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The Territorial Taxation Experience in the Netherlands

By
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This is the fifth case study in a series on territorial tax systems in other countries. The intent of the study is to see what lessons the U.S. can learn from other countries' experiences and to evaluate the validity of some of the fears critics express when discussing what would result if the U.S. were to move to a territorial system.

Companies that are healthy and grow internationally will be able to capitalize on opportunities that solely domestically operating companies will not be able to seize on. This will have a positive impact on profits and employment in the residence state. In that sense one can say that if international expansion is good for the company, it is good for the country.—Paul Vlaanderen, Director of International Tax Policy and Legislation, Netherlands Ministry of Finance, 2002[1]

The origins of the Dutch dividend exemption go back to 1893, when it became "one of the pillars" of the tax system.[2] According to Paul Vlaanderen, former director of Dutch international tax policy, there are two reasons that the Netherlands has always exempted foreign profits. First, the country respects the fiscal sovereignty of other nations to tax the business profits realized within their own jurisdictions (the "benefit principle"). Second, the Netherlands recognizes that its domestic market of 16 million people is too small to sustain growth for its innovative companies. To penetrate foreign markets and gain global market share, companies must be able to compete with other multinationals on "a level playing field" and from "an equal tax position."[3]

The exemption for active income applies to a broad swath of investment types, including some portfolio investment and financing activity. While investment institutions specifically are not eligible for the exemption, passive investment income may be exempt if it passes a "subordination requirement," meaning

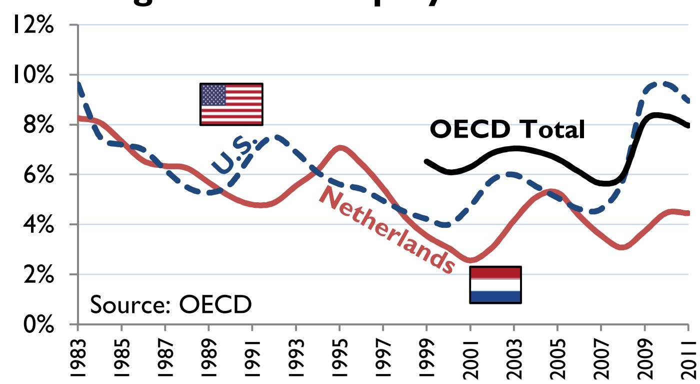
[1] *See* Paul Vlaanderen, *Why Exempt Foreign Business Profits?*, 25 TAX NOTES INTERNATIONAL 1095, 1099 (Mar. 11, 2002).
[2] *How Other Countries Have Used Tax Reform to Help Their Companies Compete in the Global Market: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (May 24, 2011) (statement of Frank M. Schoon, Partner, Ernst & Young LLP) http://www.gpo.gov/fdsys/pkg/CHRG-112hhrg72510/pdf/CHRG-112hhrg72510.pdf [hereinafter Schoon Statement].
[3] *See* Vlaanderen, *supra* note 1, at 1095.

that it was taxed at an effective rate of at least 10 percent in its source jurisdiction.[4] This provision denotes that "only so-called 'low taxed investment companies' are disqualified from the participation exemption."[5] Likewise, profits derived from permanent establishments of foreign branches are exempted as long as the income has met the same 10 percent test.[6]

For foreign dividends that are not exempt, double-taxation is mitigated with a foreign tax credit and a deferral regime. However, if a Dutch company holds 25 percent or greater of the stock in a foreign passive or low-tax asset, "the annual change in the value of the holding forms part of the Dutch taxable income." This reevaluation approach differs from most other territorial jurisdictions.[7]

The Netherlands permits deductions for costs associated with exempt foreign earnings against domestic taxable income, but there are limits on deductibility of interest payments. For a firm to deduct the costs associated with external financing, it must prove that the debt issue is relevant to the gain of taxable domestic income. The same scrutiny is applied to loan costs associated with foreign acquisitions.[8] If ever debts are deemed "excessive" by tax authorities, the interest costs are not deductible.[9]

Figure 1. Unemployment Rate



To stimulate job creation and innovation in the Netherlands, the "innovation box" regime subjects qualifying income from intangible assets to a tax rate of just five percent. This regime, similar to the UK "patent box," is aimed to eliminate the incentive to shift intangible property and income into tax havens. In addition, the Dutch system is noted by tax professionals to offer "ample possibilities for deducting expenses from gross income and a favourable treatment of losses."[10] Due to its taxpayer-friendly approach and low tax burdens, the Netherlands is the registered home to many holding companies, and KPMG has ranked the Dutch corporate tax system as the most attractive in Europe.[11]

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[4] *See* Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income* (May 20, 2011), at 31, http://www.jct.gov/publications.html?func=startdown&id=2793 [hereinafter JCT, *Background*].

[5] Fisconti Tax Consulting, *Dutch Participation Exemption in 2012* (Jan. 2012), at 2, http://www.corptax.org/images/publicaties/dutch-participation-exemption-in-2012.pdf.

[6] *See* Schoon Statement, *supra* note 2, at 5.

[7] *See* Vlaanderen, *supra* note 1, at 1097.

[8] *See* Vlaanderen, *supra* note 1, at 1096.

[9] *See* JCT, *Background*, *supra* note 4, at 32.

[10] Intertrust Group, *The Netherlands as a corporate base for international operations* (Jan. 2012), at 7, http://www.intertrustgroup.com/en/~/media/Downloads/Netherlands/Intertrust%20The%20Netherlands%20as%20a%20Corporate%20Base.ashx.

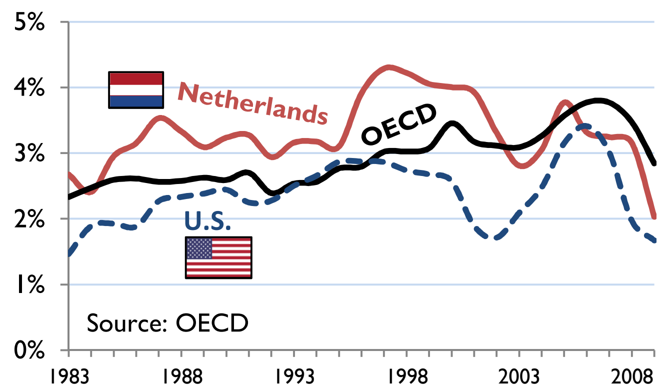
[11] Maarten Van Tartwijk, *Why Incorporate in the Netherlands? It's Less Taxing*, WALL STREET JOURNAL, Feb. 15, 2011, http://online.wsj.com/article/SB10001424052748704409004576146384199592002.html.

Data

The unemployment rate in the Netherlands has trended downward since the early 1980s. Particularly since 1998, Dutch employment figures have consistently scored better marks than the U.S., and in 2011, unemployment in the Netherlands was half of the U.S. figure (Figure 1, above). This occurred while the Dutch pursued a policy of foreign engagement and outbound investment. This is not to suggest that the territorial tax system is the primary driver of positive labor market outcomes in the Netherlands, but the territorial system has clearly not prevented these outcomes.

Perhaps just as shocking is the Dutch system's tax revenue performance. It has consistently out-yielded the U.S. system, as well as the OECD average, until very recently (Figure 2). In only one of the last thirty years did the U.S. worldwide system collect more tax revenue as a share of GDP than its Dutch counterpart. And like Canada, this has occurred in the context of ever-decreasing tax rates; the top marginal rate has been lowered five times since 2001, moving from 35 percent to 25 percent.

Figure 2. Corp. Tax Revenue as Share of GDP



In sum, the Netherlands has operated a competitive territorial system with substantially lower corporate tax rates than in the U.S. and it has experienced better labor outcomes and greater levels of corporate tax revenue. The Dutch case specifically rebuts each of the fears associated with territorial taxation and may be held up as an international tax exemplar.

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