UNOFFICIAL, UNAUTHORISED TRANSLATION OF THE GENERAL NOTES TO THE PROPOSED CHANGE OF DUTCH CORPORATE INCOME TAX REGULATION, WCICH ARE SUBJECT TO CONSULTATION

POSSIBLE MODIFICATIONS IN THE CORPORATE INCOME TAX

GENERAL NOTES

1. Introduction

The letter of 15 December 2008 on the distribution of the corporate income tax burden and interest problems indicated that in principle, internationally operating companies have the possibility to influence the distribution of profit over different states in which they are located through allocation of their business activities and their assets and liabilities. For financial assets and liabilities, which are relatively easy to move, this is easier than for tangible assets or "real activities". Through the allocation of group claims or group debt, internationally operating companies can take advantage of the effective tax rate differences that exist among different countries. They may choose to conduct their internal financing activities from a low-tax jurisdiction, where the received group interest is taxed against a low effective rate. The interest paid is then charged against the tax base of the active group companies in countries with a higher tax rate.

Further, acquisitions by Dutch companies are largely financed with debt (group and third loans). This results primarily from commercial considerations (leverage effect). The difference in fiscal treatment reinforces the leverage effect: the costs of debt (interest payments) are deductible, the costs of equity (dividends) are not. Additionally, group loans can be used to finance risks which are too high for third parties like banks. The corresponding deduction of interest is then charged against the fiscal profit of the acquired company. Here too, the differences in effective rates play a role, especially when group interest is involved. Like many other countries, the Netherlands has therefore restricted the possibilities to deduct interest in order to reduce the fiscal consequences of free allocation of debt for the revenue and distribution of corporate tax.

Another point mentioned in the letter, involves the existing imbalance in the fiscal treatment of foreign participations. In the Netherlands revenue from those participations is often exempted through the participation exemption. This participation exemption aims at preventing double taxation. The profits of the subsidiary are indeed already taxed abroad. The interest costs associated with the acquisition of the participation, after the so-called Bosal Case of the EU Court of Justice, however, are deductible. This creates a 'mismatch': costs may be charged to the Dutch base, while the related revenues are exempted in the Netherlands. The consequences of this mismatch are reinforced by the differences in effective tax rates.

Possible measures to reduce this imbalance were considered. This document is an elaboration of such measures. For the interest issue this involves two measures: a. a mandatory group interest box and b. a separate restriction of the deduction of (group and third party) interest. For the separate restrictions on interest deductions, the document includes two alternatives:
• two specific restrictions on interest deductions, namely a restriction for participation interest and a measure that ensures excessive interest payments associated with take-overs are in principle not deductible from the profits of the of acquired company.
• A general restriction on interest deduction, namely an earnings stripping measure.
In addition, a relaxation of the regime of lowly taxed investment participation is included.

The effect of these measures only affects the structural design of the various measures. How to deal with existing situations, has yet been disregarded. That issue deserves attention, but will be dealt with after the discussion on structural measures. Furthermore, possible effects to other provisions in the law have only to a limited extent been taken into account. Finally, the question is whether both variants included for separate interest deduction will be adequate in all cases to limit excessive interest deduction as a result of acquisitions. It is important to balance the possibilities for interest to be deducted in case of a real financed takeovers, without losing the tax revenue of (normal) performing companies as a result of excessive interest deduction.

2. Compulsory group interest box
The difference in fiscal treatment of equity and debt partly causes arbitrage in financing within groups. With a mandatory group interest box, meaning that both received and paid group interest is taken into account at a moderate rate (5%), a more equal treatment of group interest and group dividends will be achieved. Fully removing group interest from the fiscal regime, as suggested by three professors in the Weekblad Fiscaal Recht (WFR 2008/891), is not included. The main reason is that there is a real chance that other countries will consider counter measures would the Netherlands not be taxing group interest received from abroad at all.

The starting point of the regulation is that incoming and outgoing group interest, together with income from maintaining an acquisition reserve, will to a limited extent be included in the tax base. Because the interest rate fluctuates according to the debtor- and currency risks, the scheme also applies to value adjustments in group loans and acquisition reserves and to the results on interest rate and currency hedging instruments. Lease and rental payments within groups are covered by the scheme for the financing component in those amounts. A group loan is classified as third loan, in case the group creditor has borrowed externally.

To prevent that the difference in tax treatment of group interest and external interest results in a new form of arbitrage, a provision has been included that prevents that group claims are created artificially by transferring assets within the group against debt recognition. The definition of group seeks to adhere as much as possible to the commercial criteria under which a group of bodies is required to prepare consolidated accounts. The mandatory group interest box and the separate interest deduction restrictions interact. This has been taken into account in those separate deduction restrictions.

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**UNOFFICIAL, UNAUTHORISED TRANSLATION
OF THE SUGGESTED CLAUSES FOR A PROPOSED CHANGE OF REGULATION REGARDING THE 'GROUP INTEREST BOX', WHICH ARE SUBJECT TO CONSULTATION AND THE EXPLANATORY NOTES**

Article 12c

1. To determine the profit of a year, the following will be taken into account for the 5/H part:

a. interest and costs in respect of money loans to an affiliated body as well as the costs and benefits in respect of acts which serve to hedge the interest rate or currency risks related to that money loans;

b. the revenue and cost of short-term investments, where it is plausible that they are used for the acquisition of holdings on which the participation exemption may apply, as well as the costs and benefits in respect of acts which serve to hedge the interest rate or currency risks on these investments;

c. the interest and costs in respect of money loans directly or indirectly due to a affiliated body and the costs and benefits in respect of acts which serve to hedge the interest rate or currency risks with respect to those money loans;

d. the value changes of money loans as referred to in components a and c, and the investments as referred to in part b.

Here H indicates the percentage of the highest rate, as meant in Article 22, applicable for the relevant year.

2. For the purposes of this Article, a body affiliated with the tax payer is understood as:

a. a body over which the tax payer has control;
b. a body that has control over the tax payer;
c. a third body controlled by a third party, while this third party also has control over the person liable to tax.

Control privileges of a cooperating group of bodies or natural persons will be attributed to all

members of the cooperative group. The tax payer who wants security about the answer to the question whether in his case there is a cooperating group, may apply to the inspector, who then decides, and who's decision is subject to administrative appeal.

3. For the purposes of this article:

a. a money loan is understood as a claim or debt arising from a contract of loan or a similar agreement;

b. interest and costs in respect of money or directly or indirectly due to a affiliated body also include the financing component of compensation for providing tangible fixed assets [property, plant and equipment] of an affiliated body;

c. interest and costs in respect of money loans to a affiliated body also include fees and expenses received in respect of money loans granted under such conditions that they actually function as equity of the affiliated body;

d. Value changes in the sense of the first paragraph, part d, also include value changes for the loans referred to in part c.

4. The first paragraph shall not apply with respect to interest and costs for a loan to an affiliated body to the extent that that money loan directly or indirectly relates to the transfer of assets to a related entity, unless the tax payer can show that business considerations formed the main reason for the loan and the related transfer.

The first sentence shall not apply to the transfer of shares on which the participation exemption applies and of assets that exclusively generate revenues on which the first paragraph applies.

5. The first paragraph shall not apply with respect to interest and costs for a money loan due to an affiliated body for as far as that money loan is directly related to a money loan by an affiliated body that is due to an unrelated body.

6. For the purposes of the first paragraph a money loan that is due to an unrelated body or a natural person will be counted as a loan due to an affiliated body, for as far as it is plausible that the funds derived from the loan relate to obtaining revenue on which the first paragraph applies.

7. By or pursuant to administrative arrangements further regulation, including additional conditions, can be adopted for the purposes of this article. Rules may be adopted, too, for the determination of what portion of the tax that was raised by another tax authority over the benefits which fall under this article, on the basis of arrangements to prevent double taxation, can be offset against the due corporation tax.

EXPLANATORY NOTES

Article 12c

The general introduction already indicated that the fiscally different treatment of equity and debt is one of the causes of the occurrence of arbitration in financing within groups. By taxing both paid and received group interest at a moderate rate, a treatment will be achieved that is more equal to that of group dividends. The arrangement of the group interest box focuses in particular on situations where group loans are provided from equity present within the group. Thus such a compulsory scheme for paid and received group interest offers both an instrument to protect the Dutch tax base against erosion by means of group loans (from equity for the group as a whole) as well as an alternative to the relocation of mobile capital to low tax jurisdictions.

First paragraph

The starting point of the scheme is that incoming and outgoing group interest, together with income from maintaining an acquisition reserve, will to a limited extent be included in the tax base. The use of the factor 5/H, where H stands for the highest rate in the corporation tax (25.5%), achieves that received and paid group interest and the income from acquisition reserve,

will effectively be taxed at a rate of 5% or be deductible against 5%. Evidently the costs in respect of "related" loans and equity funds, too, fall into the box.

The scheme will be - mandatory - applied per tax payer. The scheme is therefore relevant for any tax payer whose profits include any type of revenues mentioned in Article 12c or who charges any of the payments mentioned there to the profits.

Part c considers the interest and cost of money loans directly or indirectly due to an affiliated body. The words "directly or indirectly" express that this also includes interest that is formally due to a third party, but is in fact due to a group body. This is the case with a back-to-back situation, for example. The fact that a group company has provided security for a loan from third parties (external money loan) will, however, in general not lead to the situation that that loan is regarded as a group loan.

Because of the linkage that exists between the interest rate and the debtor- and currency risks, the scheme also applies to value adjustments in group loans and acquisition reserves. To prevent that a different tax regime would then apply to the results on interest rate and currency hedging instruments, the interest box will also apply to these results.

In practice it may be difficult to link hedging instruments to specific (related) claims and debts, a solution for this must still be found.

Second paragraph

For the definition of "affiliated body" the (previously used) term "stake" has been abandoned. The starting point is "control" which seeks to join the commercial criteria under which a group of bodies is required to prepare consolidated accounts (IAS 27).

Control means the power to govern financial and operational policies. Such control should also translate into a right to benefits and carrying risks. Possession of "voting rights" assumes control, but also in case of 50% or less of the voting rights there may be "control", for example if there is power to appoint or dismiss the majority of the members of the board of directors or the equivalent governing body.

The second sentence includes an arrangement under which bodies that do not have control over the tax payer independently, but do have joint control with others, can still be regarded as a body affiliated with tax payer. This can e.g. be the case with certain private equity structures and joint ventures. The explanation of the concept of joint control in IAS 31 provides the connecting link.

Control rights spread over family members, may lead to the establishment of a cooperating group. For the question whether there is a cooperating group all relevant facts and circumstances will be taken into account. Given the mandatory nature of the interest box for the existence of a cooperating group, no optional choices will be provided. However, tax payers do have the possibility to obtain certainty about the presence or absence of a cooperating group.

Third paragraph

Part a defines the concept of a money loan. This includes assets and liabilities based on an agreement which, in economic terms, is similar to a contract of money loan. One may think of financial leasing and hire-purchase. The interest component in the periods of financial leases fall in the box.

Because of the economic similarity with interest the financing component in lease and rental payments for provision of tangible fixed assets between affiliated bodies is also brought under the scheme (part b). The share of the financing component in these amounts is subject to various conditions and will be determined on a case to case basis.

According to part c received compensation on participating loans (also called hybrid loans) provided to an affiliated body, are included in the group interest box. This regards loans under civil law, provided under such conditions that these loans - according to the criteria of the jurisprudence of the Supreme Council - actually serve as equity.

This prevents a growing use of hybrid loans in related connections, which could affect the Dutch base. For interest paid on hybrid loans, the existing regime still applies. As a result of part d value adjustments in respect of hybrid loans provided, too, fall under the group interest box.

Fourth paragraph

To prevent that normal taxable results will be converted into low taxable revenue from group claims, a provision has been included that prevents that group claims are created artificially by transferring assets within the group against debt recognition. An exception is made for situations that arise from commercial reasons.

Conversion of normally taxed income into lowly taxed revenue does not occur with the transfer of participations in subsidiaries (on which the participation exemption applies) and group claims.

The last sentence includes a general exception, which provides that such transfers are not covered by the provision of the fourth paragraph. The general exception of the last sentence shall not apply in case of transfer of tangible fixed assets. This is expressed by using the word "exclusively". Revenue from transfer of tangible fixed assets is only partly covered by the interest box. The transfer of such assets may therefore result in a conversion of highly taxed revenue into low-taxable revenue.

Fifth paragraph

Many companies obtain their external debt centrally. These funds are then made available in the form of group loans to various entities of the group.

The paid interest over such group loans would, without further regulation, only be partly deductible on the basis of Article 12c, despite external financing at the group level. The fifth paragraph therefore includes a provision, which ensures that partly deductible group interest is still regarded as (fully) deductible third party interest, provided that the group creditor group has borrowed externally. For the application of the fifth paragraph a direct (historical) relationship must exist between the group loan owed by a tax payer and the external loan obtained from by an affiliated body.

The presence of such a direct link requires parallelism between the group loan and the external loan. Whether this is the case will mainly be assessed on the basis of the maturity, redemption, interest payment, size and time of entering into the loan. Differences in interest charges can be justified by commercial considerations.

Using an intermediary body for commercial reasons, such as a regional financing body, does not necessarily obstruct a direct link, provided that parallelism exists between the group loan owed by a tax payer to the intermediary body, the group loan owed by the intermediate body to the affiliated body that attracted the loan externally, and the external loan. Conduits based on non-commercial reasons are not permitted. Nor is the requirement of a direct link met if the attracted external loan is provided as equity capital to an intermediary (such as a “tax haven corporation”) and this intermediary then provides a group loan to a Dutch group company.

Sixth paragraph

The sixth paragraph provides that debt liabilities to third parties are treated as group loans to the extent that it is plausible that these loans serve to finance group loans or other assets that generate revenues that are lowly taxed in the group interest box. This provision is, as it were, the counterpart of the fifth paragraph under which group liabilities under certain circumstances can be considered as external debt. Just as in the fifth paragraph, a historical connection is required between, in this case, the resources drawn from third parties and the obtaining of revenue that falls in the box.

Seventh paragraph

Finally, a delegation provision is included, based on which additional regulation can be adopted for the more tax-technical application of the scheme. Additional rules may also be adopted for the interaction of the interest box with the provisions for the prevention of double taxation.