not satisfy the motive test and is therefore considered to be a portfolio investment, it can still qualify for the participation exemption if the so-called asset test or the low-tax test is satisfied. In practice those tests have the character of a safe harbor. Meeting the motive test, however, provides the taxpayer more flexibility in the sense that the motive should not easily change while under the asset test and the low-tax test certain circumstances can suddenly render the participation exemption inapplicable.

B.1.2. Low-tax test

If the subsidiary is subject to a tax on profits resulting in a realistic level of taxation according to Dutch standards, the low-tax test is satisfied. The low-tax test does not contain any white, grey or black lists. From parliamentary history[15] it is understood that a realistic level of taxation is considered to be an effective tax rate of at least 10%. The low-tax test is only applied at the level of the participation. The level of taxation at any indirect subsidiaries is irrelevant. The tax regime of the country of the subsidiary is considered to result in a realistic level of taxation if the statutory rate is at least 10% and there are no major deviations in the country's tax system compared to the Dutch tax system.

Deviations in tax systems that do not constitute a major deviation are amongst others differences in depreciation on business assets and differences in the possibility to carry-over taxable losses. Differences in tax consolidation regimes, like fiscal unity or group relief are in principle also not considered to be a major deviation (certain exceptions apply).

Deviations in tax systems that are considered to be major deviations are for example tax holidays, fixed deductions (e.g. notional interest deduction), deductible dividends, a participation exemption that is more favorable than the Dutch participation exemption and the absence of interest deduction limitation rules. With respect to interest deduction limitation rules can be noted that the other country does not have to have rules identical to the Dutch rules (see section B.3. below). For example, if the other country has an earnings stripping regime, this should not be a major deviation. As to broader participation exemption rules, we note that if a country applies CFC-legislation to portfolio investment participations, there should generally be no major deviation in this respect.

If it is determined that a participation is established in a country that has a tax system with major deviations from the Dutch tax system, the taxpayer can still meet the low-tax test. In such case, he can demonstrate that the major deviations do not lead to a taxation of less than 10% over a taxable base that is recalculated in accordance with Dutch standards.

B.1.3. Asset test

The background of the asset test is to determine whether a participation directly and indirectly, on an aggregated basis, predominantly (for 50% or more) holds low-taxed portfolio assets. If this is not the case, the participation exemption applies.

Under the asset test, all the assets of the direct and indirect subsidiaries of the participation need to be attributed to the participation in proportion to its direct and

[15] TK, 2009/2010, 32 129, no. 3, p. 61-65.

indirect interests in these subsidiaries. In this exercise, the fair market value of the assets should be taken into account as well as assets that are not on the balance sheet, such as self created goodwill. The assets then have to be categorized as “good” (i.e. not low-taxed free portfolio investments) or “bad” (i.e. low-taxed free portfolio investments) assets. If the total of all assets consist for more than 50% of “good” assets, the asset test is met. The assets (excluding participations) of direct and indirect subsidiaries, which itself on a stand-alone basis hold 30% or less bad assets, can fully be taken into account as “good assets” at the level of the participation.

Portfolio investments can be divided into three categories: ordinary portfolio investments, intercompany loans and business assets that are made available to related entities.

Ordinary portfolio investments are for example bonds, notes, shares and excess cash. Real estate investments are generally not considered to be portfolio investments.[16] Portfolio investments are considered “free” portfolio investments if these investments are not necessarily held in line with the business of the subsidiary. If for example an insurance company has portfolio investments, these investments would not be considered to be “free” portfolio investments, provided that the insurance company holds them to cover its insurance obligations.

Intercompany loans are generally deemed to be free portfolio investments. Business assets are also deemed to be free portfolio investments if these are deployed intra-group. This applies to business equipment as well as to intangibles. Certain exceptions apply to these deeming rules, most importantly if the intra-group loan or business asset provider qualifies as an active group finance / business asset providing company, the intra-group loans and the business assets do not qualify as free portfolio investments.[17]

Assets are only considered to be *low-taxed* free portfolio investments, if the income derived from these assets is not taxed at a realistic level according to Dutch standards. For the asset test the level of taxation is determined *per asset* and not at the corporate level. If, for example, the direct subsidiary is established in a low-tax jurisdiction and does not meet the low-tax test, but an indirect subsidiary derives income from portfolio investments – for example interest on bonds – which is taxed at a realistic level according to Dutch standards, these portfolio investments will not qualify as low-taxed portfolio investments and therefore qualify as “good” assets for the application of the asset test.

It follows from the above system that the asset test provides for the possibility of mixing “good” and “bad” assets to be able to meet the asset test. If for instance a group financing company in a low-tax jurisdiction and one or more operational subsidiaries are held by one common holding company, this holding company can meet the assets test if the good assets outweigh the bad assets. The exempted income from the holding will in such case also include the passive income from the group financing company.

B.1.4 Participation credit – switch-over

If a participation does not satisfy either of the three tests discussed above, the exemption is denied and instead a credit applies for the underlying tax. Since a credit

[16] The argument being that real estate is not mobile and therefore does not bear the risk of transferring it to low-tax jurisdictions.

[17] The strict conditions for qualification as an active group finance or business asset providing company are provided in articles 2a and 2b of the CITA Regulation 1971 (*Uitvoeringsbeschikking vennootschapsbelasting 1971).*

method is very complex and will apply only in a limited number of cases, the credit is for efficiency reasons set at a flat rate of 5%. In case of profit distributions from a EU member state it is possible to apply for a credit of the real underlying tax, instead of the flat rate.

B.2. Taxation of permanent establishments

With respect to profits and losses attributable to foreign permanent establishments ("PEs") of Dutch resident taxpayers, the CITA as of 1 January 2012, contains a full exemption method meaning that such profits and losses, calculated according to Dutch standards, are eliminated from the Dutch taxable base.[18] Mechanically, the Dutch resident taxpayer would have to calculate its worldwide profit according to Dutch standards and subsequently would have to reduce (in case of PE profits) or increase (in case of PE losses) this worldwide profit in order to eliminate the PE profits and losses.

In order to discourage Dutch taxpayers to relocate highly mobile capital to low-taxed jurisdictions, the CITA provides for a switch-over clause in case a low-taxed investment PE is involved. In such case the full exemption does not apply but instead the Dutch resident taxpayer can claim a credit against the Dutch taxation over its worldwide profit if there are PE profits and needs to take into account an add-on to its worldwide profit if there are PE losses. The credit and the add-on are, in principle, fixed at 5/H * the respective overall PE profit or loss (H represents the general statutory Dutch corporate income tax rate; 25% in 2012) but are not applicable if the PE effectively is not subject to tax. With respect to the credit it should furthermore be noted that upon request of the taxpayer the actual profit-based tax paid abroad can be taken into account as the credit but only up to a maximum of – in short – the Dutch corporate income tax attributable to the PE profit.

A PE qualifies as a low-taxed investment PE if its activities consist for more than 50% of investing, passive intra-group financing or passive intra-group deployment of assets (activity test) and it is not subject to a reasonable taxation according to Dutch standards (low-tax test). When determining the PEs activities, the activities of entities in which the taxpayer has an interest of at least 5%, and which interests are attributable to the PE, should on a pro rate basis be attributed to the PE. The assessment of the relative weight and the character of the PE's activities has not been further elaborated on in parliamentary history but it seems that in this respect one may derive guidance from the parliamentary history to article 13 CITA (meaning that one should look at a combination of the nature of the turnover, profit, activities and assets of the PE). In line with the aim of the switch-over clause, activities consisting of investing in real estate, in principle, do not qualify as investment activities since real estate is not highly mobile capital.[19] For guidance on the low-tax test, parliamentary history refers to article 13 CITA.

The switch-over clause discussed above has been included in the CITA as at 1 January 2012. It is, however, long-standing policy of the Netherlands to apply a switch-over clause to passive PEs. Although in a slightly different form, since 1989, such switch-over clause was already included in the Dutch Unilateral Decree for the Avoidance of Double Taxation.

B.3. Intra-group interest deduction limitation rules

[18] Until 1 January 2012, the Netherlands applied a tax exemption method in relation to profits and losses attributable to PEs. Under that system, the Dutch resident taxpayer was able to use PE losses to reduce its taxable base in the Netherlands (subject to a subsequent recapture once the PE became profitable).

[19] This exception does not apply to real estate owned by a Dutch fiscal or exempt investment institution of which the shares are attributable to a PE of a Dutch taxpayer.

In this paragraph we will briefly discuss the Dutch interest deduction limitation rules designed to target the deductibility of intra-group interest (articles 10a and 10d CITA) as well as the excessive participation interest deduction limitation rule, which contains an interesting exception in case of operational activities (article 13l CITA). We will not deal with the excessive acquisition interest deduction limitation rule (article 15ad CITA), the re-qualification of debt into equity rules (article 10(1)(d) CITA) and the deduction limitation related to intra-group loans with a term exceeding 10 years bearing no interest or an interest that is at least 30% below an arm's length interest (article 10b CITA). The latter provisions are not or to a lesser extent relevant to the subject matter of this IFA report.

B.3.1. Base erosion (article 10a CITA)

Article 10a CITA is aimed at certain intra-group base erosion transactions, whereby the fact whether or not the group company receiving the interest is in a low-tax jurisdiction is an important element. Article 10a CITA provides that interest - including costs and currency exchange results - in respect of borrowings legally or in substance directly or indirectly owed to a related entity is not deductible to the extent the borrowing relates to one of the following transactions:

(i) a distribution of profit or a repayment of paid-up share capital by the taxpayer/debtor or a related entity (that is subject to Dutch corporate income tax) to a related entity/individual;
(ii) a capital contribution by the taxpayer/debtor, a related entity (that is subject to Dutch corporate income tax) or a related individual (who is a Dutch tax resident) to a related entity;
(iii) the acquisition or increase of an interest, by the taxpayer/debtor or a related entity (that is subject to Dutch corporate income tax) or related individual (who is a Dutch tax resident), in an entity that after such acquisition or increase qualifies as a related entity.

The interest deduction limitation rule does not apply if the taxpayer demonstrates that there are predominantly valid business reasons underlying the debt and the transactions. If the interest income in the hands of the recipient is taxed at a reasonable levy according to Dutch standards, the tax authorities have the burden of proof that (i) the taxpayer did not have predominantly valid business reasons for entering into the transaction or for funding the transactions with debt, or (ii) the debt is created in order to benefit from anticipated tax losses.

These rules are partly a codification of the *fraus legis* case law of the Supreme Court discussed under paragraph A above, and partly an expansion thereof. An important difference in relation to the *fraus legis* doctrine is that under this doctrine, the deduction of interest paid to a group company in a non-low-tax jurisdiction, in principle, was not limited (safe haven). Under the current article 10a CITA, the fact that the group company receiving the interest is in a non-low-tax jurisdiction does not necessarily render the interest deductible. It only shifts the burden of proof as to the motives for the debt and the transactions back to the tax inspector.

B.3.2. Thin capitalization (article 10d CITA)

The Dutch thin capitalization rules are specifically aimed at limiting the deductibility of interest on loans from related entities (the rule is aimed to target the shift of taxable base within groups of companies).[20] For purposes of this limitation it is not relevant whether the related entity receiving the interest is based in a low-tax or non-low-tax jurisdiction (even if the recipient is a Dutch related entity, the limitation could apply, clearly resulting in double taxation). In short, the thin capitalization rules establish that interest on excessive debt is not deductible whereby the question whether there is excessive debt needs to be answered by applying, at the option of the taxpayer, either a fixed debt/equity ratio of 3:1 or a consolidated group ratio test. The amount of non-deductible interest due to the application of the thin capitalization rules is capped at the balance of interest paid on loans that are directly or indirectly due to related entities and the interest received on loan receivables to such entities.[21]

B.3.3. Excessive participation financing (article 13l CITA)

As at 1 January 2013, rules were introduced in the CITA limiting the deduction of interest on excessive participation debt. These rules are not so much related to curbing deduction of intra-group interest but apply to both intra-group interest and third party interest. They are the result of a heavy debate in the Netherlands on the so-called Bosal-interest (named after the decision of the European Court of Justice ("ECJ") of 18 September 2003[22]). Bosal interest, in short, is interest on debt that is used to finance exempt participations. The profit derived from such participations is exempt while the interest on the debt used to finance these participations, in principle, is deductible (unless interest deduction limitations apply). To a certain extent, this mismatch was deemed undesirable, ultimately leading to the mathematical rule laid down in article 13l CITA, which in principle curbs the deductibility of interest on excessive participation debt. There is excessive participation debt if the acquisition price (including e.g. subsequent capital contributions) of the exempt participations held by the taxpayer exceeds the taxpayer's equity for tax purposes. The non-deductible interest is calculated as the (excessive participation debt / total debt) * interest on the total debt.

Without discussing further details of these rules, we note that there are two aspects of the rules that are relevant to the subject matter of this country report. Firstly, the rules provide for an exception – subject to certain other conditions - in case the debt is used to finance the acquisition or capitalization of a participation and such acquisition or capitalization qualifies as an expansion of the operational activities of the taxpayer and the group of companies of which it forms part (in such case the acquisition price of the exempt participations is lowered). It follows from this aspect of article 13l CITA that it is primarily aimed at curbing deduction of interest on (external) debt that is used to finance an exempt participation's passive activities. Secondly, the rules contain leniency for taxpayers that are engaged in active group financing activities. In short, debt related to receivables held within the group resulting from active group financing activities, can be taken out of the mathematical equation. In parliamentary history cash pool activities are mentioned as an example of active group financing activities, provided that a cash pool contract has been concluded between the group companies.

B.4 Article 13a participations

The Netherlands does not have CFC-legislation as it is generally defined. The legislator has explicitly stated that the Netherlands does not opt for CFC-legislation, since that would have a negative effect on the image of the Netherlands as a favorable jurisdiction

[20] TK, 2003/2004, 29 210, no. 8, p. 10.
[21] For this purpose the interest component of rentals and rental payments under finance leases should also be taken into account.
[22] ECJ, 18 September 2003, C-168/01.

for structuring cross-border investments.[23] The Netherlands does, however, have an anti-abuse rule that has much resemblance to CFC-legislation. This anti-abuse rule is incorporated in article 13a CITA and is closely related to article 13 CITA.

According to article 13a CITA the shares of a company in which the company has an interest of at least 25% have to be annually valued at fair market value if:

- the assets of this subsidiary consist almost exclusively (90% or more), directly or indirectly, of low-taxed free portfolio investments, and
- the subsidiary is not subject to tax on profits resulting in a realistic level of taxation for Dutch tax purposes.

It follows that article 13a CITA does not attribute and tax the income of the CFC at the domestic company, but instead prescribes an annual revaluation of the interest in certain entities at fair market value. The increase or decrease of the value of the shares will annually be included in the taxable base of the domestic company as income from a participation. The participation exemption will not apply to this profit (gain or loss), since the subsidiary qualifies as a passive investment participation. The revaluation profit under article 13a CITA does not only include the realized but also the unrealized profits of the subsidiary and can thus in its effect be more extensive than CFC-regulations. The Dutch company can apply a flat rate credit of 5% for the underlying tax.

The scope of the anti-abuse rule is limited. It only applies to cases where it is obvious that passive income is routed to low-tax jurisdictions. It was expected that it will not be applied in a large number of cases and in our experience has not been applied much in practice until now. The provision obviously does have a preventive effect against domestic taxpayers routing their passive income to low-tax jurisdictions. As a final note, again, the application of this anti-abuse provision can be avoided by mixing passive and active subsidiaries or assets.

B.5. Intellectual property and group financing related observations

B.5.1. Measures to discourage taxpayers to transfer intellectual property or group financing activities out of the Netherlands

The Netherlands does not have specific regulations to prevent the relocation of intellectual property (“IP”) or group financing to low-tax jurisdictions. However, the general rules provide certain instruments to target the transfer or location of intangibles or group financing in low-tax jurisdictions. In this respect, we note the following three instruments:

1. Denying the application of the participation exemption on the income of company that is entitled to the income of the IP or group financing (we refer to paragraph B.1.3 above).
2. Targeting the residence of the local company that is entitled to the income of the IP or group financing (residence in the Netherlands) or assessing a PE of the local company in the Netherlands to which the IP or the group receivables are attributable.
3. Targeting the transfer price of IP.

Sub 2. In general, the chance of success with this instrument depends on the actual local substance of the company owning the IP or intra-group receivables and on whether any advice and instructions from the Dutch head office are in line with group policies and

[23] TK, 2005/2006, 30 572, no. 3, p. 14.

directives that are normal within multinational groups of companies.[24]

Sub 3. Especially in relation to the relocation of intangibles to tax havens, the arm's length principle is often used to challenge the transfer price and/or the relocation itself. For intangibles it can be very difficult to determine the value at the moment of the transfer, because the future income and risks can be highly uncertain. Discussions on the transfer price therefore often evolve around valuation and the possibility of including a price adjustment clause (the use of which is confirmed in the Decree of the Underminister of Finance of 30 March 2001, with reference to the (current) paragraphs 6.28-6.35 of the OECD Guidelines).[25] With respect to sale-and-license-back transactions, a price adjustment clause is generally deemed to be at arm's length, unless the taxpayer demonstrates otherwise (shift of burden of proof to the taxpayer).

As to challenging the relocation of IP itself, the Dutch tax authorities support the view that under circumstances the legal transfer of the IP can be ignored for tax purposes (substance over form). This will generally be the case if the local company has no control over the risks associated with the IP and/or does not have the financial capacity to bear the risk. The OECD Guidelines in such a case recognize the possibility to ignore the transaction. Reference is made to paragraph 1.65, to the cross references in chapter 9 on business restructurings (paragraph D.2) and to the discussion draft on the revision of chapter 6 of the Guidelines.

B.5.2. The Dutch innovation box regime

In addition to the 'defensive' measures to prevent the relocation of Dutch-based IP to low-tax jurisdictions, the Netherlands has introduced a tax incentive that, *inter alia*, contributes to the same result, i.e. the Dutch innovation box regime. Under the Dutch innovation box regime – in short – benefits arising from self-developed patents and qualifying IP (trademarks and brands do not qualify), in principle, are subject to an effective tax rate of 5%. The main aim of the innovation box is to attract R&D activities and resulting IP to the Netherlands and to prevent companies to transfer their R&D activities and the resulting IP abroad. In essence, the innovation box cannot be seen as a measure to attract passive intra-group IP income to the Netherlands but more as a measure to attract actual 'active' R&D activities. However, obviously, once the R&D activities result in IP, such IP would generally lead to generation of (intra-group) passive royalty streams into the Netherlands. These royalties can, in principle, benefit from the 5% rate.

C. CFC legislation

The Netherlands has not incorporated CFC rules in its tax legislation. There is a measure that has much resemblance to CFC legislation, This measure is linked to the participation exemption and has consequently been discussed in section B above.

D. General tax treaty issues

D.1. General

In general, we note that the Supreme Court is reluctant to apply domestic anti-avoidance rules under tax treaties. In this respect, the Supreme Court ascribes great importance to the intentions of the treaty partners when concluding the treaty, as evidenced by the treaty text

[24] E.g. Supreme Court, 14 October 2005, 41 050, BNB 2006/79.
[25] Decree of the Underminister of Finance of 30 March 2001, IFZ 2001/295M, paragraph 5. This Decree has been updated in the Decree of 21 August 2004, IFZ 2004/680M.

and the explanatory notes, as well as to the good faith towards treaty partner that should be observed when applying tax treaties.[26] Partly due to this case law of the Supreme Court, the Netherlands has made an observation to the 2003 OECD Commentary to article 1 OECD Model Convention ("MC") indicating that the Dutch position is that treaty effect of anti-abuse measures should be achieved by making the appropriate arrangements in the tax treaties itself.

With respect to the specific Dutch rules relating to or influencing the taxation of foreign passive income within group of companies, as discussed under B. above, we feel that application of the rules regarding the participation exemption/participation credit (articles 13 and 23a CITA) and the annual revaluation of certain low-taxed investment participations (article 13a CITA) should generally not lead to tax treaty issues. Articles 13, 13a and 23a CITA contain Dutch domestic rules for the taxation of income and realized and unrealized capital gains from a qualifying shareholding (participation) held by Dutch resident taxpayers and foreign taxpayers that have a Dutch permanent establishment to which the participation can be attributed. In these circumstances, tax treaties generally allocate the taxation rights over the income and capital gains from the participation to the Netherlands (pursuant to articles 7, 10 and 13 MC) without prescribing how the Netherlands should tax such income and capital gains under its domestic law (e.g. exemption vs. credit).[27]

As to the switch-over from the exemption method to the credit method in case of a passive investment permanent establishment (article 15e CITA), it can be noted that there will be no such switch-over if the relevant tax treaty only provides for an exemption for profits attributable to a permanent establishment.[28] This provision, consequently, seems in line with tax treaties.

The Dutch interest deduction limitation rules (articles 10a, 10d and 13l CITA) will be discussed in paragraph D.2. below.

D.2. Dutch interest deduction limitation rules

D.2.1. Articles 10a and 13l CITA

We feel that articles 10a and 13l CITA are not contrary to articles 7 and 11 MC. Articles 7 and 11 MC attribute taxation rights with respect to interest income at the level of a creditor to Contracting States but do not provide rules for determining a tax liability or determining interest deductibility at the level of the debtor. In other words, articles 10a and 13l CITA determine the facts which give rise to a tax liability (i.e. the facts which give rise to a deduction limitation), and as such should not be affected by tax treaties.[29] We note that there is some debate on whether article 10a CITA may not be in accordance with article 9 MC.[30] In this respect, we feel however that article 10a CITA is not about correcting non-arm's length

[26] E.g., Supreme Court, 5 September 2009, 37 651, BNB 2003/379 and Supreme Court, 14 June 2009, 44 050, BNB 2009/264.
[27] One notable exception to this are shareholdings in foreign real estate companies. Under certain tax treaties the taxation rights over capital gains from such shareholdings are attributed to the source country. In such case, an unlimited application of articles 13a and 23a CITA would in principle be contrary to these tax treaties. It is, *inter alia*, for this reason that real estate companies are deemed not to be regarded as low-taxed investment participations and consequently article 13a and 23a do not apply to participations in these kind of companies.
[28] Currently, it is Dutch tax treaty policy to grant double taxation relief in relation to passive permanent establishments based on the credit method. However, certain older treaties contain an exemption for all permanent establishments.
[29] E.g., Peters, F.G.F. and Roelofsen, A., IFA Cahiers 2010, 95a Tax Treaties and Tax Avoidance, Application of Anti-Avoidance Provisions, p. 567.
[30] E.g., De Hosson, F.C., in WFR 2011/1258.

conditions.[31] In light of this, it seems difficult to argue non-application of article 10a CITA based on article 9 MC.

D.2.2. Thin capitalization (article 10d CITA)

In the Netherlands, the discussion on whether the Dutch thin capitalization rules are in conformity with the arm's length provision in tax treaties (article 9 MC) is currently topical. The core of the matter, in short, is whether the arm's length provision requires that thin capitalization rules are not applied to interest incurred on intra-group loans of which the conditions are in accordance with the arm's length principle.

A case on the subject matter is currently with the Supreme Court.[32] The case involves a Dutch BV, who was denied deduction of intra-group interest on loans taken up from related French, German and Portuguese group companies under the thin capitalization rules. Dutch BV challenged the deduction limitation, in short, based on paragraph 3 of the OECD Commentary to article 9 MC and, with respect to Portugal, based on article X of the protocol to the tax treaty with Portugal.[33]

The Haarlem Court of First Instance dismissed Dutch BV's appeal, *inter alia*, based on the following arguments: (i) paragraph 3 of the Commentary was introduced after the treaties with Germany and France were concluded and consequently has limited meaning for interpreting these treaties; (ii) paragraph 3 of the Commentary leaves room to re-qualify interest payments and the Dutch thin capitalization rules lead to such re-qualification; (iii) the arm's length principle is not suitable to be applied to thin capitalization rules since these rules relate to the capital structure as a whole instead of separate loans; and (iv) with respect to article X of the protocol of the tax treaty with Portugal: the contracting states have not intended to test all thin capitalization rules against the arm's length principle.

In his opinion to the case, Advocate-General Wattel generally follows the Dutch Court of First Instance in relation to Germany and France. However, with respect to Portugal, Wattel opines in favor of Dutch BV based on (i) the conformity with article 9 MC; (ii) paragraph 3 of the Commentary to article 9 MC, which was introduced before conclusion of the Netherlands-Portugal tax treaty and to which the Netherlands has not submitted a reservation; and (iii) the text of article X of the protocol. According to Wattel, Dutch BV should be enabled to demonstrate the arm's length character of the loans to ensure deductibility in relation to the Portuguese loan. Based on Wattel's conclusion in respect of Portugal, Dutch taxpayers, which have taken up loans under arm's length conditions from group companies in countries that have a tax treaty with the Netherlands that is concluded after 1992 and that contains an OECD conform article 9, may successfully argue that the thin capitalization rules should not apply in respect of such loans. It will obviously be very interesting to see how the Supreme Court will rule on the issue.

E. EU law observations

E.1. Conformity with EU law

In this paragraph, we will elaborate on certain EU aspects of the specific anti-avoidance rules that were discussed in section B above.

[31] E.g. Marres, O.C.R., *Winstdrainage door renteaftrek*, Kluwer, Deventer, 2008, p. 273.
[32] Conclusion of Advocate-General Wattel, P.J., to Supreme Court, 10/05268, VN 2012/6.13.
[33] Article X in relevant part reads as follows: "(…) the provisions of the Convention shall not be interpreted so as to prevent the application by a Contracting State of the thin capitalization provisions provided for in its domestic law, except in those cases in which the associated enterprises can show that (…) the conditions made or imposed between those enterprises are in conformity with the arm's length principle."

E.1.1. Participation credit – switch-over

In relation to the switch-over clause for low-taxed investment participations, one could argue that such switch-over infringes the freedoms of establishment or capital because establishing or investing in a Dutch resident participation would get a different treatment (i.e. exemption) than the establishment of or the investment in certain foreign participations (i.e. credit), which different treatment cannot be justified. The essence of this argument is that Dutch resident participations will generally be subject to a profit-based tax which is reasonable according to Dutch standards, while foreign resident participations may not so easily meet this low-tax test.[34]

In our view, however, based on case law of the ECJ, the above reasoning in principle does not hold. In this respect, we point at *Test Claimants in the FII Group Litigation*,[35] *Columbus Container Services*[36] and *Haribo & Salinen*.[37] From these cases can be inferred that, although a switch-over system in principle impedes the freedoms of establishment or capital (worse treatment of foreign participations over domestic participations), such impediment is justifiable. This is because an exemption system and a credit system should according to the ECJ be seen as equivalent in view of the aim to avoid economic double taxation, if under the applicable credit system the taxpayer is enabled to credit all underlying tax (up to the amount of tax attributable to the income at the level of the taxpayer).[38] As the latter is the case in respect of the participation credit, we feel that the switch-over in case of low-taxed investment participations should generally be in accordance with EU law.[39]

E.1.2. Article 13a participations

With respect to the mark-to-market obligation in case of certain low-taxed investment participations, one may argue that this entails an infringement of the freedoms of establishment or capital as arguably holders of foreign participations would in effect, although maybe justifiably, disproportionally be treated worse than holders of Dutch participations (due to the low-tax requirement that would generally be met in case of Dutch participations). In literature, there are authors that support this view.[40] However, there are also authors that support the view that article 13a CITA does not distinguish between domestic and foreign situations as it applies to both Dutch and foreign participations and consequently is not in breach of the freedom of establishment or capital.[41]

If one would take the hurdle that article 13a CITA under certain circumstances effectively treats holders of foreign participations worse than holders of Dutch participations, one might argue that such treatment is justifiable as article 13a CITA is aimed at preventing abuse through moving highly mobile capital assets to low-tax jurisdictions. However, in

[34] E.g., Kiekebeld, B.J., Merks, P.F.E.M., and Smit, D.S., WFR 2007/129.
[35] ECJ, 12 December 2006, C-446/04.
[36] ECJ, 6 December 2007, C-298/05.
[37] ECJ, 10 February 2011, C-436/08 & C-437/08.
[38] We refer to paragraphs 86 and 89 of the ECJ ruling in Haribo & Salinen. As to the equivalence of exemption and credit systems, Wattel is critical in his note to Haribo & Salinen in BNB 2011/165.
[39] The fact that the ability to credit all underlying tax (up to the amount of tax attributable to the income at the level of the taxpayer) is limited to profit distributions and does not apply in case of capital gains, may raise questions as to the compatibility with the EU freedoms. (see*, inter alia*, Hofman, A.W., *De deelnemingsverrekening*, Kluwer, Deventer, 2011, p. 68).
[40] E.g., Van der Vegt, P.C., WFR 2009/761.
[41] E.g., Albert, P.G.H., *Deelnemingsvrijstelling*¸ SDU, Den Haag, 2010, paragraph 6.5.

light of the ECJ case *Cadbury Scheppes*,[42] it seems that such argument would not be very strong since article 13a CITA affects more than only 'wholly artificial structures' and consequently may be regarded to be disproportional. After all, a participation established in a low-taxed jurisdiction that solely holds investments but that has real substance should generally not be regarded to be a wholly artificial structure.

E.1.3. Base erosion (article 10a CITA)

The conformity of article 10a CITA to the EU freedoms of establishment and capital has been the subject of debate in tax literature and of a couple of Dutch domestic court cases. Most important questions that are raised are whether (i) the compensating levy test in effect leads to an obstruction of the freedoms of establishment or capital; and (ii) article 10a CITA can be justified by pointing at the anti-abuse character thereof and is proportionate to its aim.

With respect to the compensating levy test, the Amsterdam Court of Appeal has ruled that this test in effect means that article 10a CITA[43] mainly affects cross-border situations and consequently, in principle, obstructs the freedom of establishment. This view was followed by Advocate-General Niessen in his opinion to this case.[44] It is also the leading view in tax literature, although one might derive support for another view from the ruling of the Supreme Court in a *fraus legis* case of 23 January 2004, 38 258, BNB 2004/142.[45]

Assuming that the compensating levy element of article 10a CITA in principle obstructs the freedom of establishment, one should investigate whether article 10a CITA is proportionate in light of its aim of preventing base erosion through economically artificial transactions with low-taxed creditors. In this respect, the Amsterdam Court of Appeals and Advocate-General Niessen take the view that article 10a CITA in general aims to target tax avoidance schemes (meeting the objective test) and that the ability for the taxpayer to demonstrate that there is no tax avoidance scheme is sufficiently specific (meeting the subjective test) and proportionate to this aim (*Test Claimants in the Thin Cap Group Litigation*[46]). With respect to proportionality, it is furthermore noted that deduction of the full interest amount can be denied without taking taxation in the hands of the creditor into account as proportionality does not entail that treatment in another state should be taken into account (*Test Claimants in the Thin Cap Group Litigation*). We note that in literature, however, it has been observed that the fact that situations whereby business motives are involved (although not predominant), can be targeted by article 10a CITA, may be a disproportional aspect of article 10a CITA (since in such case arguably there would be no economically artificial transaction). In addition, one may wonder whether

[42] ECJ, 12 September 2006, C-196/04.

[43] This case law regards the application of a version of article 10a CITA that still contained a safe haven for compensating levy situations (instead of a shift in burden of proof as currently is the case). We feel, however, that (the lack of) a shift in burden of proof may also constitute an obstruction of the EU freedoms.

[44] Supreme Court, 22 December 2011, CPG 11/00675, VN 2012/11.14.

[45] In this case the Supreme Court has held that meeting the compensating levy test makes sure that the transaction does not qualify as tax evasion. Not meeting the compensating levy test meant tax evasion and according to the Supreme Court, targeting tax evasion does not need any other justification than the assessment that there is tax evasion. It remains unclear whether the Supreme Court has based its ruling on the view that abusers cannot use the EU freedoms or on the view that targeting abuse is a justification for impediments of the EU freedoms. In a recent case before the Supreme Court (1 June 2012, 11/00009, BNB 2012/213), *inter alia*, the same issue was at stake but in its judgment the Supreme Court did not clarify on which of these two views it was based.

[46] ECJ, 13 March 2007, C-524/04

the transactions stipulated in article 10a(1)(c) CITA, can generally be regarded to be economically artificial and consequently whether it is proportionate in such case to shift the burden of proof of business reasons to the taxpayer if there is a lack of compensating levy.[47]

All in all, although there are some uncertainties. it seems that based on *Test Claimants in the Thin Cap Group Litigation*, article 10a CITA generally should be regarded to be in accordance with EU law. It will be interesting to see the Supreme Court's ruling on this matter in the case currently before the Supreme Court.

E.1.4. Thin capitalization (article 10d CITA)

As to the Dutch thin capitalization rule, it can be noted that this rule in principle does not distinguish between domestic and cross-border situations. However, a much debated position has been that the thin capitalization rule is not in accordance with the freedoms of establishment or capital due to the fact that in a domestic situation its consequences can be avoided by forming a Dutch fiscal unity while such fiscal unity cannot be formed in cross-border situations. After the ECJ ruling in *X Holding,*[48] in which the denial of a cross-border fiscal unity was judged not to breach the EU freedoms, the Supreme Court ruled in 24 June 2011, 09/05115, BNB 2011/244 that a difference in treatment resulting from the inability to form a cross-border fiscal unity is justified and proportional if such difference follows from the nature of the fiscal unity. It may well be that on this basis, the Supreme Court in BNB 2012/27[49] has subsequently judged that the thin capitalization rule is not in breach of the EU freedoms (although in the judgment this is not explicitly stated by the Supreme Court).

The above-discussed case law does, however, not necessarily mean that the thin capitalization rule is now fine from a primary EU law point of view. In this respect, one could argue that the thin capitalization rule distinguishes based on the (legal) form of establishment. The argument being that a foreign entity, which would establish itself in the Netherlands through a PE, to which external financing would be attributable, does not fall under the thin capitalization rule while a Dutch subsidiary of a foreign entity that on-lends external funds to its Dutch subsidiary does. If one would accept this comparison between a foreign entity's Dutch PE and Dutch subsidiary (which could be based on *CLT-UFA SA*[50]), one would have to assess whether the different treatment is justifiable in light of the aim of the rule and if so, whether it is proportional to such aim. The thin capitalization rule aims to target the shift of taxable base within groups of companies In this respect, it may be inferred from *Test Claimants in the Thin Cap Group Litigation* that targeting artificial shifts of taxable base can form a justification and that such targeting is proportional if it respects the arm's length principle. Especially given the reference to the arm's length principle, it may well be that based on *Test Claimants in the Thin Cap Group Litigation,* the general character of the thin capitalization rule and the lack of the ability to prove the arm's length character of the internal loan, may lead to the conclusion that the thin capitalization rule is disproportional and not in accordance with EU law (assuming the comparison between a PE and a subsidiary holds true).

In addition to the above, it is worthwhile noting that the conformity of the thin capitalization rule to the EU Interest and Royalty Directive has been subject to debate in

[47] Based on ECJ, 5 July 2012, C-318 (SIAT), one might argue that the presumption of abuse in case of lack of compensating levy is too general.
[48] ECJ, 25 February 2010, C-337/08.
[49] Supreme Court, 18 November 2011, 10/01719, BNB 2012/27.
[50] ECJ, 23 February 2006, C-253/03. Reference is also made to the Conclusion of Advocate-General Kokott, ECJ, 19 April 2012, C-18/11 (Philips Electronics).

tax literature. However, in view of the ECJ judgment in *Scheuten-Solar,*[51] this issue has in our view been decided in favor of the thin capitalization rule.

E.2. EU law impact on Dutch approach to taxation of foreign passive income for groups of companies

Following the discussions on harmful tax competition in the OECD and the report of the EU Code of Conduct Group of 23 November 1999 (Primarolo report), the Netherlands made some adjustments to its legislation affecting the taxation of intra-group passive income. Firstly, article 8c CITA was introduced, providing special rules for intra-group finance companies/interest or royalty flow trough companies established in the Netherlands. If such a company does not bear real economic risks, the interest and/or royalties received and paid are not included in the taxable base and the withholding taxes are consequently not creditable in The Netherlands. In addition, the Dutch ruling practice relating to such companies was amended (tailor-made solutions instead of standardized rulings).

Furthermore, the Dutch preferential regime for companies engaged in international finance activities (CFA-regime) was listed as one of the 66 harmful tax regimes in the Primarolo report and was considered state aid. In light of this, the CFA-regime has been terminated on 15 September 2005 with retroactive effect until 11 July 2001. The aim of the CFA-regime was to prevent internationally operating Dutch companies to transfer their group financing activities abroad. As an alternative, on 1 January 2007, an optional group interest box was introduced in the CITA with the same aim. In short, under this regime, taxpayers could opt for taxation on intra-group debt and intra-group receivables at a rate of 5%. The optional group interest box was introduced under the condition that it would be approved by the European Commission as not constituting state aid. In 2009, the European Commission decided that the group interest box did not constitute state aid provided that certain elements would be amended, most importantly, the optional element had to be eliminated. Ultimately, at the end of 2009 the Dutch government decided not to move forward with an obligatory group interest box in view of adverse effects for certain groups of taxpayers. It seems fair to conclude that EU rules have prevented the Netherlands to introduce the desired measures to keep and attract intra-group financing activities.

[51] ECJ, 21 July 2011, C-397/09.