

Israel Desk E-mail Bulletin

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Dutch proposal amending taxation of interest and the participation exemption

Introduction

On June 15th the Dutch Ministry of Finance published a consultation paper to amend the corporate tax treatment of financing income and expenses and the Dutch participation exemption regime ("Consultation"). The Ministry of Finance invites the public to surrender their comments and observations before 1 August 2009. We therefore kindly invite you to share your thoughts and questions with us.

The present Consultation paper and the above-mentioned comments and observations will be the basis of a tax bill. Such tax bill is promised to be released shortly after the 2009 summer recess. Parliamentary approval of such tax bill is envisaged before this year's end, with an expected entry into force as per the 2010 tax year.

Topics covered by the Consultation

The Consultation proposes the following changes to the current Dutch corporate tax system:

- a. a reduced effective corporate tax rate with respect to group financing income and expense and proceeds derived from a 'war chest';
- b. a partial disallowance of group and third party financing charges. In this regard, the Consultation proposes two alternative regimes; and
- c. a simplification of the participation exemption requirements.

Notably, the Consultation does not propose changes to the current interest deduction limitation rules which target (specifically) erosion of the tax base.

Ad a: Partial corporate tax exemption group financing income and expenses

As an amendment to the current, still inapplicable interest box, the Consultation proposes to abolish the current optionality by making the interest box compulsory for taxpayers which have qualifying items of income or expense. This compulsory nature should ensure that the regime disqualifies as illegal state aid under EC law.

Pursuant to the interest box, the balance of group interest income and interest expenses will for approx. 80% not be taken into account when determining the taxable basis. This translates to an effective tax rate on the balance of qualifying items of 5%.

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The experience of the members as regards the Israeli market is combined with their extensive knowledge of international tax law, corporate structuring, banking and securities law, regulatory law, employment law. In addition to being part of the Israel Desk, the members also participate in Loyens & Loeff teams that focus on specific industries and sectors, such as energy, real estate, private equity, fund structuring, corporate finance, and financial products.

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Loyens & Loeff
Fred. Roeskestraat 100
1076 ED AMSTERDAM
T: +31 20 578 57 85
F: +31 20 578 58 20



Items to be included in the interest box are:

- group financing income and expenses;
- associated charges;
- fluctuations in value of the underlying financing instruments;
- expenses and benefits derived from financial instruments which purport to hedge fluctuations in value of said financing instruments; and
- the benefits derived from short-term portfolio investments which are held as a 'war chest'.

In addition, the proposal is to tax income from hybrid loans qualifying as equity for Dutch tax purposes in the interest box, whereas currently the income from hybrid loans is exempt under the participation exemption if certain conditions are met. For purposes of the regime, 'group' has been defined as the group of companies who are affiliated through common control. Control is to be interpreted in accordance with commercial accounting consolidation rules (IAS 27). Group debt will be treated as external debt in case the group creditor has funded the group loan with external debt.

Ad b: Partial disallowance of group and external financing expenses

Current tax law in principle allows deduction of financing charges incurred by the taxpayer even though the debt financing has been applied to make an investment in a Dutch or foreign participation. Therefore, the effect is that the related financing charges can be set off against taxable profits of the taxpayer derived from other investments and activities (possibly through application of the fiscal unity regime). The Consultation seeks the public's comments on two alternatives, both of which purport to partially disallow the deduction of (group and external) financing expenses:

- (i) provisions which specifically target financing expenses if certain conditions are met, or
- (ii) a general 'earnings stripping' provision.

Alternative (i) - specific, targeted measures

One of the alternative proposals put forward is that financing expenses, which exceed € 250,000 will not be deductible to the extent that they are assumed to relate to equity investments in subsidiary companies which qualify for the participation exemption and group receivables which qualify for the interest box. The taxpayer will be facing disallowance of financing expenses to the extent the average tax book value of all qualifying participations and group receivables taken together during the year exceeds the average amount of the taxpayer's net equity during the year. Group receivables will for the purposes of this test be taken into account for approx. 80%. In addition, the amount of equity will be increased with (i) approx. 80% of group loans payable and (ii) the amount of tax loss carry forwards of the taxpayer (excluding prior liquidation losses).

Ancillary provisions are proposed if the taxpayer and the subsidiary company are included in the same tax consolidation (fiscal unity) or in case of a (de)merger. Under the proposals, financing expenses insofar they exceed € 250,000 would only be deductible up to the amount of the taxable profits of the taxpayer on a standalone basis ('ringfencing'), unless the taxpayer is able to demonstrate that it meets a 3:1 debt-to-equity ratio (whereby for purposes of this ratio the amount of equity is reduced by the average bookvalue of qualifying participations). In this alternative the current thin capitalisation provision will be abolished.

Alternative (ii) – 'earnings stripping'

The second alternative proposed is a generic 'earnings stripping' provision. This provision would entail certain amendments to the current thin capitalisation provision. The earnings stripping provision would generally be triggered if the taxpayer belongs to a group for commercial accounting purposes and if the taxpayer is more thinly capitalised in comparison to the consolidated capitalisation ratio of the (worldwide) group to which the taxpayer belongs (whereby for purposes of this ratio the equity is reduced by the average book value of participations qualifying for the participation exemption). The proposed alternative restricts the deduction of the balance of financing expenses to 30% of the taxpayer's profits, insofar as this balance exceeds € 250,000. The rule would apply to group and third party loans. Excess expenses can be carried forward for a maximum of nine years. In general terms, the 30% must be measured against the taxpayer's EBITDA determined pursuant to Dutch tax accounting principles.

Ad c: Changes to the participation exemption regime

As of 2007, the participation exemption applies to a participation of at least 5% in a (domestic or foreign) subsidiary if either (i) less than 50% of its direct and indirect (through lower-tier subsidiaries) assets are of a passive nature with no function in the enterprise in which the entity is engaged in ("Asset Test"), or (ii) from a Dutch tax perspective the subsidiary is liable to a corporate tax on its profits resulting in an effective tax rate of 10% or more ("Tax Burden Test").

Before 2007, the intention of the taxpayer for holding shares in a (foreign) subsidiary was of importance for the question whether or not the participation exemption applied. Based on the Consultation paper, the participation exemption will apply to a participation of at least 5% in a (domestic or foreign) subsidiary if the subsidiary is not held as 'portfolio investment', effectively returning to the previous rule. According to the Consultation paper, even if the shareholding is held as portfolio investment (and the participation exemption will not apply based on the new principal rule), the participation exemption will still apply if either the Asset Test or the Tax Burden Test is met. In this respect, both the Asset Test and the Tax Burden Test will be simplified and relaxed.

Finally

Should you have any questions or should you wish to share your thoughts regarding this Consultation with us, please feel free to contact jeroen.janssen@loyensloeff.com or any other member of the Israel desk.

Furthermore, please note that we are planning to visit Tel Aviv in the beginning of September 2009. We would be very happy to discuss the outcome of the Consultation with you. It could be interesting to see how these changes affect the tax structure. Should you wish to meet us, please contact jeroen.janssen@loyensloeff.com or any other member of the Israel desk.

Members of the Israel Desk visit Tel-Aviv on a regular basis. If you would like to make an appointment or would like to receive more information with respect to the above, please feel free to contact jeroen.janssen@loyensloeff.com or any other member of the Israel Desk.

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