Dutch Participation Exemption in 2012

Main principles

The participation exemption is one the main pillars of the Dutch corporate income tax system. Due to this tax facility, the Netherlands is home country for many holding companies. These holdings include intermediary holding companies for foreign-based multinational enterprises as well as top holding companies for multinationals that have their principal headquarters in the Netherlands.

The underlying principle for the Dutch participation exemption is the aspiration to avoid double taxation when profits of a subsidiary are distributed to the parent company. The exemption system is chosen to achieve a level playing field for Dutch enterprises operating abroad, since those companies will be subjected to the corporate income tax rate applied in the foreign country without having to pay additional tax in the home country (as would be the case if a credit system is applied).

All benefits gained from shareholdings are exempt. In principle, the term "benefits" covers profits and losses. Profits include dividends paid by the subsidiary as well as hidden profit distributions.

The exemption also covers the profit realised on the sale of a participation (i.e. capital gains). On the other hand, losses realised are not deductible. If the value of a participation decreases (as a result of losses suffered or as a result of forex movements), the write-down by the parent company is not deductible either. Losses arising from liquidation of a subsidiary may be set off under certain conditions.

The costs associated with maintaining a subsidiary are deductible. The costs of acquiring and selling a participation, however, are non deductible. Limitation of interest deduction may apply under Dutch domestic tax rules, that also include thincap provisions (1:3 equity to debt ratio).

Who qualifies for the exemption?

The participation exemption applies if the following conditions are met:

1. ownership of at least 5% of the issued share capital of the subsidiary;
2. the subsidiary has an equity divided into share capital; and
3. the participation is not held as a portfolio investment or passive financing company.

There is no requirement as to the duration of the period in which a participation must be held by the parent company.

In certain specific situations, a lower percentage of ownership than the aforementioned 5% can suffice.

If the subsidiary is a vehicle that is treated as tax transparent in the country of residence but for Dutch tax purposes considered as a corporate entity (i.e. not tax transparent), like some types of LLCs, KGs or SNCs, special rules are applied to determine whether the participation is eligible to the participation exemption.

For the purpose of the third condition (the motive test) the intent of the Dutch parent company is a decisive criterion. A participation in a company is held as a portfolio investment if the Dutch parent company holds the investment with a view to gaining a return that can be expected in case of normal asset management. In practice, the 'motive test' is considered to be satisfied if the business conducted by the participation is in line with the business of the Dutch parent company. Also if the Dutch parent company carries out essential activities in the business of the subsidiary (e.g. management, strategy or finance) the 'motive test' may also be met. Furthermore, a Dutch holding company acting as an intermediary between the ultimate parent company and the operating subsidiaries is generally considered as sufficient for meeting the 'motive test'.

If the third condition is not met, two additional tests are applied to determine whether the participation exemption is applicable notwithstanding defaulting the 'motive test'. These two additional tests are:

- the 'asset test' (the assets of the subsidiary may not consist for more than 50% of passive assets);
- the 'subject to tax test' (subject to a profit tax at an effective rate of at least 10%).

Meeting one out of these two tests is sufficient to qualify for the participation exemption. The two extra test effectively mean that only so-called 'low taxed investment companies' are disqualified from the participation exemption.

Under the 'asset test' the business assets of the subsidiary are compared to the passive assets. If over 50% of the subsidiary's asset base is made up of passive portfolio investments/assets (this includes receivables on group companies), the subsidiary is considered an investment company. The assets are measured, in principle, on a consolidated basis.

A number of asset categories previously qualified as passive assets are not longer qualified as such under the current tax rules. The assets that are now considered as 'good assets' include real estate, assets that are used in an active leasing business and assets that generated income that is taxed at an effective tax rate of at least 10% (the same threshold as the 'subject to tax test').

A minimum 10% tax is calculated based on Dutch tax rules, i.e., a statutory tax rate of 10% may be insufficient if there are substantial exemptions or deductions not known under Dutch tax rules. As of 1 January 2010, the 'subject to tax test' is more relaxed since the translation of the foreign tax base to the virtual Dutch tax base is not always required. Under current tax rules, the calculation can be made on the basis of domestic rules as long as these domestic rules are more or less equivalent to Dutch tax rules. Rules that are not equivalent to Dutch tax rules include for instance, deductible dividends, tax sparing credits in situations where the Netherlands would not grant such credits, and local tax holidays. In such case a translation of the foreign subsidiary's tax base to the taxable profit under Dutch tax rules may still be required.

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