

Summary and conclusions

The Netherlands levies corporate income tax (CIT) at a 25 per cent rate. Resident corporate taxpayers are taxed on their worldwide income. Non-resident taxpayers are taxed on their Dutch source income.

The double tax relief (DTR) system distinguishes between active and passive income. Economic DTR is available with regard to proceeds from substantial (out-bound) equity investments. Eligible are proceeds from a “participation” (i.e. an equity investment of at least 5 per cent in the paid-up capital of the underlying company). Proceeds from actively held participations and “qualifying portfolio participations” are exempt from the CIT base under the “participation exemption regime”. Proceeds from “non-qualifying portfolio participations” are eligible for relief under the “participation credit regime”. Juridical DTR is available for taxpayers having eligible foreign source income. It is provided in double tax convention (DTC) and non-DTC scenarios. A tax-exemption mechanism is available for active income; an ordinary credit for passive income.

The tax policy consideration for exempting active income is capital import neutrality. The credit regimes for passive income are applied under capital export neutrality and anti-avoidance considerations. The latter is recognized in the switch-over to credit mechanisms regarding passive financing permanent establishments (PEs) and non-qualifying portfolio participations. The presence of these mechanisms implies that credit regimes are considered to be more effective in countering tax avoidance than exemptions. Adverse tax deferral is countered as shareholdings more than or equal to 25 per cent in non-qualifying portfolio participations whose assets almost exclusively consist of low-taxed portfolio investments are subject to mark-to-market valuation. Notably, the tax legislator is unable to unilaterally shift to another juridical DTR mechanism as provided in a DTC.

Foreign losses of resident taxpayers may or may not be deductible depending on the legal form under which the economic activities have been arranged and the income’s active/passive nature. Losses suffered by resident taxpayers from business activities carried on through a PE are deductible. A recapture rule applies. If foreign business activities are carried on through a shareholding in a foreign subsidiary to which the participation exemption applies only liquidation losses are

* Loyens & Loeff NV, Erasmus University Rotterdam, the Netherlands

** Ministry of Finance, the Netherlands

deductible. Losses suffered by resident taxpayers from (outbound) portfolio investment activities may be deducted against domestic income. The same is true if these activities are carried on through non-qualifying portfolio participations or passive financing PEs.

Generally, the operation of the individual DTR mechanisms does not pose great practical difficulties. In borderline scenarios, however, the DTR system may be difficult to understand, manage and apply as various elements of both a technical and administrative nature should be appreciated. Problems in the DTR system's practical operation mainly occur due to the concurrent presence of several DTR mechanisms and their particular features. Other relevant aspects identified are:

- The DTR mechanisms' application is subject to various eligibility criteria and limitations such as tax base and subject to tax requirements, as well as the character of income limitations, geographic limitations and tax credit limitations. Scenarios not meeting these criteria and limitations may entail double taxation.
- Both domestic CIT law and the DTCs are interpreted and applied autonomously in the Netherlands. The existence, source, nature and the timing of taxable income as well as subsequent DTR entitlements are generally determined independently of foreign tax implications. The same is true regarding the classification of legal entities as (non-)transparent. This approach is sensitive to double (non-)taxation, which – as well as ensuing tax planning opportunities – remains unresolved unless it is explicitly dealt with in a DTC or domestic law.
- Inconsistencies arise in the jurisdictional allocation of deductions and corresponding profits under the participation exemption regime. Its application enables taxpayers to deduct financing expenses relating to their foreign business activities operated through foreign subsidiaries from the Dutch CIT base, yet to receive the gross proceeds from their foreign operations – i.e. as dividends and capital gains – exempt from the CIT base. This effect, the so-called *Bosal* mismatch, entails significant base erosion issues.

Taxpayers need to file a CIT return (electronically) in good time. DTR is claimed by filling in the relevant subject fields in the CIT return computer program. Taxpayers seeking guidance as to their CIT positions may refer to the general tax enforcement considerations made public through policy regulations. Moreover, taxpayers may settle tax uncertainties under compliance covenants, mutual agreement or arbitration procedures, or advance tax rulings (ATRs)/advance pricing agreements (APAs).

Elements in the CIT system commonly addressed as contributing to the attractiveness of doing business in the Netherlands are the participation exemption regime, the extensive DTC network, the absence of source taxation on outbound interest and royalty payments and the possibility of settling CIT positions in advance. The *Bosal* mismatch has led many to submit proposals to remedy its distortive effects. Draft legislative bills have not (yet) been proposed, though.

1. Introduction

The Netherlands levies a national corporate income tax (CIT) on corporate bodies such as publicly and privately held companies.¹ Resident taxpayers are subject to unlimited tax liability and taxed on their worldwide income. This holds true irrespective of whether a bilateral DTC applies as the Netherlands consistently reserves the right to include both the domestic and foreign source income of resident taxpayers in the CIT base. Non-resident taxpayers are subject to limited tax liability and taxed on their income derived from Dutch sources. The marginal CIT rate is 25 per cent.²

Economic DTR is available with regard to proceeds from substantial (outbound) equity investments under the participation exemption regime or participation credit regime.³ Eligible are proceeds from a participation, i.e. an equity investment of at least 5 per cent in the paid-up capital of the underlying company.⁴ A combined system is in place which distinguishes between active and passive income. Proceeds from an actively held participation are fully exempt from the CIT base under the participation exemption regime. Proceeds from a passively held 5 per cent or more equity investment (portfolio participation) are ineligible save for a safe harbour referred to as the qualifying portfolio participation.⁵ A qualifying portfolio participation is a portfolio participation meeting an assets test or a subject to a reasonable tax test. Proceeds from a non-qualifying portfolio participation are eligible for relief under the participation credit regime. This regime provides for an indirect credit generally calculated by making reference to a fictitious amount of underlying tax.

Juridical DTR is available for resident taxpayers having eligible foreign source income items. Relief is provided in both DTC and non-DTC scenarios. DTR is available respectively under the applicable DTC and the Unilateral Decree for the Avoidance of Double Taxation 2001. Again, a combined system operates. Regarding active income from business activities carried on abroad through a PE relief is available under the tax exemption with progression regime.⁶ The relief mechanism operates as a credit for domestic CIT attributable to foreign income and is applied on a per-country basis. Relief is calculated without taking the foreign tax burden into account. Regarding passive income arising from abroad (such as eligible dividend, interest and royalty receipts and proceeds from so-called passive financing PEs), relief is granted under the ordinary credit regime.⁷ Foreign taxes levied are recognized as a deductible item when the tax exemption regime or ordinary

¹ Art. 1 Dutch Corporate Income Tax Act (CITA). Legislative references concern the CITA unless expressed otherwise.

² Art. 22.

³ Art. 13 and art. 13aa in conjunction with art. 23c.

⁴ Eligible equity investments include directly or indirectly held shares, call option rights on shares and shareholding interests granting the shareholder 5 per cent or more of the voting rights.

⁵ The participation exemption regime generally applies to proceeds from participations whose assets are mainly comprised of landed property.

⁶ Art. 31 Decree. The tax exemption regime consistently applies to proceeds from landed property located abroad.

⁷ Art. 36 Decree.

credit regime is unavailable. Taxpayers may opt to deduct foreign taxes from the CIT base instead of crediting them against CIT.⁸

The outline and topics covered follow the general reporter's directives. The following section describes some of the DTR system's technical features that may lead to double (non-)taxation. Section 3 makes some qualitative remarks on its practical operation.⁹

2. Key factors of unrelieved double taxation

2.1. Divergent views on taxable income

Domestic CIT law and the DTCs concluded are interpreted and applied autonomously. The existence, source and nature of taxable income and subsequent DTR entitlements are generally recognized independently of foreign tax implications. DTCs are interpreted and applied with the due observance of domestic CIT law, DTC definitions and the DTC context.

The Netherlands has made an observation on the OECD's view as advocated in its commentary to the OECD model tax convention (MTC) regarding the residence state's juridical DTR obligations in cases of conflicts of qualification.¹⁰ The government disagrees with the OECD that the residence state should follow the source state's qualification in those cases and apply its DTR system accordingly. It agrees that the single taxation of proceeds from cross-border business activities should be achieved yet preserves the right to reach a solution under a specific DTC provision, unilateral policy, or mutual agreement procedure.

This approach is sensitive to double (non-)taxation due to mutual divergences in income qualification between the Dutch and foreign tax systems. Such scenarios, and the ensuing tax planning opportunities, however, remain unresolved unless they are explicitly dealt with in a DTC or – unilaterally – in domestic CIT law.

2.1.1. *Existence of income*

Resident taxpayer companies are deemed to carry on a business and employ their entire property for this purpose.¹¹ The CIT base is calculated as the sum of all profits/losses and capital gains/losses of whatever description or nature.¹²

Business proceeds are in principle eligible to be granted DTR subject to the relevant eligibility criteria and limitations. It is irrelevant whether such income is considered to exist for tax purposes in the source state. Consequently, DTR may be granted, for instance under the tax exemption regime, even if certain benefits are not considered as taxable income abroad. Accordingly, such benefits may not be

⁸ Art. 38 Decree.

⁹ Data on actual CIT positions of identifiable taxpayers is unavailable. This makes it unfeasible to provide a comprehensive quantitative study on the current DTR system's impact on compliance, administrability and business decisions.

¹⁰ Para. 80 commentary on art. 23A and 23B.

¹¹ Art. 2, fifth indent.

¹² Arts. 7 and 8. Individuals earning business proceeds are liable to individual income tax.

taxed at all. No relief is provided if certain benefits are not recognized as business proceeds. This is true even when taxable income is recognized abroad. For instance, no ordinary credit is granted if a foreign state recognizes a constructive dividend distribution to a Dutch taxpayer and consequently subjects it to a source tax while the existence of such an income item has not been acknowledged under Dutch CIT law. Such a tax levied is not eligible to be credited against the CIT payable on other income.

2.1.2. Source of income

As DTR is available regarding a taxpayer's foreign income, it should be recognized whether the income items originate abroad. For this purpose, it should be mentioned that no particular set of source rules is in place. The CIT legislation simply refers to "Dutch" or "foreign" income. The identification of the income's location typically occurs alongside the standards developed in international taxation on the basis of which taxing rights and/or income items are allocated to taxing jurisdictions.

Business profits are allocated to taxing jurisdictions consistent with OECD standards. The allocation of profits realized by a single taxpayer occurs in two steps. First, it is decided whether the PE threshold has been met. The PE descriptions in the applicable DTCs – and in non-DTC scenarios alternatively the decree – generally follow the OECD MTC description. Second, the profits are attributed to the accordingly identified PE. This basically occurs in accordance with the "two-step analysis" as adopted by the OECD in its attribution of profits to PEs report. Some uncertainty exists, however, with regard to the allocation of interest expenses to PEs and the (non-)recognition of notional interest, as earlier case law in this area diverges from the OECD's current approach. The allocation of profits with regard to associated enterprises occurs in accordance with the OECD's transfer pricing guidelines. The application of the transfer pricing methodology to PEs and associated enterprises regularly triggers discussions between taxpayers and the tax authorities, for instance on the applied functional and factual analysis or the chosen transfer pricing methods subsequent to the third party comparability analysis and benchmarking process. Transfer pricing issues may be settled through APAs; see section 3.2.2.

Regarding dividends, interest and royalties, the identification of the source state is relevant if a limited taxing right is allocated to that state under a DTC or, unilaterally, the decree. Dividend, interest and royalty payments are generally considered to have their source in the state in which these payments arise (i.e. the payer's state of residence or in some DTC scenarios the state in which a PE is situated to which the payments are attributable). Dividends are considered to be sourced in the distributing company's state of residence.

Double (non-)taxation may occur when views adopted abroad diverge from those of the Netherlands. Double taxation for instance occurs if certain income items are taxed abroad under local sourcing rules while these items are not considered to originate from foreign sources under Dutch CIT law or the Netherlands' interpretation of a DTC with the effect that DTR is unavailable. Juridical DTR is for instance not granted if a taxpayer is not considered to operate a business abroad through a PE (even if a PE exists under the laws of the other state) or if a taxpayer's

income is not considered attributable to a foreign PE. Double taxation arises if such income is also taxed in the foreign taxing jurisdiction. Double non-taxation (and ensuing tax planning opportunities) occurs in the mirror scenario: DTR is granted regarding a taxpayer's income attributable to a foreign PE while a PE is not recognized locally. Occurring issues may be solved through mutual agreement or arbitration.

2.1.3. Nature or character of income

The income's nature or character is identified autonomously. The way in which income is qualified and dealt with abroad is generally considered irrelevant.

Qualification conflicts may lead to double (non-)taxation, for instance in respect of debt arrangements that in fact function as equity (hybrid loans). A subordinated profit participating loan issued under a term exceeding 50 years is considered an equity contribution for CIT purposes. Taxpayers issuing such a hybrid loan to a foreign participation are eligible to be granted relief under the participation exemption regime with respect to the interest payments – which are treated as dividends for CIT purposes – received. Economic double non-taxation occurs if the foreign jurisdiction involved recognizes the hybrid loan as a debt arrangement for which tax-deductible interest payments are made. No juridical DTR for locally levied source taxes is available as the tax base requirement has not been met (see section 2.4.3). Economic double taxation occurs if a loan issued by a taxpayer is regarded as a debt arrangement for CIT purposes while the foreign jurisdiction involved considers it an equity contribution. That has the consequence of a taxable interest receipt recognized in the Netherlands while a non-deductible dividend payment is taken into account abroad. Notably, the ordinary credit may be available for locally levied source taxes. Such a tax is creditable against CIT irrespective of the foreign perspective that it is imposed on a dividend distribution.

Moreover, double taxation occurs if the Netherlands as the residence state does not qualify a certain payment to be a royalty under the applicable DTC. The ordinary credit for foreign source tax is unavailable irrespective of the payment's qualification as a royalty in the source state.

2.2. Inconsistent allocation of deductions between domestic and foreign sources

Inconsistencies in the allocation of deductions between domestic and foreign sources particularly occur under the participation exemption regime. The regime generally operates as a gross exemption. Its application does not affect the deductibility of interest expenses incurred on debt capital attracted to finance the participation's acquisition or to provide it with equity capital. This enables taxpayers to deduct financing expenses relating to their foreign business activities operated through foreign subsidiaries, yet to receive the gross proceeds from such operations abroad – i.e. as dividends and capital gains – exempt from the CIT base under the participation exemption regime. This discrepancy between deductible expenses and exempt profits is commonly referred to as a jurisdictional mismatch regarding the territorial allocation of expenses (recognized at the level of the corporate shareholder in the Netherlands) and earnings (recognized at the level of the subsidiary

abroad). This effect, known as the *Bosal* mismatch,¹³ entails significant base erosion issues (see sections 3.3.2 and 4).¹⁴ The mismatch does not arise under the tax exemption regime, the ordinary credit regimes and the participation credit regime. These provide for DTR on a net basis.

2.3. (In)ability to deduct foreign losses against domestic income

2.3.1. General

The (in)ability to deduct foreign losses depends on the legal form under which the economic activities have been arranged and the income's active/passive nature.

2.3.2. Foreign direct investment

Losses suffered by resident taxpayers from business activities carried on abroad through a PE are included in the CIT base. Foreign losses are deductible accordingly. Since these losses may also be recognized in the source jurisdiction under a local loss set-off mechanism, relief under the tax exemption regime is not granted in the following profitable years as long as the losses from earlier years have not been recaptured.¹⁵ The amount of losses to be recaptured is formalized through a declaration from the tax authorities.

Losses from business activities carried on abroad through a shareholding in a foreign subsidiary are treated differently. As corporate bodies are individually taxed, business losses suffered by foreign subsidiaries are not included in the taxpayer's/shareholder's CIT base and cannot be deducted against domestic income. Notably, the tax consolidation regime does not enable the foreign losses of foreign subsidiaries to be offset against domestic profits realized at the level of the shareholding company either, as it does not allow cross-border tax consolidation.¹⁶ Capital and impairment losses on the equity investment are nevertheless included in the CIT base.¹⁷ Consequently, such a loss may be deducted. If the equity interest is, however, considered a participation, which is eligible for economic DTR under the participation exemption regime, a deduction of such losses is rendered impossible as all proceeds from a participation – both positive and negative including impairments – are excluded from the CIT base. Final losses realized at the level of the shareholding company upon the liquidation of its (foreign) participation may nonetheless be deducted under the liquidation losses regime.¹⁸ The deductible liquidation loss is generally calculated as the difference between the participation's acquisition price and the sum of the liquidation proceeds.

¹³ The mismatch is named after the Court of Justice's ruling in case C-168/01 (*Bosal*) in which it held that a former tax provision that subjected a deduction of interest expenses related to the financing of a participation to the requirement that the participation derived from Dutch-source taxable profits was incompatible with EU law.

¹⁴ A thin capitalization regime (art. 10d) and a loss set-off limitation for holding or group financing companies (art. 20, fourth indent) were introduced to mitigate this effect.

¹⁵ Art. 35 Decree. The recapture is not subject to a limitation in time.

¹⁶ Art. 15.

¹⁷ Participations are generally valued at cost price or going concern value if lower.

¹⁸ Art. 13d.

The differences in the CIT treatment of PEs and subsidiaries entail arbitrage issues. The tax exemption regime for PEs allows current losses to be deducted while the participation exemption regime for subsidiaries does not. This may encourage taxpayers to initially set up foreign operations through a PE and subsequently to issue them into a participation as soon as the business breaks even. This would render the recapture of PE losses under the tax exemption regime impossible. Initial losses would be deducted while subsequent repatriated business profits would be exempt from the CIT base. A claw-back mechanism has been adopted to counter this effect.¹⁹ The participation exemption is unavailable as long as the initially deducted PE losses have not been recaptured. Instant recapturing is required if the taxpayer in effect transfers its participation or underlying business to an affiliate.

2.3.3. Portfolio investments

Losses, including impairment losses, suffered by resident taxpayers from (outbound) portfolio investment (PI) activities are included in the CIT base and may be deducted against domestic income. If the gross proceeds (e.g. dividends, interest, royalties) have been subject to a local source tax, DTR under the ordinary credit regime may be unavailable if the losses are caused by related (financing) expenses incurred. Excess source taxes levied abroad may be carried forward to subsequent tax years.²⁰

The CIT treatment of losses suffered by resident taxpayers from (outbound) PI activities carried on through a shareholding in a portfolio participation differs depending on whether that participation is classified as a qualifying or non-qualifying portfolio participation. Qualifying portfolio participations are passively held 5 per cent or more shareholdings in companies meeting the safe harbour rules, i.e. an asset test or a subject to a reasonable tax test (see section 3.2.1). As the participation exemption regime applies to proceeds from a qualifying portfolio participation, only liquidation losses are deductible. Non-qualifying portfolio participations are passively held participations not meeting the safe harbour rules. As the participation exemption is unavailable (capital and impairment) losses on a non-qualifying portfolio participation may be deducted from the CIT base. If incurred (financing) expenses attributable to a non-qualifying portfolio participation exceed its proceeds, the participation credit is unavailable. The amount of (fictitiously) levied underlying tax on the participation's proceeds may be carried forward.

Resident taxpayers may also derive income from PI and passive group financing activities carried on abroad through a PE (the passive financing PE). In such cases, the Netherlands seeks to switch over from the tax exemption regime to the ordinary credit regime for juridical DTR purposes (see also section 3.4).²¹ Losses suffered through passive financing PEs may be deducted against domestic income similar to

¹⁹ Art. 13c.

²⁰ Art. 37 Decree.

²¹ Art. 39 Decree.

active PEs. DTR is unavailable. Taxes levied abroad may be carried forward.²² In following tax years the credit remains unavailable if losses from earlier years have not been recaptured.²³

2.4. Foreign tax credit limitations

2.4.1. General

The application of the credit mechanism is subject to various eligibility criteria and limitations. If an eligibility criterion has not been met double taxation may be the outcome. The same is true if source taxes levied abroad exceed a certain limitation.

2.4.2. Eligible taxpayers

Juridical DTR is generally granted to resident taxpayers only. If a taxpayer earns income abroad through an interposed legal entity that is considered transparent for CIT purposes (e.g. a partnership or tax-consolidated subsidiary) relief is granted at the level of that taxpayer (i.e. the partners or the parent company).²⁴

A non-resident taxpayer is eligible to be granted juridical DTR in triangular cases where it derives passive income from third state sources that is attributable to its business activities carried on through a PE situated within Dutch territory. The non-resident taxpayer may credit source tax levied in the third state against the CIT payable on the income realized through the Dutch PE. Relief is only available for non-resident taxpayers having their place of residence in another EU/EEA Member State or a state with which the Netherlands has concluded a DTC containing a non-discrimination clause.

Economic DTR under the participation credit regime is available to both resident and non-resident taxpayers. Non-resident taxpayers are entitled to be granted relief if the non-qualifying portfolio participation is attributable to the taxpayer's business carried on through a PE situated within Dutch territory.

2.4.3. The tax base requirement

Juridical DTR is available provided that the foreign income items are included in the CIT base. This tax base requirement entails that relief is unavailable once the recipient is not subject to CIT²⁵ or that the income items are exempt from CIT.

The tax base requirement is for instance not met when proceeds from a participation (e.g. dividends) are excluded from the CIT base under the participation

²² Art. 40 Decree.

²³ Art. 41 Decree.

²⁴ Tax-consolidated subsidiaries are effectively treated as being tax transparent, but they formally maintain their taxpayer status. The DTR entitlements of parent companies of tax consolidated groups are accompanied by detailed provisions covering the CIT implications of group companies entering or exiting the tax consolidation.

²⁵ E.g. CIT-exempt investment institutions under art. 6a.

exemption regime.²⁶ Relief for source taxes levied (e.g. dividend tax) is then unavailable. To mitigate the resulting double taxation, the Ministry of Finance has adopted the international tax policy objective of reducing dividend withholding tax rates on cross-border inter-company dividend distributions, preferably to 0 per cent, on a reciprocal basis.

In triangular cases where a resident taxpayer derives passive income from third state sources that is attributable to a PE situated abroad, the foreign PE income is exempt from CIT under the tax exemption regime. As a result, the foreign income items are not in fact considered as being included in the CIT base. Consequently, the taxpayer cannot (also) credit the third state source tax against CIT since the tax base requirement has not been met.

2.4.4. The subject to tax requirement

In non-DTC scenarios juridical DTR is granted provided that the foreign source income items have been subject to a local profit tax. This subject to tax requirement – not to be confused with the subject to a reasonable tax test in the participation exemption regime – applies under both the tax exemption regime and the ordinary credit regime. In DTC scenarios generally no such requirement applies. The DTC is applied in respect of the taxes listed therein. Economic DTR under the participation credit regime is available if the non-qualifying portfolio participation has actually been subject to a levy on its profits.

The subject to tax requirement operates as a back-stop to counter double non-taxation. The requirement is particularly relevant in non-DTC scenarios in respect of the application of the tax exemption regime as relief is granted under this mechanism without taking the actual foreign tax burden into account. The requirement may initially seem less relevant regarding the application of the credit regimes since a credit for foreign tax essentially may only be granted if that tax has actually been levied. However, it has some significance regarding the ordinary credit regime for passive financing PEs and the participation credit regime for non-qualifying portfolio participations. These allow for a credit of fictitiously levied tax (see section 2.4.7). Accordingly, the requirement counters the possibility that a credit for fictitiously levied tax is granted, while no tax has actually been imposed abroad.

The term profit tax is generally interpreted broadly. It covers corporate taxes, withholding taxes and branch profit taxes. In non-DTC scenarios, these should be levied at sovereign state level or at the level of an autonomous area. Taxes levied at state level in federal states are eligible for juridical DTR if no such tax is levied at the federal level. Ineligible are taxes levied at regional levels of government. Most DTCs, however, cover taxes levied at both national and regional levels. Some DTCs (e.g. the Netherlands–Brazil DTC) entitle taxpayers to be granted a tax sparing credit (i.e. a credit for fictitiously levied tax). Ineligible taxes levied constitute deductible items. Taxpayers claiming DTR should therefore assess both the nature of the tax and the level of government imposing it.

²⁶ The same holds true for interest and royalty flow-through companies whose earnings from intra-group back-to-back debt financing and/or asset licensing arrangements are excluded from the CIT base under art. 8c. This occurs in scenarios where a taxpayer does not bear sufficient economic risks on its debt financing and/or asset licensing arrangements. The State Secretary for Finance has issued substance criteria to provide guidance on this matter.

2.4.5. *Character of income limitations*

Juridical DTR under the ordinary credit regime is available for dividends, interest and royalties as defined in the applicable DTC or – in non-DTC scenarios – the Decree.²⁷ Proceeds from PI activities operated through passive financing PEs are also eligible. The descriptions of dividends, interest and royalties in the DTCs and the Decree to a great extent correspond with those found in the OECD MTC. There are some discrepancies, though. Under the decree, for instance, proceeds from profit participating bonds are considered to be interest while most DTCs consider them to be dividends. Moreover, the decree provides for a broad royalty description, which includes payments for the use of (or the right to use) industrial, commercial, or scientific equipment, payments for information concerning industrial, commercial or scientific experience and fees for technical services rendered in a developing country. Several DTCs, particularly those with developing countries and countries with transitional economies, also provide for such widened royalty descriptions.

Economic DTR under the participation credit regime is available for proceeds from a participation, which include dividends in cash and kind, interest payments in connection with hybrid loans, capital gains and losses, impairments, proceeds from share repurchases as well as liquidation and earn-out payments.²⁸ Accordingly, taxpayers claiming relief should assess the character of the foreign income.

2.4.6. *Geographic limitations*

The ordinary credit regime's operation is subject to geographic limitations. In DTC scenarios, its geographical confines are dealt with in the respective DTC. In non-DTC scenarios the credit is granted subject to the requirement that the income items have arisen in a listed developing country. The operation of the participation credit is not subject to geographic limitations.

2.4.7. *Tax credit limitations*

DTR under the ordinary credit regime is subject to credit limitations. The credit equals the lower of:

- (a) the foreign tax levied on the foreign income items; or
- (b) the Dutch CIT that is attributable to the foreign income items.

The first limitation corresponds to the amount of tax levied abroad,²⁹ provided that – from the Netherlands' perspective – these taxes are levied in accordance with the DTC. When it concerns dividend payments the amount is maximized at 15 per cent of these payments. Taxpayers operating passive financing PEs may choose between calculating the first limitation at an amount equal to the foreign tax levied on the respective PE's income or a fictitious amount equal to 50 per cent × marginal CIT rate of 25 per cent × foreign income.

²⁷ Art. 5 Decree.

²⁸ If considered active such proceeds are eligible for DTR under the participation exemption regime.

²⁹ Or the amount of fictitiously levied tax under a tax sparing credit entitlement.

The second limitation corresponds to the amount of CIT levied on the foreign income. It is calculated on the basis of the fraction: (foreign income/worldwide income) \times CIT on worldwide income.³⁰ The numerator is calculated on a net basis: the gross proceeds need to be on-balanced with incurred expenses economically related to the dividend, interest or royalty payments. Impairments do not have to be taken into account. Incurred expenses reduce the numerator in the fraction and with that the amount of relief provided for. Not only expenses incurred at the level of the taxpayer claiming the relief should be considered. Related expenses incurred at the level of its affiliates that deducted these items from their Dutch CIT base should be taken into account as well. This prevents groups from circumventing the net approach by legally attributing related (financing) expenses incurred to a group company other than the group company/taxpayer earning the gross proceeds that is invoking the credit. The application of such a net approach in effect entails that incurred expenses economically related to the gross proceeds are attributed to the foreign jurisdiction alongside these proceeds.

Source taxes levied abroad which exceed the second limitation may be carried forward to subsequent years. In the following years, the first limitation is calculated as the sum of the carried forward amounts of excess source taxes levied in earlier years and the amount of source tax levied that year. Should the taxpayer derive a profit from its PI in a following year the carried forward amount may be credited against the CIT that is levied on that taxpayer's foreign portfolio income that year. Taxpayers need to obtain a declaration from the tax authorities formalizing the amounts carried forward.

Excess source taxes are continuously carried forward to subsequent years as long as the second limitation does not provide for sufficient room to credit these taxes against CIT.³¹ This may have the consequence of an ever increasing amount of unrelieved carryforward excess source taxes. The fact that withholding taxes on dividend interest and royalties are generally levied on the gross amounts, thereby disregarding expenses incurred, adds to this. Particularly, taxpayers deriving modest spreads on their PIs are confronted with this effect. Such taxpayers generally resort to deducting the foreign taxes from their CIT base to be subject to a more tax-efficient treatment.

A special limitation applies for taxpayers that have opted to have their net earnings from self-developed intangible assets effectively taxed at a decreased CIT rate of 5 per cent under the innovation box regime.³² The regime operates as a partial base exemption. A fraction (5/25) of the earnings is included in the CIT base. To prevent the effect that source taxes levied abroad would become ineligible to be fully credited against CIT due to the functioning of the tax base requirement, it is explicitly provided that the first limitation equals the entire amount of foreign source taxes. The fact that the income is effectively taxed at a decreased rate is acknowledged under the second limitation: the numerator equals the 5/25 fraction. Excess source taxes may be carried forward.

³⁰ The same fraction applies under the tax exemption regime.

³¹ The carryforward is not subject to a limitation in time.

³² Art. 36a Decree. The innovation box regime (art. 12b) applies in respect of intangible assets that have originated from innovative technical R&D activities.

DTR under the participation credit is also subject to limitations. The credit equals the lower of:

- (a) 5 per cent \times the grossed-up (i.e. $\times 100/95$) proceeds from non-qualifying portfolio participations; or
- (b) the Dutch CIT as levied on the grossed-up proceeds from non-qualifying portfolio participations after the deduction of attributable (e.g. financing) expenses.

The first limitation equals a fictitious amount of underlying profit tax levied on the proceeds from the participation. An exception applies to equity investments in non-qualifying portfolio participations having their place of tax residence within EU/EEA territory. Eligible taxpayers/shareholders can opt to calculate the participation credit by making reference to the underlying profit tax actually levied in the respective EU/EEA Member State. The second limitation ensures that the credit is granted on a net basis. Excess underlying tax may be carried forward if a declaration from the tax authorities has been obtained.

2.4.8. The overall approach

Under the decree the ordinary credit for source taxes levied abroad on dividends, interest and royalties is calculated on an overall basis (the overall method). The aggregate of these taxes is creditable against the CIT attributable to the net income. Generally, this is beneficial to taxpayers as it enables them to cross-credit excess source taxes levied at a higher than Dutch CIT level against the residual CIT on other foreign source income items subject to source taxes levied at a lower than Dutch CIT level. The overall method also applies in respect of the ordinary credit regime for passive financing PEs.

The DTCs provide for a per-country approach. Taxpayers may nevertheless opt, on a yearly basis, to have the overall method applied instead, thereby enabling cross-crediting in DTC scenarios as well. Partial opting-in is impossible. Tax sparing credit entitlements cannot be employed for cross-crediting purposes. The participation credit is also applied on an overall basis.

2.5. Distortions due to temporal differences in the recognition of taxable income

The timing of the recognition of taxable income is determined regardless of foreign views. DTR entitlements are accordingly acknowledged.

The attribution of business proceeds to tax years occurs under the principle of sound business practice.³³ Its operation to a large extent corresponds with common business economics and accounting principles (e.g. the reality, matching, realization and prudence principles). As the timing of payments is generally irrelevant, the time of profit realization cannot be extended by delaying payments.

Mutual divergences in the timing of income between the Dutch and foreign tax systems may give rise to double taxation issues. This is particularly true regarding the application of the ordinary credit regime. Dividends, interest and royalties are recognized under CIT law as taxable income when accrued, whereas source taxes

³³ Art. 8.

may be levied by a foreign tax jurisdiction at a later time, for instance upon payment in a subsequent tax year. Such a temporal difference might entail the credit not being (fully) available. As the income was realized in a previous year for CIT purposes the second limitation may not provide for sufficient room in the subsequent year to (fully) credit the source tax against CIT levied in the later year. The State Secretary for Finance considers this effect unwanted if such a tax would have been fully creditable against CIT had not the temporal differences occurred. It has therefore been approved that the credit is available in the subsequent year as if the temporal difference had not occurred.

Under the tax exemption regime, typically no difficulties arise as the foreign income items are exempt from the CIT base when realized. Double taxation is mitigated irrespective of the timing of the taxable income abroad. The State Secretary for Finance has for instance explicitly recognized this effect concerning foreign branch profit taxes. PE profits are eligible for relief under the tax exemption regime under the Decree, notwithstanding that a branch profit tax may be levied in another tax year than that in which the underlying PE income is considered realized under Dutch CIT law for juridical DTR purposes. The same is true under the participation exemption regime, which applies to proceeds from a foreign participation irrespective of how and when that participation is taxed abroad.

Worth mentioning is that the application of the participation exemption regime basically entails the single taxation of underlying business income since repatriated profits are not taxed in the hands of the shareholder. Non-repatriation of underlying business proceeds therefore does not lead to a deferral of tax. Profit repatriation is not discouraged. Corporate cash management and financing decisions in this respect are not influenced by CIT implications.

The application of the participation credit regime entails that proceeds from a non-qualifying portfolio participation are effectively taxed at the Dutch CIT level. Accordingly, non-repatriation of underlying PI income sheltered in low-taxing jurisdictions would entail a tax deferral. This is considered adverse where taxpayers have 25 per cent or more shareholdings in non-qualifying portfolio participations whose assets almost exclusively consist of low-taxed PIs. This is countered by subjecting such interests to mark-to-market valuation (see section 3.3.1).

2.6. Inconsistent classification of foreign entities

The classification of a foreign entity as transparent or as a taxable unit occurs autonomously. DTC entitlements are subsequently recognized accordingly. Foreign tax classifications are not taken into account.

The entity classification process occurs in two steps. First, the entity's features under the company laws of its incorporation are scrutinized. Of relevance generally is: (a) whether the entity has legal personality (i.e. its capacity to own property and to conclude legal transactions); (b) whether its equity capital is divided into shares; (c) the participant's (un)limited liability; and (d) the question of whether a participant may publicly trade its corporate interest (i.e. without the consent of its fellow participants). This typically requires an investigation of the entity's articles or memorandum of association. Second, it is assessed to which Dutch company law equivalent the entity is (most) comparable. If the entity is considered similar to a limited or general partnership it is classified as CIT transparent, save for the

exception of the “open” limited partnership which is classified as non-transparent.³⁴ If considered similar to a company, the entity is classified as non-transparent.

Mutual divergences in entity classification can trigger differences in taxpayer identification and differences in the qualification, allocation and timing of the income. This may subsequently entail double (non-)taxation. Without specific measures, such hybrid entity issues remain unresolved as the Netherlands has made a general observation on the positions advocated by the OECD in its partnership report. The government disagrees with the OECD’s view that the entity classification in one contracting state should be followed by the other. Although it concurs with the report’s findings from a policy perspective it only adheres to its conclusions if explicitly confirmed under a DTC provision, unilateral measure, or mutual agreement procedure. For that reason, various recently concluded DTCs contain specific hybrid entity clauses.³⁵ Typically, these provisions achieve single taxation in a manner which is equivalent to the OECD’s findings in scenarios falling within these DTCs’ scope of application.

In the remaining scenarios, double (non-)taxation remains unresolved if not explicitly dealt with unilaterally. Double taxation issues may for instance arise when a Dutch resident taxpayer invests in a foreign business enterprise through a foreign entity that is considered transparent for Dutch CIT purposes while being considered a taxable entity abroad. The foreign tax jurisdiction subjects the business profits to a corporate tax at the level of that entity and subsequently to a dividend tax upon its repatriation while these profits are taxed in the hands of the Dutch resident taxpayer under Dutch CIT law. This taxpayer is eligible for juridical DTR under the tax exemption regime if its operations are considered a business carried on abroad through a PE. However, source taxes levied abroad upon the profit repatriation are ineligible for DTR as the transparent entity’s profit repatriation is not considered a taxable event under Dutch CIT law.

Moreover, issues may arise when a Dutch resident taxpayer invests in foreign landed property by participating in an interposed foreign entity that is considered tax transparent locally while being considered non-transparent for Dutch CIT purposes. The foreign tax jurisdiction subjects the Dutch resident taxpayer to corporate tax on the landed property investment’s proceeds, while the Netherlands considers the foreign entity as the taxable unit receiving the proceeds from the underlying landed property investment. As the Dutch resident taxpayer is not recognized as the taxable unit earning the proceeds from the landed property investment and refrains from being taxed thereon, juridical DTR under the tax exemption regime is unavailable. Taxable income is recognized upon profit repatriation. The ordinary credit may be unavailable since the corporate tax levied abroad on the landed property may not be considered a creditable source tax.³⁶ The participation exemption is unavailable if the 5 per cent threshold is not met.

³⁴ Limited partnerships are considered “open” if the limited partners are entitled to trade their partnership interests without the consent of all the other partners (art. 2, third indent, paragraph c, General Law on Taxation (GLT)).

³⁵ E.g. art. 24, para. 4, Netherlands–USA DTC.

³⁶ A report recently issued by a parliamentary committee dealing with petitions has triggered some uncertainty in this respect. It notes that the Ministry of Finance, in a case involving an individual, expressed the view that the income tax levied abroad on the proceeds from landed property was creditable against the Dutch individual income tax levied on the recognized dividends.

In earlier times, double non-taxation due to mutual divergences in entity classification for instance occurred under the Sara Creek tax planning arrangement. A Dutch resident parent company finances its business activities carried on abroad through a PE operated by its tax-consolidated subsidiary with an intra-group loan issued to that subsidiary. Under current CIT law tax-consolidated subsidiaries are effectively treated as transparent. CIT is levied as if there is one taxable unit, i.e. the parent company. DTR is granted with respect to the taxable unit's PE income under the tax exemption regime. Tax consolidation among other things entails that intra-group debt financing arrangements are considered non-existent for CIT purposes. Accordingly, the tax exemption was calculated without recognizing a DTR reducing interest expense at the level of the PE. If the foreign tax jurisdiction considers the subsidiary non-transparent, the loan issued by the parent company is typically recognized for local CIT purposes and attributed to the PE under the functional and factual analysis (since the PE's business operations have been financed with the intra-group loan issued by the subsidiary's parent). This leads to the recognition of tax-deductible financing expenses in the foreign tax jurisdiction to be offset against local operational profits. This in effect reduces the local CIT base without the recognition of a corresponding taxable receipt at the level of the parent company in the Netherlands. The loophole has been closed under a counter-measure in the tax consolidation regime.³⁷ It basically takes back the intra-group loan's non-existence for juridical DTR purposes if the financing expenses have been recognized as a tax-deductible item abroad. The amount of DTR granted is reduced as the tax-exempt PE income is calculated by making reference to a deductible intra-group interest expense recognized at the level of the foreign PE. In effect the measure's application entails the recognition of a taxable intra-group interest receipt in the Netherlands equivalent to the deduction of the interest expense abroad, thereby closing the loophole and cancelling out the planning opportunity.

Not all double non-taxation – and ensuing tax planning – has been cancelled out (see section 3.3.2 for an example of unrelieved non-taxation caused by mutual divergences in entity classification).

2.7. Currency exchange results

Under the tax exemption regime and ordinary credit regime, currency exchange results are included in the CIT base. These DTR mechanisms' operation does not affect the CIT payable on currency exchange results. Consequently, there are as many deductible/taxable currency exchange results recognized for CIT purposes as there are activities which the taxpayer carries on in foreign jurisdictions employing currencies other than the euro.

An alternative approach has been adopted under the participation exemption regime and participation credit regime. A currency exchange result on an equity investment eligible for economic DTR is considered to be a proceed from a participation. Such results are exempt from the CIT base if the participation is eligible for relief under the participation exemption regime.³⁸ Currency exchange results on

³⁷ Art. 15ac, fourth to sixth indent.

³⁸ The exemption of currency exchange results (e.g. losses) raised questions as to its (in)compatibility with EU law since the Court of Justice's ruling in case C-293/06 (*Deutsche Shell*).

related hedging instruments are considered exempt proceeds upon the taxpayer's request. Currency exchange results on non-qualifying portfolio participations are included in the CIT base. But relief is subsequently available under the participation credit regime.

Taxpayers may opt to calculate their CIT base in a currency other than the euro.³⁹ The tax authorities take the position that taxpayers who have opted for the application of the functional currency rules should calculate the amount of juridical DTR to be granted in that functional currency.

3. Pros and cons of credit versus exemption

3.1. Complexity and sophistication

Generally, the operation of the individual DTR mechanisms – particularly in typical, non-borderline, scenarios – does not pose practical difficulties. If observed as a whole the DTR system may nevertheless be considered as being difficult to understand, manage and apply as various elements of both a technical and administrative nature should be appreciated. Problems in the DTR system's practical operation mainly occur due to the concurrent presence of various DTR mechanisms (e.g. delimitation issues), their particular features (e.g. the *Bosal* mismatch), or mutual divergences with foreign jurisdictions (e.g. qualification and classification conflicts).

3.2. Administrative burden

3.2.1. Delimitation issues

A first feature which is responsible for some complexity is the necessity to distinguish between active and passive income. Under general CIT law, a property right qualifies as a PI, yielding passive income, if the taxpayer holds it to earn a yield that may be expected from normal portfolio asset management. A property right qualifies as a direct investment producing active income if the taxpayer holds it to employ it for the benefit of its business enterprise. If property (e.g. an equity interest) is partly held as a PI and partly for business reasons, the tax legislator considers the predominant motive to be decisive. The taxpayer's intention is objectified through a functional and factual analysis of the property right's position in the taxpayer's property. The test is applied to debt and equity investments, as well as lease and licensing arrangements. Substance criteria are in place to decide whether group financing operations conducted abroad through PEs can be labelled active or passive.⁴⁰ Despite the guidance available the active/passive distinction is not always easily established in practice. Borderline scenarios in particular pose challenges for both taxpayers and the tax administration to effectively argue the income's nature. This triggers legal uncertainty and administrative inconvenience.

³⁹ Art. 7, fifth indent.

⁴⁰ Arts. 2a–b Implementing Ordinance to the CITA.

Complexity is added where it involves proceeds from participations. The equity investment's active or passive nature should be observed to decide whether the participation exemption regime or participation credit regime applies. The CIT legislation contains a motive test for this purpose, which is referred to as the not held as portfolio investment requirement. Proceeds from participations are considered active if the requirement has been met. Otherwise, the equity investment is considered passively held and referred to as portfolio participation. The requirement has been interpreted in case law as being not met if the participation is held to earn a yield that may be expected from normal portfolio asset management. Furthermore, the CIT legislation sets forth that a shareholding is deemed to be passively held if (a) more than half of the participation's consolidated assets consist of shareholding(s) of less than 5 per cent or (b) the predominant role of the subsidiary – together with the roles performed by its lower-tier participations – is to put (liquid) assets at the disposal of other group companies. The requirement has been interpreted in case law as being met if the participation is in a line of business common to its shareholders. When it concerns participations in intermediate holding companies – “acting as a link between the ultimate parent and its underlying operative group companies by playing an essential role in the group's business enterprise due to its activities in terms of management, strategy or finance” – parliamentary history indicates that the requirement may be considered as also having been met. If a (lower-tier) participation conducts group financing or leasing activities, substance criteria apply to decide whether the shareholding qualifies as a direct (active) or portfolio (passive) investment.⁴¹

The administrative burden for taxpayers may increase further when it concerns the identification of a qualifying portfolio participation. Under the safe harbour rules laid down in the CIT legislation, the portfolio participation should meet an asset test or a subject to a reasonable tax test. The asset test is met if the taxpayer demonstrates that less than 50 per cent of its portfolio participation's directly and indirectly held assets generally consist of low-taxed PIs. The participation's asset qualification should be applied at the level of the respective participation and each of its lower-tier shareholdings. Group receivables are deemed PIs, unless (a) the participation conducts active group financing activities, (b) the receivables are mainly financed (i.e. 90 per cent or more) from third party debt, or (c) the receivables' yield is subject to sufficient taxation (i.e. the subject to a reasonable tax test is met). Landed property and capital assets used in an active leasing business are not deemed as PIs. Typically this requires the taxpayer to draft an account reflecting its participation on balance amounts of (in)directly held assets.⁴² The subject to a reasonable tax test is met if the taxpayer demonstrates that the portfolio participation is subject to a reasonable levy according to Dutch standards in its country of residence. Parliamentary history indicates that a profit tax levied at an effective rate of at least 10 per cent suffices. Both national and regional profit taxes may be taken into account. Registration levies, capital duties, transfer taxes, etc. are ineligible. Typically this requires taxpayers to draft an analysis of their participation's profit tax burden. A full recalculation of the participation's taxable profits under

⁴¹ *Ibid.*

⁴² Inter-company back-to-back loans may be considered as the consolidated amount of debts and receivables.

Dutch standards may not be required. It generally suffices to broadly analyse whether the passive income is sufficiently taxed. The analysis should contain a comparison of the local profit tax system with the Dutch one. Various aspects should be taken into consideration, such as local tax rates, base exemptions, tax consolidation or profit pooling regimes, DTR mechanisms, tax incentive regimes, local tax treatment of debt/equity financing arrangements, entity classification rules, etc. Currently, there is some uncertainty in practice concerning the required thoroughness of the accounts and analyses as well as the question of when exactly a foreign tax system is comparable on a satisfactory basis.

A second feature of the DTR system which is responsible for the complexity is the effect of switching over from one DTR mechanism (e.g. participation exemption) to another (e.g. participation credit) at a particular time. A switch-over takes effect when an eligibility criterion is no longer met (or vice versa) due to a change in facts and circumstances (e.g. a transfer in the income's nature) or in the applicable law. Issues particularly arise when it concerns the effect of applying the switch-over in cases of accrued income to which the imposition of CIT is postponed until the moment when the income has been realized (e.g. upon an asset disposal). There is some guidance available regarding the application of the participation exemption regime on liquidation proceeds and capital gains realized. A compartment approach should be adopted. The proceeds realized need to be chronologically allocated in a manner corresponding to the time period in which the income economically accrued. Subsequently, the so allocated accrued earnings are subject to the DTR regimes as applicable during the period of the capital accrual. If a certain eligibility requirement is no longer met at any time within the capital accrual period – triggering the switch-over to another DTR mechanism – the accrued earnings are accordingly divided into compartments to which the available DTR mechanisms are applied alongside. The application of the compartment approach entails administrative inconvenience and legal uncertainty, particularly where it concerns the process of evaluating and chronologically allocating the accrued earnings.

3.2.2. *Administrative aspects*

The tax authorities assess CIT liability. No self-assessment procedure is in place. Taxpayers are nevertheless required to file a CIT return (electronically) in good time. The (amounts of) DTR is claimed by filling in the relevant subject fields in the CIT return computer program. The filed CIT return is subject to a computerized compliance analysis. In most cases, the CIT assessment is subsequently formalized and issued to the taxpayer. Should the computer analysis or any findings of a tax administrative officer result in a call for a further inquiry, the tax authorities commonly advance by issuing questionnaires or information requests (e.g. on the substance of foreign activities, the amount of foreign taxes imposed, the income's passive/active nature, etc.). Taxpayers are required to fully cooperate and submit all information which is relevant for determining CIT liability (except tax advice).⁴³

⁴³ Art. 47 GLT. Taxpayers should have a properly organized financial administration and transfer pricing documentation available (arts. 52 GLT and 8b). The tax authorities may estimate the CIT liability in cases of extreme non-administrative compliance. Taxpayers challenging the accordingly assessed CIT liability in court face the burden of providing conclusive evidence supporting their position (art. 25 GLT).

Where necessary for appropriately assessing the CIT liability, the tax authorities may inquire further or commence a tax audit. The tax administration is in principle able to call in additional CIT subsequent to the issuance of the CIT assessment for a period that may be extended from 5 to 12 years.⁴⁴

Taxpayers seeking guidance or certainty on their CIT positions may resort to several means. Taxpayers may for instance rely on the tax authorities' general policy considerations on CIT law and DTC interpretation matters. These are made public by the State Secretary for Finance through policy regulations.

Furthermore, taxpayers are able to obtain certainty concerning their CIT positions in the pre-tax return filing stage on an ad hoc basis. They may request the competent tax inspector to conclude an APA and/or to provide an ATR.⁴⁵ An APA provides for legal certainty concerning transfer pricing issues, an ATR on the CIT implications of a contemplated (set of) transaction(s), for instance concerning the application of a particular DTR mechanism. APAs and ATRs are regularly agreed upon. Prior to bringing an APA or ATR to a close, the tax inspector consults the APA/ATR team, a resource unit within the tax administration. The APA/ATR team issues advice by which the tax inspector is bound.⁴⁶ No rulings are provided if taxpayers attempt to avoid Dutch CIT or if foreign states' DTC (e.g. source tax) entitlements are sought to be artificially avoided. In cases lacking economic substance the tax inspector may proceed to spontaneously exchange the relevant information with the respective DTC partner (e.g. following a taxpayer's request for a residency certificate, affidavit, or at the time of formalizing the CIT assessment). If double taxation remains, taxpayers may request the competent authorities to commence mutual agreement or arbitration procedures under the respectively applicable DTC and/or EU instruments.

Finally, a relatively new phenomenon worth addressing is "horizontal monitoring". Horizontal monitoring is inspired by the idea of reducing administrative burdens and providing legal certainty by settling tax uncertainties in the pre-tax return filing stage. For a few years the tax authorities have actively approached large and medium-sized multinational enterprises (MNEs) having (or willing to develop) solid tax control frameworks.⁴⁷ The objective is to get taxpayers to voluntarily conclude compliance covenants on the basis of "mutual trust, understanding and transparency".⁴⁸ A compliance covenant lays down contractual arrangements

⁴⁴ Art. 16 GLT.

⁴⁵ Foreign investors/potential taxpayers may obtain legal certainty on contemplated transactions through a ruling. For this purpose a resource unit has been formed (the potential foreign investors contact point).

⁴⁶ If necessary for policy synchronizing purposes the APA/ATR team consults other resource units (e.g. the transfer pricing coordination group, the anti-tax avoidance coordination group and the entity classification knowledge group). The Ministry of Finance's Directorate of International Tax Affairs is consulted in case of bilateral or multilateral APA requests. The Directorate is the competent authority under the (inter)national/EU instruments on mutual administrative assistance.

⁴⁷ A tax control framework is an internal control instrument focusing on a business's tax process. It forms an integral part of a company's business or internal control framework drafted for the purpose of issuing "in control statements" to its stakeholders on various subjects. The issuing of such statements is triggered by growing risk management demands in financial reporting and corporate governance.

⁴⁸ The project is coordinated by a resource unit within the tax authorities (the very large business knowledge group).

on cooperation between the tax authorities and the taxpayer. Taxpayers bind themselves to actively submit, in a timely fashion, current or impending tax positions of significant (revenue) importance that may allow for differing legal interpretations. The tax authorities bind themselves to quickly decide on these matters. Tax positions and their consequences would be openly discussed and assessed, tax returns would be filed with due observance of the consensus reached earlier.⁴⁹ If the relationship between taxpayers and tax authorities develops accordingly, the tax returns filed are monitored only to a limited extent (e.g. through random sample searches). The issuing of the tax assessment may even be reduced to a mere formality.

3.3. Sensitivity to international tax planning and tax avoidance

3.3.1. General

The tax policy consideration for exempting active income is referred to as capital import neutrality. It should enable taxpayers to operate their foreign business activities under the same tax conditions as their local competitors. The credit regimes for passive income are founded on a combination of capital export neutrality and anti-avoidance considerations (i.e. countering the sheltering of PI income in low-tax jurisdictions). The presence of the switch-over to credit mechanisms for passive financing PEs and non-qualifying portfolio participations, ensuring that (repatriated) low-taxed PI income is effectively taxed at the Dutch CIT level, implies that credit regimes are considered more effective in countering tax avoidance than exemption mechanisms. Exemptions are considered more vulnerable to profit-shifting. Adverse tax deferral is countered as 25 per cent or more shareholdings in non-qualifying portfolio participations, whose assets almost exclusively consist of low-taxed PIs, are subject to a mark-to-market valuation rule.⁵⁰ This in effect results in the current imposition of corporate tax on the underlying PIs at the Dutch CIT level.

3.3.2. Tax planning

Notwithstanding the anti-avoidance measures in place, some elements in the DTR system are sensitive to tax planning. Planning opportunities are triggered by:

- (a) features of the adopted DTR mechanisms;
- (b) mutual divergences with foreign jurisdictions.

Some features of the DTR system enable tax planning. Taxpayers financing their foreign business activities with debt capital may, for example, utilize the *Bosal* mismatch facilitating a reduction of the Dutch CIT burden if such activities are operated through a subsidiary rather than a PE (see section 2.2). Tax planning arrangements employing the mismatch are regularly implemented in practice.

Moreover, taxpayers deriving low-taxed PI income to some extent seek to circumvent the application of the switch-over mechanisms for the purpose of repatriating their passive income to the Netherlands exempt from CIT. Regarding passive

⁴⁹ Parties remain entitled to litigate unresolved matters through the court system.

⁵⁰ Art. 13a.

financing PEs, a switch-over mechanism to the ordinary credit applies. However, various DTCs in the Dutch DTC network do not entitle the tax authorities to effectuate it (see section 3.4). In these DTC scenarios taxpayers are in principle able to obtain the proceeds from such passive activities exempt from CIT. In practice, however, not many Dutch treaty partners facilitate the low-taxed sheltering of PI income. Moreover, the effective attribution of passive investments to foreign PEs meets various practical issues. To the reporters' knowledge, the quantity of such tax planning arrangements is moderate. Moreover, a switch-over to the participation credit applies to portfolio participations not meeting the safe harbour rules. The participation exemption is nonetheless available as long as less than 50 per cent of the portfolio participation's assets consist of low-taxed PIs. This enables the mixing of "good" and "bad" assets just up to the 50 per cent threshold for the purpose of applying the exemption to the participation's entire proceeds, including the low-taxed PIs' yields. Tax planning arrangements seeking this effect have been occasionally implemented in practice. To the reporters' knowledge the number of such planning arrangements is, however, limited as their implementation meets various practical hazards. The tax risks and the legal uncertainty involved, administrative inconvenience and the substantial maintenance costs seem to discourage taxpayers from persevering in their tax planning efforts in this area.

Mutual divergences between the Dutch and foreign corporate tax systems entail tax planning opportunities. Taxpayers, for instance, utilize differences in income qualification or entity classification for tax planning purposes.

A technique which makes use of qualification conflicts is the implementation of inter-company hybrid loans. Interest payments received by shareholders/creditors in connection with a hybrid loan issued to a foreign subsidiary/participation are eligible to be exempt from CIT under the participation exemption regime. Foreign CIT implications are not considered. If the interest payments are tax deductible in the country in which the participation/debtor resides an overall corporate tax reduction is achieved.

Hybrid entities may also be utilized. For example, a Dutch tax resident company holds an interest in a foreign legal entity that is considered tax transparent for Dutch CIT purposes. The entity's business activities are financed with a loan issued by the Dutch company. Should that entity conduct its commercial activities abroad through a fixed place of business, the Dutch company is considered to operate a business through a PE to which the tax exemption regime applies for juridical DTR purposes. The debt financing arrangement may not be recognized for CIT purposes as Dutch CIT law does not recognize an internal debt financing arrangement between a head office (in this case the Dutch company) and its PE as a taxable event.⁵¹ Accordingly, an internal interest payment from the hybrid entity to the Dutch company may not constitute a taxable item in the Netherlands. The tax exemption would then be calculated without recognizing a DTR reducing interest expense at the level of the PE. If the foreign legal entity is considered non-transparent in its local tax jurisdiction and the debt financing arrangement is recognized for local CIT purposes, the interest payments from that entity are considered deductible and can be offset against operational profits (e.g. realized by the hybrid entity itself or its affiliates under the application of a local profit

⁵¹ This holds true if the PE cannot be considered to be financed with external debt.

pooling regime). This would reduce the local tax base without the recognition of a corresponding taxable receipt in the Netherlands at the level of the Dutch tax resident company.⁵²

3.4. Compatibility with applicable international commitments

The legal basis for DTR is found in the applicable DTC. Typically the DTCs in the Dutch DTC network contain a general provision prescribing the DTR mechanism to be applied. A reference is subsequently made to domestic tax legislation, i.e. the Decree, for the technicalities concerned. In non-DTC scenarios, DTR is unilaterally provided under the decree.⁵³

The tax legislator is unable to shift to another juridical DTR mechanism in DTC scenarios as the Constitution does not allow for treaty overrides.⁵⁴ Treaties supersede conflicting domestic law. Shifting to another DTR mechanism would require the renegotiation of the respective DTC. An example is the switch-over from the tax exemption to the ordinary credit for passive financing PEs under the decree. As most older DTCs prescribe the application of the tax exemption regime to PE income – including passive financing PE income – the tax authorities are unable to resort to the credit under these DTCs.⁵⁵ Notably, the switch-over to the participation credit is not affected by the DTCs as it falls outside their confines. It has nevertheless attracted attention as to its (in)compatibility with EU law.

3.5. Impact on economic decisions

Various factors contribute to the attractiveness of doing business in the Netherlands (e.g. social and political stability, an educated population, a sophisticated public health and legal system, infrastructure). Corporate taxation is one of them. In particular, the participation exemption, the extensive DTC network, the absence of source taxation on outbound interest and royalty payments and the possibility of settling CIT positions in the pre-tax return filing stage are commonly addressed as features which add to this attractiveness. The common presence of holding and group servicing activities may be explained by this.

4. Future trends

A sophisticated DTR system is in place. Its operation generally does not seem to pose great problems. Various features add to the attractiveness of doing business in the Netherlands. However, some problems may be identified. Key are the *Bosal* mismatch, double (non-)taxation due to mutual divergences between the Dutch and

⁵² The countermeasure addressed in section 2.6 would not apply as it only provides for a DTR reduction if the loan would have been issued by the Dutch company's parent if that parent would have tax consolidated its subsidiary.

⁵³ Art. 38, second indent, GLT in conjunction with the decree.

⁵⁴ Arts. 93 and 94 Constitution 1983.

⁵⁵ E.g. the current DTCs with Belgium, Canada, Denmark and Switzerland do entitle the tax authorities to apply the switch-over.

foreign corporate tax systems, as well as legal uncertainty and administrative inconvenience due to delimitation issues.

The *Bosal* mismatch in particular has led scholars, the Ministry of Finance and the study group tax system (a government-appointed advisory committee) to submit various proposals to remedy its distortive effects. Suggestions range from notional deductions for equity financing arrangements, the non-deductibility of financing expenses on loans attracted to finance domestic and foreign participations to (partial) base exemptions for intra-group debt financing arrangements (the group interest box regime). Proposals for replacing the various interest deduction limitations with, for instance, an earnings and stripping regime have also been forwarded. Furthermore, a base exemption for PE income has been suggested to replace the tax exemption regime to remove the ability to deduct foreign PE losses against domestic income. At the time of finishing the report, however, draft legislative bills have not been proposed.