BUDGET DAY 2018 - CORPORATE AND INTERNATIONAL TAXATION

This week, Budget Day 2018 in the Netherlands brought a collection of fiscal legislative proposals which might have an impact on your Dutch company or investment venture. Below HVK Stevens will set forth the broad outlines of the company taxation proposals.

CORPORATE INCOME TAX

Reduction of Dutch corporate income tax rates

The rates for the Dutch corporate income tax will gradually be reduced. Currently the corporate income tax amounts 25% for profits exceeding € 200,000 and 20% for profits up to € 200,000. The rate for profits up to € 200,000 will gradually reduce in three years to 19% in 2019, 17.5% in 2020 and 16% in 2021. The rate for profits exceeding € 200,000 will be gradually reduced over three years to 24.3% in 2019, 23.9% in 2020 and 22.25% in 2021.

Loss carry-forward period reduced to six years

Currently, corporate income tax payers can set-off tax-losses against taxable profits of the previous financial year (carry-back) or of the nine subsequent financial years (carry-forward). The carry-forward period will however as per 2019 be limited to six financial years. This means the limitation of the carry-forward period will apply for the first time to losses incurred in financial years commencing in the 2019 calendar year.

This restriction will increase the need to take measures in order to avoid tax-losses to evaporate unused.

A transitional rule will facilitate the possibility to prioritize the offset of losses suffered in 2019 and 2020 over losses that are suffered in 2017 and 2018. This prevents the more recent losses (those suffered in 2019 or 2020) to evaporate earlier than older losses (the ones suffered in 2017 or 2018).

Limitation of depreciation of buildings in own use

Currently the Dutch (corporate) income tax determines that buildings in own use can be depreciated to 50% of the so-called WOZ-value. WOZ-value is a municipality assessed value that should theoretically approach fair market value. Other buildings can only be depreciated to 100% of this WOZ-value.

As of January 1, 2019 the limitation on the depreciation of buildings will be equal for all buildings. As a result, buildings in own use can henceforth only be depreciated to 100% of the WOZ-value. In most cases this effectively ends all potential to depreciate real estate assets for tax purposes. Please note that this measure only applies for Dutch corporate income tax purposes and not for Dutch personal income tax purposes.

As a result of this measure it is expected that a critical assessment of the WOZ values for real estate in own use will become of greater importance.

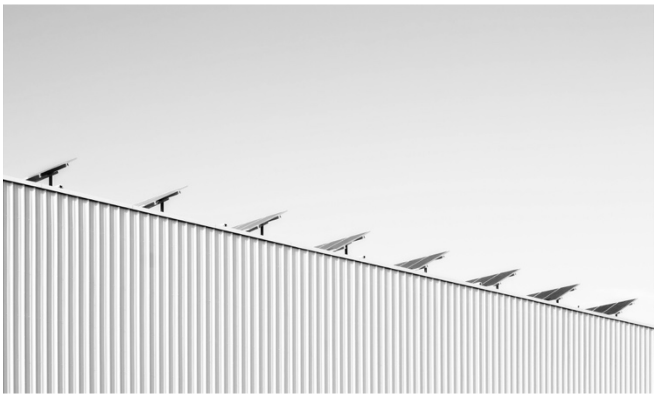
Earnings stripping rule

Implementing the European Anti-Tax Avoidance Directive ("ATAD") 1, an interest-deduction limitation rule will become effective in the Dutch corporate income tax as of January 1, 2019. As a result of this earnings stripping rule, net borrowing costs (including intercompany and external borrowing costs) are non-deductible if and to the extent that the borrowing costs exceed the highest of the following thresholds (*i.e.* the interest capacity):

1. 30% of the fiscal earnings before interest, tax, depreciation and amortization (EBITDA);
2. € 1 million (the de-minimis amount).

Borrowing costs which exceed the interest capacity and are therefore non-deductible, can be carried-forward for an unlimited period of time. In a subsequent financial year, the carried-forward borrowing costs will be deductible in addition to the net borrowing cost of that subsequent year if and to the extent that the aggregate amount of net borrowing cost does not exceed the interest capacity of that subsequent financial year. This earnings stripping rule does however not provide for a carry-back of non-deductible borrowing costs or in a carry-forward of unused interest capacity.

The earnings stripping rule is applicable per entity or, in case of a fiscal unity for Dutch corporate income tax purposes, per fiscal unity. This means that the Dutch government did not chose to introduce a new exception for the earnings stripping rule in the Dutch fiscal unity regime, as it recently did for other targeted interest-deduction limitation rules. Consequently, fiscal unities including one or more entities with insufficient stand-alone interest capacity to support their stand-alone borrowing costs, could benefit from this per-fiscal unity approach, which allows for a pooling of interest capacity by and among members of the fiscal unity. This approach for example is to the benefit of acquisition or holding entities within a fiscal unity, which usually have significant interest expenses but do not have any taxable income and therefore no interest capacity of their own.



Contrary to such pooling of interest capacity, other Dutch corporate tax payers may actually benefit from a de-consolidation of results in order to benefit from the € 1 million threshold multiple times. Such de-consolidation could be achieved for example by separating activities of stand-alone corporate taxpayers into separate entities through spin-off or through dissolution of an existing fiscal unity.

As expected, the Dutch government did not choose to implement a number of exceptions in the earnings stripping rule allowed under ATAD 1:

- a group exemption on the basis of which the interest capacity is determined by the consolidated corporate group to which the taxpayer belongs;
- a grandfathering of existing loans; or
- an exception for financial institutions.

The Dutch government will however proposes an exemption for existing long-term public infrastructure projects.

Finally, the earnings stripping rule will apply to every Dutch corporate income taxpayer, including taxpayers which are not part of a consolidated group for reporting purposes and taxpayers with only one or more individuals as shareholders.

Other measures relating to interest deduction

As a result of the introduction of the earnings stripping rule, several targeted interest-deduction limitation rules are proposed to be abolished with effect from 1 January 2019. The rules proposed to be abolished are:

- interest-deduction limitation for debt relating to subsidiaries (article 13*l* Dutch CITA)
- interest-deduction limitation for debt of take-over holding companies (article 15ad Dutch CITA)

Please note however that other currently existing interest-deduction limitations will continue to apply beyond 31 December 2018. These include:

- interest-deduction limitations for hybrid debt (articles 10 and 10b Dutch CITA), and
- anti-base erosion rules (article 10a Dutch CITA).

Separate from the introduction of the earnings stripping rule, the Dutch government proposed the abolition with effect from 1 January 2019 of a deduction of compensation due on additional tier 1 capital issued by financial institutions. These instruments often come in the form of contingent convertible bonds, or CoCo's. This abolition is proposed out of EU state concerns governing the legal deduction. Recent case law of the Dutch Supreme Court has however cast doubt on these concerns and the need to abolish the clause confirming the right to deduct such compensation. One could argue that even with this clause abolished, a right to deduct might continue to exist based on Dutch case law (depending on the features of the individual instrument).

Finally, the Dutch government has again announced that it will separately propose in the course of 2019 a minimum-equity rule for financial institutions, which should enter into force with effect from 1 January 2020.

Controlled Foreign Companies

The European ATAD 1 imposes EU Member States to levy tax on corporate shareholders of direct and indirect subsidiaries in low-tax jurisdictions.. This is achieved by adding specific undistributed profits of a so-called Controlled Foreign Company ("CFC") to taxable income of the CFC's European direct or indirect parent company. The reason for the CFC-rule is to prevent profit shifting to low-taxed states. The Dutch government has on Budget Day last September 18 has made a legislative proposal to implement the CFC-rule into Dutch domestic tax law with effect of January 1, 2019.

In general, an entity is qualified under the Dutch implementing law as a CFC if:

(i) the EU shareholding company holds an interest in the entity of 50% or more or has a permanent establishment, and

(ii) the entity or permanent establishment is situated in

- a state which taxes entities at a rate of less than 7%, or
- a state which has been qualified as non-cooperative by the EU.

Following the CFC-rule, undistributed tainted CFC-income is included in the taxable base of the Dutch shareholder, according to that shareholder's relative interest in the CFC. Tainted CFC-income basically is passive income including (but not limited to) dividends, interest or royalties.

Inclusion of tainted CFC-income in the taxable base of the shareholder is not required if total annual income of the CFC for more than 70% qualifies as income other than tainted CFC-income, or if the CFC carries on a substantial economic activity. If the CFC performs a substantial economic activity, its income will only be added to the tax base of its Dutch parent company if and to the extent that the CFC generates the income through functions performed by that parent company in the Netherlands. This obligation for the Dutch parent company to recognize income however is already applicable for Dutch entities under current Dutch transfer pricing regulations.

An activity qualifies as a substantial economic activity if the CFC complies with certain minimum-substance requirements, which are also used for purposes of the Dutch dividend withholding tax when assessing if a shareholding structure is set-up for valid business reasons which reflect economic reality. A CFC should for example have real estate with office space at its disposal during a minimum period of 24 months in its state of residence and have qualified personnel at its disposal which results in at least € 100,000 in annual wage costs (according to Dutch price standards).

As a result of the CFC-rule, double taxation could arise. Although Dutch shareholders should be able to credit the CFC's foreign corporate income tax against the Dutch corporate income tax, other intermediate holding locations are not taken into account when determining the foreign tax credit. Therefore, double taxation could still arise in multiple-tiered structures with holding entities situated in various states which also apply the CFC-rule. As a consequence, if your company is an indirect shareholder of a CFC, it might be recommendable to mitigate intermediate holding companies from the structure.

DUTCH DIVIDEND WITHHOLDING TAX

As part of the measures proposed during Budget Day, the Dutch government intends to entirely abolish the Dutch Dividend Withholding Tax Act and to introduce, as per January 1, 2020, a withholding tax on dividends (including capital gains) for distributions to certain related entities in low-tax jurisdictions. As per January 1, 2021, a similar conditional withholding tax will be introduced for outgoing interest and royalty payments.

The Dutch government expects on the one hand that with these measures the Netherlands will remain attractive for multi-nationals. On the other, it will become more difficult to use the Netherlands in so-called aggressive tax planning schemes (for example by setting-up a letter box company in the Netherlands to access the extensive tax treaty network of the Netherlands).

Current Dutch dividend withholding tax act

Since January 1, 2018, profits distributed by a Dutch entity (such as a corporation and, under certain conditions, a cooperative) to its foreign parent company are exempt from withholding tax if the parent company is located in an EU country or a country with which the Netherlands has concluded a tax treaty that includes an article on dividends. In addition to this, the interest in the Dutch entity may not be:

(i) held with (one of) the main purpose(s) to avoid Dutch dividend withholding tax, that otherwise may have been due by another individual/entity, and;

(ii) part of a(n) (series of) artificial arrangement(s)/transaction(s).

In other words, the structure should reflect economic reality and have valid business reasons. Valid business reasons may exist if the shareholding interest held in the Dutch corporation/cooperative can be allocated to the foreign parent company which carries on a business. This is the Dutch interpretation of the so-called principal purposes test ("PPT") as introduced in the OECD BEPS project.

New withholding tax act per January 1, 2020

Although the Dutch dividend withholding tax will be abolished and replaced by a general withholding tax act, elements from the existing dividend withholding tax act, such as the above described PPT, will be transposed into the new withholding tax act.

In brief, the new withholding tax act, if approved by parliament, extends the scope of the current dividend withholding tax exemption, but at the same time introduces stricter anti-abuse provisions:

As per January 1, 2020, distributions by Dutch resident entities to related entities established in low-tax jurisdictions may become subject to a withholding tax. Entities are considered related if the recipient entity (either directly or indirectly via a third party) effectively controls the distributing entity (e.g., more than 50% voting rights). Furthermore, a jurisdiction is considered low-tax if the local corporate income tax rate is less than 7% or if the jurisdiction is on the EU list of non-cooperative jurisdictions. Distributions to individuals are out of the scope of the new withholding tax act, however, please note that they could still be subject to the Dutch non-resident taxation (in case the individual owns, directly or indirectly, 5% or more in the Dutch distributing entity).

Payments made to entities not established in low-tax jurisdictions could still be subject to withholding tax if the ultimate recipient/beneficiary is an entity in a low-tax jurisdiction and that entity effectively controls the distributing entity. However, in such case, the payments will only be subject to the withholding tax if the PPT applies (i.e., the structure is considered artificial):

If in such case the direct foreign parent company qualifies as an intermediate holding company ("linking function"), which is often seen in private equity investment structures, it will have to meet the 'relevant substance' criteria as introduced earlier this year. In addition to the normal substance requirements it should (i) allocate salary costs of at least EUR 100,000 to its activities, and (ii) have its owns office for at least 24 months). In case however such intermediate holding is established in an EU country (for example Luxembourg), these minimum substance criteria are not considered a minimum-requirement but a safe harbor as other arguments may be used to demonstrate that the structure is not abusive (for example because the direct shareholder is part of a joint venture structure in another jurisdiction).

An important and significant increase of the scope of Dutch taxation is that as of 2020 not only direct distributions will fall under the new withholding tax act, but also capital gains that are, ultimately, derived by an entity in a low-tax jurisdiction from either a direct or an indirect sale of an interest in the Dutch entity. For example, if the ultimate parent company of a Dutch entity is located in a low-tax jurisdiction and sells the shares in a Luxembourg intermediate holding entity – that in turn owns shares in the Dutch entity – the sale of the shares in the Luxembourg entity may trigger Dutch withholding tax.

Also distributions made via a hybrid entity (tax transparent from a Dutch perspective however opaque from the perspective of the ultimate shareholder/investor's jurisdiction), may be subject to withholding tax if such hybrid entity is not a tax-resident anywhere or a tax resident of a low-tax jurisdiction.

The rate of the withholding tax is set at the same rate as the Dutch corporate income tax (23.9% for 2020 and 22,25% for 2021). Please note that in case Dutch non-resident corporate income taxation applies to the direct shareholder as well, the new withholding tax cannot be credited against this non-resident taxation.

Furthermore, as per January 2020, repayments of share capital may be subject to withholding tax, under the above described conditions, to the extent the distributing entity has profit reserves. Under current legislation, such a repayment of share capital was, under certain conditions, not subject to Dutch dividend withholding tax.

Finally, the new withholding tax will no longer be due upon the distribution, however, will be due within one month after the relevant calendar year of distribution. This is different in case of capital gains, in which case the entity subject to the taxation will have to file a tax return in the Netherlands declaring the income.

Interest and royalties

To make the Netherlands less attractive for so-called aggressive tax planning schemes, the Dutch government intends to introduce, as per January 1, 2021, a withholding tax on interest and royalties as well.

The scope of this withholding tax is expected to be similar to the scope of the withholding tax on dividends as described above and thus only apply in intra-group structures.

Way forward

The new rules will have an impact on many investment structures (either positive or negative). Investors/shareholders owning minority interests in Dutch entities will most likely benefit from abolishing the current Dutch dividend withholding tax. However, especially private equity/investment funds using Dutch entities as platforms for their investment structures should carefully analyze the impact of the new Dutch withholding tax. A solution for them could be to remove all low-taxed entities from the investment structure.

In certain circumstances (especially where it concerns the withholding tax on interest and royalties), a migration of the platform/investment structure to another jurisdiction (such as Luxembourg) might be an alternative.

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