KPMG Meijburg & Co Tax & Legal

STRIKING A BALANCE IN CORPORATE INCOME TAX

Summary of the report of the Advisory Committee on the Taxation of Multinationals

Introduction

In June 2019, in response to a motion adopted by the Lower House of Parliament, the Deputy Minister of Finance set up an Advisory Committee on the Taxation of Multinationals ('the Committee'). The Committee comprises tax experts, economists and EU law specialists and is chaired by Bernard ter Haar. The Committee was asked to advise on measures to make the taxation of the profits of multinationals fairer, while at the same time ensuring that the Netherlands remains attractive for Dutch head offices. The 145-page Committee report was released on April 15, 2020.

Problem areas in the current system of taxing multinational enterprises

The Committee identified eight problem areas in the current international system for taxing profits realized by multinational corporations. It concerns the following problem areas:

1. Opportunities for profit-shifting to low-tax countries without significant changes to the investment structure.

Because each entity that is a member of group is, in principle, an independent taxpayer, an entity's profit can be affected by the transfer prices set for transactions between various entities within a multinational corporation. The arm's length principle, which focuses on combating the tax-driven manipulation of mutual transfer pricing, is not always effective.

2. Taxation of profit that potentially differs from the total consolidated profit, resulting in double taxation or taxation of less than the full profit.

Because the group as such is generally not regarded as a taxpayer, the total amount that is taxed in the various countries where a multinational corporation is active may deviate from the total (consolidated) profit of the group (both upward and downward).

3. Asymmetry between (the location of) deductible costs and (the location of) taxable income for the head offices of multinationals.

According to the Committee, this problem area mainly occurs with regard to the head offices of large multinational corporations with a head office in a country with a relatively small domestic market, such as the large Dutch multinationals. To illustrate this problem area, the Committee refers to the fact that head office costs and shareholder costs are taken into account in the jurisdiction where the head office of the multinational is located, although the profits realized by the group are taxed in the jurisdictions where the participations are established and not in the jurisdiction of the head office. According to the Committee, surplus profits often do not end up at the head office but in jurisdictions where a 'principal' is established.

4. Opportunities for profit-shifting by opting for equity or debt-financing within the group.

By using group loans, profits can be shifted from high-tax to low-tax countries by means of interest payments, resulting in an erosion of the tax base in high-tax countries. The Committee refers to a 'tax rate mismatch' in this respect.

5. Numerous disputes between countries, with taxpayers bearing the risk.

In this respect, the Committee refers to the fact that an increasing number of countries believe that a country's power to tax must partly be dependent on the location of its customers and not only on where the supplier or service provider has a tax presence (whether or not only for strongly digitalized business models).

6. Administrative burden for companies.

Internationally operating companies are to a large extent (administratively) hindered as a result of being subject to different rules in all the countries where they are active.

7. A sub-optimal capital structure at the group level.

According to the Committee, companies are encouraged (for tax purposes) to attract excessive amounts of external debt.

8. Stimulus for tax competition between countries.

Tax autonomy creates differences in tax regulations and the effective tax burden on investments is dependent on the location of the investment. This makes investments in low-tax jurisdictions more attractive. Countries are therefore encouraged to lower the effective tax burden on companies in their countries in order to attract foreign investment.

These eight problem areas form the basis for the Committee's advice.

The Committee's advice

1. Continue investigating

The Committee's advice is threefold. Firstly, the Committee advises gathering more data on a structural basis to increase the insight into the tax paid by multinationals, both internationally and nationally. At the international level, the Committee proposes improving the quality of country-by-country reporting and then to move toward public country-by-country reporting. At the national level, the Committee proposes that companies always report the profit for accounting purposes realized in the Netherlands. The Committee also recommends that further research be done into companies that are (permanently) loss-making for corporate income tax purposes (these are not only multinationals), into the importance of transfer pricing and in particular the role of royalties in profit attribution, into the return on capital invested in the Netherlands and into the differences between profit determination for tax and for accounting purposes at multinationals.

2. International cooperation

The Committee emphasizes that it is important for the Netherlands to take the lead in international cooperation on profit taxes (both in the EU and the OECD, especially with

regard to the discussions about Pillar 1 and Pillar 2) and in this respect it formulates eight points to which the Netherlands should commit itself:

1. Aim for some form of consolidation of the tax base. Within Europe, the Committee sees an opportunity for a revised Common Consolidated Corporate Tax Base, the CCCTB 2.0, whereby the consolidated tax base is distributed across countries on the basis of a destination country-oriented turnover formula.
2. Aim for allocation rules that result in less manipulation.
3. Aim for a minimum tax rate, so that the stimulus for tax competition is weakened.
4. Examine whether allocating more profit to market countries is appropriate in a digitalizing economy.
5. Aim for leaving as little room as possible for national differences, should a harmonized tax base be created.
6. Aim to limit the tax benefits of debt.
7. Aim for arbitration to be binding on all the countries involved, so as to avoid double taxation.
8. Aim for meticulousness. Major reforms require a nuanced balance between income and costs, including the effects on prosperity. Pay attention to (implementation) deadlines when introducing international agreements.

3. Unilateral Dutch measures

3.1. General

To explore potential unilateral policy options for the Netherlands, the Committee examined five matters:

1. How important is corporate income tax for the business climate?
2. How does Dutch corporate income tax compare with profit tax in other countries?
3. Does the revenue from corporate income tax change over time and how does this compare with other countries?
4. How much corporate income tax do multinationals pay in the Netherlands compared to other types of companies?
5. What corporate income tax problem areas can contribute to a distortion in the amount of tax paid by multinationals?

According to the Committee, compared to other developed economies the Netherlands' corporate income tax revenue as a percentage of gross domestic product is relatively high: 3.3% in 2018 compared to 2.9% as the average for OECD countries. The Netherlands does not as such differ from other smaller developed countries with an open economy. Based on its investigation, the Committee further contends that it cannot be concluded that multinationals, as a group, systemically pay far less corporate income tax than previously or than domestic companies. The effective tax burden on profitable multinationals does not appear to be lower than on profitable non-multinationals: 24.5% versus 24.8% over the period 2010-2017. Within the group of multinationals, the effective tax burden of 19% on Dutch multinationals is less than that on the other multinationals. As possible reasons for the lower effective tax burden on Dutch multinationals compared to other multinationals, the

Committee refers to the fact that Dutch multinationals can be expected to make relatively more use of the deduction of liquidation losses and the Innovation Box regime. In light of these facts, the Committee recommends a degree of restraint in taking additional (unilateral) measures. Despite this observation, the Committee sees opportunities for broadening the corporate income tax base for companies in order to address problem areas in corporate income tax that can contribute to a distortion in the amount of tax paid by multinationals while at the same time maintaining the Netherlands as a good location to establish a head office. In that respect, the Committee recommends a 'baseline scenario' of seven measures to be taken by the Netherlands that indeed result in a broadening of the corporate income tax base, but according to the Committee do not lose sight of the importance of the business climate. There is consensus within the Committee about these seven measures. The Committee also mentions 13 additional measures (both measures that increase the tax burden and measures that decrease the tax burden). However, the Committee could not reach consensus on these measures.

3.2 The baseline scenario

The measures of the baseline scenario are aimed at realizing two objectives:

1. The creation of a threshold for corporate income tax purposes for companies with profitable activities in the Netherlands ('Corporate income tax threshold').
2. The elimination of mismatches with countries outside the Netherlands ('Eliminate mismatches').

Where the section on international cooperation limited itself to formulating general recommendations for the approach to be adopted by the Netherlands, the section on unilateral policy options contains a number of specific measures, classified into 'Corporate income tax threshold' and 'Eliminate mismatches' categories.

The seven measures in the baseline scenario on which the Committee reached consensus are set out below.

Corporate income tax threshold

1. Maximizing the annual loss set-off (both the loss carry-forward and the loss carry-back) to no more than 50% of the taxable profit for the year for all profit exceeding EUR 1 million, while at the same time introducing an unlimited loss carry-forward period. Limiting the loss to be taken into account in a year, which was mainly inspired by rules in neighboring countries, is a departure from a long tradition. As quid pro quo, the loss carry-forward period should be made unlimited; as of 2019 it had been shortened from nine to six years.
2. Limiting the deduction of non-recharged shareholder costs to a maximum percentage of the taxable profit, in combination with an efficiency threshold. 'Shareholder costs' include the costs borne by a head office for the preparation of the financial statements, for share issues, for the activities of the supervisory board and for corporate governance.
3. Examine whether the deduction of royalties in group structures should be limited to a maximum percentage of the taxable profit, possibly in combination with an efficiency

threshold; an amount that, in any case, is not affected by the deduction limitation. According to the Committee, EU law is a point for consideration.

4. Limiting the deduction of the balance of interest and head office costs and/or royalties to a combined amount of (for example) 50% of a joint tax base (in combination with measures 2 and 3). The measure is in part an addition to the current earnings stripping measure and ensures that there will always be a minimum tax base after the deduction of interest, shareholder costs and/or royalties. The Committee points out that when drafting this measure careful attention must be paid to overlap and priority provisions between the various earnings stripping measures. The Committee also asks that attention be paid to the impact of EU law, more particularly the overlap with the fiscal unity and the per element approach.

Eliminate mismatches

5. Make the current CFC rules more effective by, for example, taxing the profits distributed by the CFC and amending or completely abolishing the exception for economic activities with substance. In this proposal it is therefore no longer possible to avoid the application of the CFC rules by having the CFC distribute the tainted income before the end of the year. Entities that perform economic activities with substance should also fall under the scope of the CFC rules. Furthermore, the CFC's income should no longer be recalculated according to Dutch standards, neither downward nor upward. The CFC's profit for accounting purposes should be decisive when calculating the benefit to be taken into account. Whether an entity qualifies as a CFC , should be based on the effective profit tax rate on the CFC income and no longer on the statutory rate as is now the case. Adequate rules to avoid double taxation of the CFC income should be introduced. Against the background of the OECD initiative on Pillar 2, the Committee suggests that CFC income not be taxed at the national rate but at the internationally agreed OECD minimum rate.
6. Not applying the arm's length principle if it results in a reduction of the taxable profit in the Netherlands, insofar as the other country involved in the transaction does not include the adjustment in its tax base. The Committee refers to 'transfer pricing mismatches' in this respect. This measure would have a huge impact in practice, as it would in fact narrow the basic concept of the informal capital contribution. According to the Committee, there is reason to do so, because this downward adjustment means that the Netherlands is out of step with the rest of the world. According to the Committee, currently only Luxembourg and the Netherlands are jurisdictions where it is possible to adjust the profit realized by an entity downward on the basis of transfer pricing rules.
7. Limit the depreciation/amortization of assets that were transferred within the group, insofar as the write-off relates to untaxed gains and reserves in the asset that were not sufficiently taxed during the transfer. The Committee refers to 'tax rate mismatches' in this respect. This measure will also have a major impact in practice, in particular in light of the onshoring activities that took place in 2019 with regard to the entering into force of ATAD2 as of 2020. The Committee does propose introducing transitional rules for this measure, because parties could not have been aware that depreciation/amortization opportunities would be curtailed.

3.3 Additional measures

To supplement the above seven measures, the Committee also offers a number of additional measures for consideration. However, the Committee failed to reach a consensus on them. It concerns the following measures.

Corporate income tax threshold

1. Tightening the current earnings stripping measure for interest by reducing the deductible interest balance from 30% to 25% of the EBITDA. The Committee noted that the Dutch earnings stripping measure that was introduced as part of the implementation of ATAD1 is already stringent in itself, but still sees room to further tighten it in order to weaken the 'incentive' for debt-financing even further.

2. Limit the deduction of interest related to the acquisition of participations (closing the 'Bosal loophole')). This deduction limitation should not only apply to foreign participations but also to domestic participations. The deduction limitation would supplement current measures that limit the deduction of interest, such as Section 10a and the earnings stripping measure. To protect SMEs, the Committee suggests applying a threshold amount of EUR 1 million per annum for deductible 'Bosal interest'. The Committee also draws attention to the overlap with the current fiscal unity regime.

Eliminate mismatches

3. Expanding Section 10a Corporate Income Tax Act 1969, which limits the deduction of interest, to royalty and lease payments. The Committee refers to the following as an example of a situation that currently falls outside the scope of Section 10a. A Dutch company contributes capital to a foreign subsidiary in a low-tax jurisdiction. The subsidiary uses the received funds to purchase or develop an intangible asset and makes the asset available to the Dutch group company. A royalty payment is thus created, although the capital with which the intangible asset was acquired came from the Netherlands. The deduction limitation means that the royalty payments are not allowed to be deducted in the Netherlands, because the making available of the asset was related to a tainted transaction (i.e. the contribution from the Netherlands to a low-tax jurisdiction). It is striking that in its elaboration of this measure the Committee does not address the potential qualification of the foreign subsidiary as a CFC and other limitation measures for the deduction of royalties, which the Committee itself proposed (see numbers 3 and 4 of the baseline scenario).

4. Limiting the deductibility of all types of payments within the group, which are insufficiently taxed in the recipient country ('combating tax rate mismatches'). The aim of this provision is to make the Netherlands less vulnerable to tax base erosion. Companies will have less incentive to shift profits from the Netherlands to low-tax countries. The Committee also refers in this respect to the OECD plans to arrive at a minimum tax level (OECD Pillar 2).

5. Expanding the current CFC measure – which only covers passive income such as dividends, interest, royalties – to cover active income. This in fact means that all low-taxed

profits from direct and indirect subsidiaries in the Netherlands would be included in the tax base. This would in fact result in an effective minimum tax on all profits from activities performed ‘under’ the Netherlands. The advantage of this would be that it would lessen the importance of setting transfer prices for group transactions between a Dutch parent company and its foreign subsidiaries and thus also the opportunity for manipulation. This measure is also related to OECD Pillar 2.

Increasing other tax burdens

6. The introduction of an unconditional withholding tax on interest and royalties. This measure is intended as an amendment to the Withholding Tax Act 2021, which introduces a tax of 21.7% on interest and royalty payments to group entities in low-tax jurisdictions and in abuse situations. The measure outlined by the Committee will result in a complete prohibition on interest and royalties in group structures. This will lessen the opportunities for eroding the tax base through interest and royalty payments. Points to consider include EU law and the double tax treaties concluded by the Netherlands.

7. Amending the current ‘equity requirement’ for financial service entities (flow-through companies) to an open norm. The running of a real risk is currently linked to holding a minimum amount of equity to cover risks. Section 8c Corporate Income Tax Act 1969 currently assumes a minimum equity of the lower amount of:

1) 1% of outstanding loans or 50% of the royalties received annually; or
2) EUR 2 million.

The proposed amendment means that the legal definition of ‘the appropriate amount of equity’ will no longer apply, which means that the measure will take effect earlier or it will be harder to build upon. This will make the Netherlands less attractive for flow-through companies.

8. The introduction of a unilateral digital services tax. A digital services tax (DST) is a tax on the turnover from digital services. The DST is a percentage (3% for example) of the gross turnover from specifically defined digital services of which Dutch users are considered to have played a major role in the creation of value. The Committee believes that international discussions have the most chance of offering fundamental solutions for the challenges of the digitalizing economy. The preference is for a solution in the context of OECD Pillar 1. According to the Committee, a DST should therefore at most be considered an interim measure.

9. The introduction of a tax related to employment. This measure is inspired by the political wish to have employees benefit more from increased corporate earnings in the form of wage rises. An incentive to do so could take the form of a corporate income tax measure, for example the introduction of a ‘corporate surtax’, which is reduced as and when the taxpayer has created additional employment or awarded wage rises.

Reducing the tax burden

Because the Committee also recognizes that on the basis of, for example, political preferences, various options are possible where the business climate is concerned, it also

offers possible compensatory measures for the business climate. There is also no consensus within the Committee on the desirability of the following four measures.

1. Deferring the deduction of liquidation and cessation losses. This measure is not so much intended to reduce the administrative burden compared to the current situation, but as a limitation of the scope of the government's stated intention to drastically curtail the current opportunities for deducting liquidation and cessation losses incurred outside the EU/EEA. The Committee proposes that liquidation and cessation losses incurred outside the EU/EEA be taken into account up to a maximum of 50% of the taxable profit, in combination with an unlimited carry-forward period.

2. Abolishing the prohibition on the deduction of acquisition and selling costs incurred for participations. This proposal represents a radical departure from the current system and is mainly intended to keep the Netherlands attractive for head offices. The Committee does however suggest that in that case the acquisition and selling costs of participations should be included in the measure to limit the deduction of head office costs outlined in the baseline scenario.

3. Reducing the corporate income tax rate. A specific percentage is not mentioned in the report.

4. Reducing the rate for the Innovation Box. A specific percentage is also not mentioned for the Innovation Box.

Meijburg & Co comments

The Committee should be praised for its report. In a relatively short time it has performed an impressive and solidly substantiated study containing a lot of interesting information and points of view, while also identifying the connection between its work and the ongoing initiatives, in particular within the OECD, the Pillars 1 and 2. It is important that the Committee has shown that the view that multinationals pay 'too little' corporate income tax, a view that is also often expressed by politicians, is generally incorrect. The Committee's recommendation to continue to investigate and further analyze the facts should be followed to avoid the debate about 'fair' taxation being based on gut feelings.

When looking at the seven specific recommendations on which there is unanimity in the Committee, the emphasis seems to be on the creation of additional tax revenue at the expense of the business climate. It is however true that, for example, using efficiency thresholds means that SMEs will not be affected. In the appendix to the report, the Committee however states that the seven options proposed in the baseline scenario are not expected to result in any deterioration, or only a negligible deterioration, of the business climate, nor will they have any impact, or only a negligible impact, on the choice of the Netherlands as a head office location. The proposed major amendment of the CFC measure is striking, coming as it does so soon are its introduction. Certainly revolutionary are the curtailment of the informal capital concept and making the opportunity to depreciate/amortize acquired operating assets dependent on whether the transferor was

sufficiently taxed. In particular, due to the onshoring of intangible assets that took place as a result of the introduction of ATAD2 as of 2020, the transitional rules proposed by the Committee will also be necessary. The plans for curtailing the informal capital concept and the tightening of the depreciation/amortization opportunity raise the question whether the Netherlands will then have the unconditional power to tax if the particular operating asset is sold in the future.

The Committee did not address matters being studied by the government, such as future-proof group rules to replace the current fiscal unity regime. The participation exemption as such also remains unchanged, it being understood that within the Committee it was suggested that the prohibition on the deduction of acquisition and selling costs be withdrawn.

Publishing the report during the crisis caused by COVID-19 raises the question whether the proposals made by the Committee will now fall on fertile political ground in terms of the business sector. If the Netherlands is indeed facing a severe economic recession as suggested by the IMF, will broadening the tax base, including limiting the amount of the loss set-off, be the right medicine for now. The reduction of the standard corporate income tax rate, the reduction of the Innovation Box rate and the extension of the loss carry-back and loss carry-forward periods without limiting the amount of the loss set-off in a year appear to be obvious (interim) measures to help kick-start the economy. Possibly in combination with a number of less drastic tax base broadening measures proposed by the Committee. It is now up to the politicians who asked for the investigation to follow up on the investigation’s findings and the suggestions made by the Committee.

We will of course keep you updated on developments.

Meijburg & Co
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