European Tax Newsalert

A Washington National Tax Services (WNTS) Publication

Netherlands

June 5, 2012

Dutch proposal would restrict interest deductions

The Dutch government on June 4 sent a bill to parliament that would restrict interest expense deductions for debt used to finance qualifying participations. Under the bill, taxpayers could not deduct interest expense on "excessive" debt. If adopted, the proposed measure would apply to fiscal years starting on or after January 1, 2013. The proposal contains no grandfathering rules.

The bill relates to the European Court of Justice (ECJ) decision in the *Bosal* case (summarized below).

The Dutch government may also abolish the thin capitalization rules. However, the 2013 tax package would include such abolishment only if the government can offset the related revenue losses.

Background

Before January 1, 2004, interest expense relating to foreign subsidiaries to which the participation exemption applied was not deductible under the Dutch participation exemption rules (article 13, paragraph 1 Corporate Income Tax Act "CITA").

In *Bosal* (ECJ September 18, 2003, C-168/01) the ECJ decided that this distinction between interest expense relating to Dutch subsidiaries (deductible) and interest expense relating to foreign subsidiaries (non-deductible) conflicted with European law based on the freedom of establishment. Many taxpayers in addition to Bosal deducted interest expense relating to foreign subsidiaries based on, or in anticipation of, the ECJ's decision.

Effective January 1, 2004, Dutch legislation abolished article 13, paragraph 1 CITA to comply with European law. As of that date, interest expense related to foreign subsidiaries therefore became deductible, unless restricted by other provisions. On the same date, a thin capitalization provision took effect.

On June 30, 2011, the Dutch parliament submitted a resolution to the Dutch government to introduce legislation addressing the perceived adverse consequences of the *Bosal* case. The new legislative proposal is estimated to reduce the country's budget deficit by € 150 million.

Legislative proposal - highlights

This proposal aims to restrict interest deductions relating to Dutch and foreign subsidiaries only to the extent the Dutch taxpayer's debt level relating to subsidiaries is excessive and undesirable, i.e., in situations that are considered abusive.

The interest deduction limitation would apply to excessive interest expense on debt relating to participations to which the participation exemption applies ("participation debt"). A mechanical, formulaic rule would determine the participation debt amount (described in detail below under technical design).

Non-deductible interest expense would equal the Dutch taxpayer's average participation debt divided by its average total debt, multiplied by the taxpayer's total interest expense.

A € 1 million threshold would apply, such that interest expense on participation debt up to that amount would be deductible, unless restricted by other provisions. The proposal would apply to interest expense on intercompany debt *and* third-party debt.

Legislative proposal - technical design

Determination of participation debt

Under the bill, the participation debt amount is deemed to equal the difference between the average cost price of the Dutch taxpayer's participations and its average equity for tax purposes. This mechanical rule deems the Dutch taxpayer to have equity-financed participations up to the point at which the participations' cost price equals the equity; once the cost price exceeds the equity, the rule deems the Dutch taxpayer to have financed its participations with debt. This approach is taxpayer friendly. The calculation is based on the Dutch taxpayer's tax balance sheet. However, specific rules apply to determine the cost price of the participations and the equity of the taxpayer if the tax book value of the participations differs from the cost price.

Example:

Tax Balance Sheet BV (amount in millions)

Participations	400	Equity	250
Other assets	300	Debt	450
Total	700		700

Participation debt is deemed to equal the difference between the participations' cost price (400) minus the equity (250) = 150. Non-deductible interest expense equals (150 / 450) multiplied by the interest expense on the total debt, minus the € 1 million threshold.

Exception for qualifying expansion investments

This participation debt formula excludes participation investments that qualify as "expansion investments". This exclusion is meant to *avoid* interest deduction restrictions for operational expansion investments by Dutch taxpayers. Thus, interest expense on debt-financed expansions of the group's operational activities (e.g., manufacturing, R&D, distribution and sales activities) through acquisitions of, or capital investments in, subsidiaries remains deductible.

Situations that do *not* qualify as expansion investments include transfers of participations within a group, portfolio investment activities, and capital contributions to a group financing subsidiary.

The expansion investment exception does not apply if the expansion-related interest expense is deducted elsewhere within the group ("double dip") or if the participation financing is predominantly tax driven. The latter could occur when, for example, the taxpayer cannot demonstrate a management link between the Dutch taxpayer and the participation. The explanation to the legislative proposal outlines various structures that effectively lead to a double dip. This approach chosen by the legislator seems connected to recent developments at OECD and EU level dealing with double non-taxation situations.

Interaction with other measures that address interest deductibility

The legislative proposal also confirms the government's intention to abolish the thin capitalization rules if it can find a revenue offset. For now, the thin capitalization rules will continue to apply.

Other measures restricting interest deductibility (e.g., anti-base erosion rules, hybrid loan rules, and leveraged acquisition rules) also will continue to apply. The legislative proposal contains explicit rules addressing the mechanical interaction between the proposed rule and the existing measures restricting interest deduction.

Other

The legislative proposal applies to interest expenses on and costs relating to (e.g., brokerage fees) participation debt. This includes costs regarding interest hedge instruments or currency exchange hedge instruments with regard to the interest installments.

Impact on the US market

The proposed restriction of interest deductions relating to subsidiaries would affect most US multinationals and private equity funds that have Dutch holding companies as well as Dutch operational companies/regional headquarters that also have a holding function. The legislative proposal targets interest expense deductions in situations that are considered abusive and has been designed not to affect bona fide situations. However, the proposed measure is complicated, especially when viewed in conjunction with existing measures. Given that the proposal includes no grandfathering rules, US taxpayers that have leveraged Dutch (holding) companies should review carefully the potential impact of this legislative proposal.

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