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Overview of the 2012 Dutch Tax Package

Following approval from the House of Representatives, discussions in the Senate and several amendments, the Senate today adopted the 2012 Dutch Tax Package (first published on September 15, 2011).

This newsalert summarizes important changes to the Dutch tax law that will impact US multinationals and investment funds after entry into force on January 1, 2012.

Research & Development deduction

To encourage innovation in the Netherlands, the Dutch government introduced a research and development ("R&D") deduction. The new R&D deduction is in addition to existing tax measures that stimulate innovation, i.e., the Innovation Box (a corporate income tax incentive) and reduced wage tax remittance on wage costs related to qualifying R&D activities ("R&D wage tax incentive"). The new R&D deduction will be available for costs and investments relating to R&D activities performed after December 31, 2011. Wage costs, R&D financing costs and costs related to contract R&D are excluded from this new measure.

The new R&D deduction will be determined as a percentage of the qualifying costs and investments allocable to R&D activities. This percentage will be set annually by the Dutch Ministry of Finance. For 2012, the percentage is 40%. With this new R&D deduction, an additional 40% of qualifying R&D costs can be deducted from the taxable profit beginning January 1, 2012.

The taxpayer must apply for the R&D deduction, through a procedure comparable to the application procedure for the R&D wage tax incentive.

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Interest deduction restrictions on acquisition debt in a fiscal unity

For tax book years beginning on or after January 1, 2012, interest expense deductions for acquisition debt may be restricted when a Dutch company acquires a target company and they subsequently join in a *Dutch fiscal unity* (the government will introduce similar rules for legal mergers and demergers).

The restriction applies to interest expenses (including costs and foreign exchange losses) on related party debt as well as third party debt used for acquisition financing. Foreign exchange gains on acquisition debt will remain taxable to the extent those gains exceed acquisition debt-related interest expenses and costs.

In principle, income and expenses from different companies within a fiscal unity may offset. However, under the new rules interest expense incurred by the acquisition company on acquisition debt cannot offset the target company's income. Such expenses can only offset the acquisition company's own income, which may not exist if the acquisition company is a special purpose company set up to acquire the target company. The restriction will not apply to the extent that (*i*) the acquisition debt interest expense does not exceed EUR 1,000,000; or (*ii*) the acquisition is not excessively debt-financed.

The acquisition is deemed to be excessively debt financed if the acquisition debt exceeds 60% of the target company's acquisition price. After the acquisition, the 60% debt financing threshold is reduced by five percentage points per year (i.e., 55% in the first year after acquisition, 50% in the second year, etc.) until it reaches a floor of 25% of the acquisition price. Acquisitions within the same tax book year are combined to determine whether the debt financing threshold is exceeded. If the acquisition is excessively debt financed, only the interest expense allocable to the excessive amount of the acquisition debt is nondeductible.

Nondeductible interest expense under this measure may be carried forward to future years. Grandfathering rules exist for target companies that have been acquired and included in a fiscal unity (or merged/demerged in the acquisition company) prior to November 15, 2011. Grandfathering rules also apply to acquisition debt refinancing for fiscal unities that were formed prior to November 15, 2011.

Dividend withholding tax for some Cooperatives

Under certain circumstances, effective January 1, 2012 Cooperatives ("Coops") may become withholding agents for Dutch dividend withholding tax purposes. A Coop will be a withholding tax agent for dividend withholding tax purposes if it holds shares where the main purpose, or one of the main purposes, is to avoid Dutch dividend withholding tax or foreign tax, *and* where the Coop's membership rights are not part of the Coop member's business. If the membership rights are part of the member's business, the measure may, under certain conditions, also apply if the Coop holds a Dutch company interest where an *existing* Dutch dividend withholding tax claim is at stake. For instance, when a foreign entity transfers shares in an existing Dutch BV (where dividend distributions would be subject to Dutch dividend withholding tax pre-transfer) to a Coop, the Coop member will be liable for tax on the BV's reserves (retained earnings/hidden reserves/fiscal reserves) available at the time of the transfer. This measure can also apply if a Coop is (or was) set up to acquire an existing BV from a third party, provided the BV's dividend distributions would be subject to Dutch dividend withholding tax pre-acquisition.

We expect no adverse consequences when a Coop's membership rights are attributable to a foreign entity's business (e.g., corporate structures or private equity structures with active management involvement), provided the Coop was not interposed or established to avoid existing Dutch dividend withholding tax claims. Existing Advance Tax Rulings will be respected during the remainder of their term.

Amendment of rules for foreign entities with substantial interests in Dutch entities

Under certain conditions foreign entities that hold a 5% or more interest in a Dutch company (a “substantial interest”) may be subject to Dutch corporate income tax ("CIT") on income derived from the substantial interest. This will occur if the interest in the Dutch company cannot be allocated to a foreign shareholder's business. For tax book years beginning on or after January 1, 2012, this tax levy will also be subject to the condition that the foreign shareholder holds the Dutch company shares with the main intention (or one of the main intentions) of avoiding Dutch personal income tax or dividend withholding tax.

If the taxpayer is only avoiding Dutch dividend withholding tax, then the CIT rate on dividends received is reduced to 15%. This additional condition highlights the legislation's intended anti-abuse nature. Entities that are incorporated under Dutch law but managed and controlled outside the Netherlands and that hold a substantial interest in a Dutch company will be treated as foreign tax payers when applying the substantial interest rules (effectively broadening the application's scope to entities incorporated under Dutch law).

Note that, as with current law, no tax will be levied if the substantial interest in the Dutch company can be allocated to a foreign shareholder's business. Therefore, this amendment should not affect existing structures that meet this condition and may, in effect, be a relaxation for certain other situations.

A more territorial approach for foreign permanent establishments

Under the current regime losses incurred through a foreign permanent establishment ("PE") may offset Dutch profits. If a foreign PE generates profits they are, in principle, exempt from Dutch tax, unless in previous years losses incurred through the PE have offset Dutch profits. For tax book years starting on or after January 1, 2012, an object exemption will apply to results generated through a foreign PE. As a result, foreign PE losses can no longer offset Dutch profits and profits generated through a foreign PE will be exempt. Under the new rules foreign PE results should, as under current law, initially be included in the taxpayer’s worldwide profits. Subsequently, the PE's results will be eliminated from worldwide profits. Taxable or deductible foreign PE currency exchange results can still arise in the Netherlands under the proposed regime. This legislation will also apply to income derived from foreign real estate.

As a general rule the object exemption will not apply to income derived from a ‘passive foreign portfolio investment enterprise’. This is a foreign PE whose activities directly or indirectly consist of more than 50% in portfolio investment or passive group financing/licensing/leasing activities and that is not subject to an effective tax rate considered realistic under Dutch tax principles. In that case the foreign PE's profits will be included in the Dutch tax base, although, under certain conditions, it

may receive a (deemed) credit for the underlying tax. However, the extent to which a PE's losses can offset Dutch profits will be restricted.

The application of the proposed domestic rules may differ depending on whether the foreign PE is based in a tax treaty or a non-tax treaty jurisdiction. In non-tax treaty situations the 'subject-to-tax requirement' will be abolished. Thus, should a Dutch taxpayer hold a foreign PE with active business activities in a non-tax treaty jurisdiction that does not tax the foreign PE's profits, the Dutch taxpayer is still entitled to an exemption for the profits attributable to the foreign PE. In tax treaty situations the application of the new rules may be affected by the specific wording of the applicable tax treaty with regard to allocation of taxing rights and relief for double taxation.

An exception to the rules described above applies to a PE's final losses. This occurs when the foreign activities have either indefinitely ceased or been sold to an unrelated party. In the latter case, an additional condition applies: the incurred losses may not be transferred to the acquiring third party, which could have offset the losses against future profits.

The legislation abolishes or amends certain other accompanying measures regarding foreign PEs. For example, the legislation abolishes, under transitional rules, the specific anti-abuse measure where application of the participation exemption is denied if previous foreign PE losses have offset Dutch profits (the current article 13c of the Dutch CIT Act).

The interaction between the new object exemption rules and other existing rules dealing with foreign PEs may have unexpected consequences in certain circumstances. Taxpayers should review the impact of the new legislation on existing foreign PEs held through the Netherlands.

Extension of the dividend withholding tax refund scheme

Effective January 1, 2012 the scope of the refund scheme for dividend withholding tax will extend to third countries with whom a sufficient (bilateral or multilateral) agreement on exchange of information exists. This extension applies only for investments where there is no (potential) control over the withholding company ('portfolio investments'). Notably, the refund scheme extension will apply to exempt pension schemes that are established in qualifying third countries.

Amendment of the expat arrangement ('30% ruling')

Under certain conditions, inbound employees who come to work in the Netherlands are eligible for a special expense allowance scheme: the 30% facility or ruling. Effective January 1, 2012, the legislation amends the 30% ruling. The ‘specific expertise’ requirement will be based on a salary norm. For employment beginning on or after January 1, 2012, the maximum duration will be reduced to eight years and the 30% ruling ends if the conditions are no longer met, or on the last day of Dutch employment. The legislation extends, to 25 years, the look-back period for the 'reduction rules' that reduce the 30% ruling's duration. Employees that lived within a 150 kilometer radius of the Dutch border in at least two-thirds of the 24 month period prior to the Dutch employment will be excluded. Alternatively, relief will be available from the condition to recruit university doctorates from abroad. A lower salary standard applies to employees in this category who are younger than 30. Transitional rules apply for existing cases.

Impact on US multinationals and US funds

The introduction of a special deduction for R&D costs, combined with existing measures such as the Innovation Box, should attract more innovative activities to the Netherlands.

The interest deduction restrictions for leveraged acquisitions can affect US multinationals and funds that acquire(d) Dutch targets on or after November 15, 2011 through the typical leveraged acquisition structure using a Dutch acquisition vehicle followed by Dutch fiscal unity inclusion of the target (or similar (de)merger strategies). The measure provides for safe harbor rules.

The changes to the dividend withholding tax treatment of Dutch Coops may affect specific situations, thereby requiring careful review. Corporate structures and most private equity fund structures with active management involvement will likely not be affected (exceptions may apply).

The changes to a more territorial approach for foreign PEs target specific situations importing foreign PE losses but lead to a significant conceptual change in the Netherlands' dealings with foreign PEs. This may affect US multinationals (in particular oil and gas companies) that hold foreign PEs through a Dutch structure. In some circumstances the foreign PE legislation may have unexpected consequences, therefore careful review of existing structures is recommended.

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