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The Netherlands
Topic 1: Direct tax rules and the EU's fundamental freedoms: Origin and scope of the problem; national and Community responses and solutions
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1. The Dutch tax system

All individuals resident in the Netherlands, or earning income from certain sources in the Netherlands, are subject to personal income tax (*inkomstenbelasting*). Companies are subject to corporate income tax (*vennootschapsbelasting*). Under these systems, residents are taxed on their worldwide income, whereas non-residents are taxed only on certain Dutch-source income.

Personal income tax is based on a schedular system (effective from 1 January 2001). There are three income 'boxes':
- Box 1 includes all types of 'active' income (business income, income from employment and other activities, etc.), which is taxed at progressive rates;
- Box 2 includes income from substantial shareholdings (both dividend income and capital gains), which is taxed at 25%; and
- Box 3 includes income from savings and investments (based on a deemed yield of 4% on net assets), which is taxed at a rate of 30% (as a result of which 1.2% of one's net assets is payable annually).

The income reported in these three boxes is taxed separately, and a negative result in one box cannot be set off against a positive result in another.

Business profits, including capital gains, are subject to 29.6% corporate income tax (25.5% for the amounts up to EUR 22,689). Corporate income tax is based on the classical system (i.e. distributed profits are fully taxed in the hands of the shareholders); dividends and capital gains derived from domestic of foreign participations, however, may be exempt under the participation exemption.

Dividends distributed by companies resident in the Netherlands are subject to dividend tax at a rate of 25% (which of course may be reduced under double taxation treaties or the EC Parent Subsidiary Directive).

Personal and corporate income tax are levied by imposing a tax assessment; dividend tax is levied by self-assessment.

The Netherlands has concluded approximately 80 bilateral tax treaties regarding income and capital. Virtually all of these are generally in conformity with OECD Model Treaty. There is also a law for the avoidance of double taxation within the Kingdom of the Netherlands (which applies between the Netherlands, the Netherlands Antilles and Aruba), and a unilateral arrangement for the avoidance of double taxation in respect of income from non-treaty countries. Generally, the following methods for the avoidance of double taxation apply:

a. The exemption method for foreign profits (except for passive investment income from branches in some cases), labour income, income from foreign-situs immovable property, capital gains, etc. (the exemption is calculated as a pro rata parte reduction of the amount of corporate income tax due); and
b. The ordinary credit method for tax withheld by other countries (treaty countries or developing countries) on dividends, interest and royalties.

2. National Courts

Taxpayers may file an objection against a personal or corporate income tax assessment, or against their own tax return in the case of self-assessment (e.g. against their dividend tax return). If the objection is turned down by the Dutch Revenue, the taxpayer may appeal before the District Court (*Rechtbank*). Both parties (the taxpayer and the Dutch Revenue) may appeal the verdict of the District Court before the Court of Appeal (*Gerechtshof*). Finally, both parties can appeal the verdict of the Court of Appeal to the Dutch Supreme Court (*Hoge Raad der Nederlanden*). The Supreme Court only reviews the correct application of the law and compliance with all formalities, and does not make any determinations of fact. Pursuant to Article 234 of the EC Treaty, only the Supreme Court is obliged to refer cases to the ECJ for preliminary rulings.

I have identified the following Dutch direct-tax cases (plus two cases regarding capital contribution tax) which were referred to the ECJ for preliminary rulings:

Referrals from the District Courts (*rechtbanken*)[1]: none
Referrals from the Courts of Appeal (*gerechtshoven*):
- Den Bosch[2]: *Wielockx* (C-80/94); *Terhoeve* (C-18/95); *Heirs of H. Barbier* (C-364/01), D (C-376/03); *Blanckaert* (C-512/03); *Heirs of M.E.A. Van Hilten-van der Heijden* (C-513/03); *Bujara* (C-8/04)
- The Hague: *Baars* (C-251/98)
- Amsterdam: *Leur-Bloem* (C-28/95); *Amurta* (C-379/05; pending)
- Arnhem: *N* (C-470/04, pending)
- Leeuwarden: none
Referrals from the Supreme Court[3]: *Halliburton Services BV* (C-1/93); *Asscher* (C-107/94), *Verkooijen* (C-35/98); *De Groot* (C-385/00); *Bosal Holding* (C-168/01); *Magpar VI BV* (C-509/04); *Senior Engineering Investments BV* (C-494/03); Supreme Court referral of April 14, 2006, no. 40 037: not yet reported.

These cases can be categorized as follows:
a. personal income tax:

[1] These District Courts have only been competent to rule in tax matters since 1 January 2005.
[2] The number of references by the Court of Appeal Den Bosch can be explained by the fact that non-resident taxpayers fall within the jurisdiction of the Dutch Revenue's Heerlen office, which falls within the jurisdiction of the Court of Appeal of Den Bosch.
[3] It is interesting to note that all these references by the Supreme Court were made in cases in which the Advocate-General delivered an Opinion (which only happens in approximately 10-15% of the cases). In all but the *Senior Engineering* case, the Advocate-General advised the Supreme Court to refer the case. In the *Senior Engineering* case, the Advocate-General opined that Dutch tax law was not in conformity with EC law (but for reasons other than those cited by the ECJ).

- personal allowances: *Wielockx* (C-80/94); *De Groot* (C-385/00); *Bujara* (C-08/04)
- exit tax: *N* (C-470/04, pending)
- EC merger directive: *Leur-Bloem* (C-28/95)
- No exemption of foreign dividend: *Verkooijen* (C-35/98)
- Tax rate non-residents: *Asscher* (C-107/94)

b. net wealth tax[4]
- personal allowances: *D* (C-376/03)
- no exemption foreign shares: *Baars* (C-251/98)

c. corporate income tax
- no deduction of interest regarding foreign participation: *Bosal Holding* (C-168/01)

credit of foreign tax paid by investment companies: Supreme Court referral of April 14, 2006, no. 40 037 (not yet reported)
- dividend tax
- no exemption foreign shareholder: *Amurta* (C-379/05; pending)

d. Social security contributions
- emigrating employee: *Terhoeve* (C-18/95)
- tax credits for insured persons only: *Blanckaert* (C-512/03)

e. capital contribution tax
- contribution to sub-subsidiary: *Senior Engineering Investments BV* (C-494/03)
- merger exemption: *Magpar VI BV* (C-509/04)

f. inheritance tax
- estate of emigrant national: *Heirs of M.E.A. Van Hilten-van der Heijden* (C-513/03)
- no deduction of obligations related to property: *Heirs of H. Barbier* (C-364/01)

g. real estate transfer tax
- no restructure exemption if seller is non-resident: *Halliburton Services BV* (C-1/93)

3. Area of potential conflicts / remedial action

Many provisions in Dutch direct tax legislation may conflict with EU law. What follows is a non-exhaustive list of areas of potential conflict.

I. Personal income tax:

a. Personal allowances

Some allowances are available only for resident taxpayers. Important allowances are the following:
- general tax credit (*heffingskorting)*: a reduction of the tax owed
- tax-exempt property (*heffingsvrij vermogen*): a tax-free allowance of assets
- deductions for alimony, expenses relating to sickness and disability, etc.

Under the *Schumacker* doctrine, resident taxpayers and non-resident taxpayers are not, as a rule, comparable. As far as personal allowances are concerned (i.e. tax allowances relating to the personal and family circumstances of the taxpayer), it is generally up to the State of residence to grant them, since that State is in the best position to asses the taxpayer's personal ability to pay

[4] Abolished in 2001.

tax.[5] However, discrimination could arise if resident and non-resident taxpayers are in a comparable situation but non-resident taxpayers are nevertheless denied the personal allowances that are granted to residents. This may the case where a non-resident does not have significant income in the State of residence, as a result of which the State of residence is not in the position to grant the personal allowances. In those circumstances, the State of source may be required to grant its personal allowances to such non-residents, provided that the non-resident earns the main part of his taxable income in the State of source.[6] This case law[7] has been heavily criticised by Wattel[8], who advocates a system of pro rata allocation of personal allowances to the source state and state of residence.

According to the Personal Income Tax Act, none of the above allowances are granted to non-residents, even if they earn all of their income in the Netherlands. However, an optional system was introduced and entered into force in 2001. In this system, a non-resident taxpayer may elect to be taxed as a resident taxpayer (Section 2.5 Personal Income Tax Act; hereinafter 'PITA').[9]

In addition to the general tax credit (*heffingskorting*), there is a a similar reduction of social security contributions. A resident taxpayer who owes insufficient social security contributions to be able to claim the full credit may set off the non-deductible part against income tax owed. Non-resident taxpayers are not entitled to a reduction of social security contributions if they are not insured under the Dutch social security system. In the *Blanckaert* case, the ECJ ruled that the EC treaty freedoms do not preclude such a law.[10]

In the *De Groot* case, the ECJ ruled that the Dutch exemption method infringed the principle of the free movement of workers. This method led to the result that the benefit of personal allowances disappeared pro rata parte (i.e. in proportion to the quotient yielded by dividing the exempt income by the total income). According to the ECJ, this infringed the principle of the free movement of workers, since the Netherlands (as the state of residence) was required to grant the full relief of the available personal allowances to those of their residents working in other Member States. The tax legislation has been amended accordingly. However, the effect found to infringe EC law still exists for non-resident taxpayers who elect to be taxed as resident taxpayers under Section 2.5 PITA.[11] To that extent, therefore, Dutch legislation is still not compatible with EC law where the non-resident taxpayer meets the *Schumacker* criterion.

b. exit taxes

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[5] See Case C-279/93*, Schumacker*, [1995] ECR I-0225, paragraphs 31-32, and Case C-391/97, *Frans Gschwind and Finanzamt Aachen-Außenstadt*, [1999] ECR I-5451, paragraph 22.
[6] Refer *Schumacker*, op cit., paragraphs 36-37 and *Gschwind*, op cit., paragraph 27.
[7] Including subsequent case law such as Case C-80/94, *Wielockx*, [1995] ECR I-0249, Case C-385/00, *De Groot*, [2001] ECR I-3801, and ECJ 5 July 2005, Case C-376/03, *D. v Inspecteur van de belastingdienst*.
[8] See, e.g., Ben J.M. Terra and Peter J. Wattel, *European tax law*, 4th ed., Kluwer 2005, pp. 89 *et seq.*, and Peter J. Wattel, "Red Herrings in Direct Tax Cases before the ECJ", 31 *Legal Issues of Economic Integration* 2 (2004), pp. 81-95.
[9] There are still some differences, however, between resident taxpayers and non-resident taxpayers that elect to be treated as resident taxpayers; see Section 2.5(2) PITA.
[10] ECJ 8 September 2005, Case C-512/03, *J.E.J. Blanckaert v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen*.
[11] See Section 2.5(2) PITA and Section 3(5)(a) of the Personal Income Tax Implementation Decree 2001 (*Uitvoeringsbesluit inkomstenbelasting 2001*).

If an individual emigrates from the Netherlands, he may face a tax assessment in various situations, including the following:
- the individual ends an enterprise in the Netherlands
- the individual owns a substantial interest in a company
- the individual has pension rights or annuities.

The enterprise's hidden reserves, reserves allowed for tax purposes and goodwill are taxed without any deferment being available. This exit tax is a hindrance to emigration, and although it seems justified in view of the territoriality[12] and coherence[13] principles, it seems disproportionate to levy this tax on unrealised gains without any deferment.[14]

The unrealised capital gains on shareholdings representing a substantial interest in a company and the value of pension or annuity capital is also taxed, but in this case a 'conservatory' (i.e. provisional, deferred) assessment is levied. Deferment of collection is granted until the shares, pension rights or annuities are sold or until the pensions or annuities no longer qualify as such under Dutch tax law. In principle, security for the payment of tax must be provided to the Dutch Revenue. However, in response to the *De Lasteyrie du Saillant* case, security need no longer be provided if the taxpayer emigrates to another EU or EEA Member State.

In the *N* case (Case C-470/04), referred to the ECJ by the Court of Appeal of Arnhem, the ECJ was asked to decided upon various issues, including whether:
(i) Article 18 or 43 of the EC Treaty preclude the relevant legislation pursuant to which income tax and social security contribution assessments are imposed in respect of the deemed profit from a substantial shareholding, solely on the ground that a resident of the Netherlands who ceases to be a domestic taxpayer because he has moved his place of residence to another Member State is deemed to have disposed of those of his shares which form part of a substantial shareholding, and
(ii) If the answer is affirmative because security has to be provided to enable a deferment of payment of the tax assessed, the existing obstacle can then be removed with retroactive effect through the release of the security provided.

Advocate General Kokott recommended that the ECJ rule that Articles 18 and 43 EC do not preclude a provision by virtue of which tax is assessed on profits from a substantial shareholding immediately before the emigration to another Member State, provided that:
- the tax is deferred until the shares are actually disposed of without any further conditions having to be met and
- the tax levied on a disposal following emigration is guaranteed to be no higher than the tax that would have been levied on disposal within the territory.

II. Corporate income tax
a. Corporate interest deduction

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[12] See Case C-250/95, *Futura Participations*, [1997] ECR I-2471.
[13] See Case C-204/90, *Bachmann*, [1992] ECR I-0249.
[14] See Case C-436/00, *X & Y v Riksskatteverket*, [2002] ECR I-10829, Case C-9/02, *Hughes de Lasteytie du Saillant*, [2004] ECR I-2409.

Income and capital gains derived from a qualifying participation are exempt in the Netherlands. Until 2004, interest (and other costs) relating to participations was non-deductible unless the profit of the participation was taxable in the Netherlands. As a result, interest relating to domestic participations was generally deductible, whereas that relating to foreign participations was not. In the *Bosal Holding* case, this unequal treatment was deemed to entail a breach of EC law to the extent that the situation in question concerned participations in other EU countries.[15] The Corporate Income Tax Act ("CITA") was amended with effect from 2004. Since then, interest relating to foreign or domestic participations has been deductible. Furthermore, thin capitalisation rules have been introduced which apply indiscriminately to interest paid by, and to, both domestic and foreign taxpayers.

Another interest-deduction limitation is found in Section 10a CITA. This provision is aimed at base erosion by interest deduction (more specifically, the deduction of interest on loans to related persons or companies, taken up in connection with certain transactions, such as capital contributions, dividend distributions and acquisitions of group companies). Common to all the situations which fall within the scope of Section 10a CITA is the absence of actual changes of circumstance as a result of the transactions. The deduction disallowance does not apply if the taxpayer can prove that the loan and the transaction were entered into for sound business reasons, or if the amount of tax the creditor owes on the interest is reasonable according to Dutch standards (this reasonable tax rate is not quantified under current law; under the legislative proposal mentioned in paragraph 5, an effective tax rate of 10% is considered reasonable). The last provision has given rise to debate. Although it is a non-discriminatory measure, the 'reasonable tax' provision may make it less attractive to borrow from a foreign creditor: a creditor resident in the Netherlands is generally taxed according to Dutch standards, whereas that is not necessarily the case for foreign creditors. In the case of a wholly artificial arrangement, a justification based on the risk of tax evasion may be invoked.[16] The definition of a 'wholly artificial arrangement' promulgated by the EC Court of Justice is stricter than the sound business reasons criterion of Section 10a CITA. Therefore, it seems that this justification cannot be invoked in every case which falls within the scope of Article 10a CITA.

In the *Marks & Spencer* case,[17] however, the ECJ seems to give the Member States more leeway to combat tax evasion. The ECJ ruled that in light of three justifications, taken together, the disallowance of the transfer of losses may be justified. One of these justifications related to the risk of tax avoidance. In this respect, the ECJ referred to the risk that within a group of companies losses are transferred to companies established in the Member States with the highest rates of taxation.[18] The same may be argued in respect of intra-group interest payments: profits are shifted from high-tax jurisdictions to low-tax jurisdictions. Therefore, ban on compensatory tax arrangements[19] may not apply to intra-group transactions. However, if tax evasion is occurring, it must also be established that the national measure (in this case, the interest disallowance) ensures achievement of the aim in question (counteracting tax evasion) and does

[15] According to the decision of the Supreme Court of 14 April 2006, no. 41 815, this did not infringe the freedom of capital movement in the case of participations in non-EU/EEA countries, pursuant to Article 57 of the EC Treaty.
[16] See Case C-436/00, *X and Y*, [2002] ECR I-10829, paragraph 26, Case C-324/00, *Lankhorst-Hohorst*, [2002] ECR I-11779, paragraph 37, Case C-9/02, *Lasteyrie du Saillant*, para 50.
[17] ECJ 13 December 2005, Case 446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*.
[18] Paragraph 49.
[19] See Case C-294/97, *Eurowings Luftverkehrs AG*, [1999] ECR I-7447, paragraph 45.

not go beyond what is necessary for that purpose. The interest deduction is presumably suitable for counteracting tax evasion, but because for the purposes of Article 10a CITA the compensatory tax functions as a safe haven (and therefore does not apply to every case of tax evasion), one may doubt whether the measure as a whole is suitable for that purpose. Furthermore, the disallowance of the total amount of the interest goes beyond what is necessary for preventing abuse.

b. Exit taxes

All reserves allowed for tax purposes, hidden reserves and goodwill are taxed upon the transfer of a company's central management of control if that transfer entails that it no longer qualifies as a resident of the Netherlands, either under national law or under a treaty. As mentioned above, such an exit tax seems to be disproportionate. The question, however, is whether this is different for legal persons (as opposed to natural persons; see above). In the *Daily Mail* case,[20] a UK holding company (Daily Mail and General Trust plc) tried to avoid taxation on the sale of its subsidiaries by transferring its residence to the Netherlands. The ECJ did not disqualify the levy on a UK exit tax on the unrealised capital gains on the subsidiaries. In the *Überseering* case[21] this decision was explained by the ECJ:

> *70. In so doing, the Court confined itself to holding that the question whether a company formed in accordance with the legislation of one Member State could transfer its registered office or its actual centre of administration to another Member State without losing its legal personality under the law of the Member State of incorporation and, in certain circumstances, the rules relating to that transfer were determined by the national law in accordance with which the company had been incorporated. It concluded that a Member State was able, in the case of a company incorporated under its law, to make the company's right to retain its legal personality under the law of that State subject to restrictions on the transfer of the company's actual centre of administration to a foreign country.*

In other words: it is up to the exit state to formulate the conditions under which companies emigrate. Professional literature suggests that the ECJ may have assumed that the UK was the actual jurisdiction in which the registered office was located (rather than the jurisdiction in which the company was incorporated).[22] In that case, the ruling makes sense: if a Member State may restrict emigration of companies by depriving them of their existence, then *a fortiori* it is permitted to tax them. However, the UK was the jurisdiction in which the company was incorporated. Therefore there are two possibilities:
(i) The case law is based on a misconception of UK company law, or
(ii) In both jurisdictions, the exit state may tax the emigrating company without any restriction.

In view of this uncertainty, it remains impossible to predict whether the Netherlands, as an incorporation jurisdiction, may levy the exit tax as described above.

[20] Case 81/87, *Daily Mail*, [1988] ECR 5483.
[21] Case C-208/00, *Überseering*, [202] ECR I-9919.
[22] See Ben J.M. Terra and Peter J. Wattel, *European tax law*, 4th ed., Kluwer 2005, p. 117-119.

c. Fiscal unity / cross-border loss set-off

If a resident or a non-resident company carrying on a permanent establishment in the Netherlands directly or indirectly holds at least 95% of the share capital in one or more other resident companies, these companies can apply for the fiscal unity regime (*fiscale eenheid*). By doing so, the parent company may file a consolidated tax return. One great advantage of this facility is that the losses of one company can be set off against the profits of another. Furthermore, assets and liabilities can be transferred free of tax.

Foreign subsidiaries cannot be included in a fiscal unity, which means that their losses cannot be set off against the Dutch company's profits, nor can depreciation losses be deducted from the parent company's tax base if the participation exemption applies. It is possible, however, to deduct the capital loss on a subsidiary after its liquidation, even if the participation exemption applies. This feature, the deduction of liquidation losses, was the main reason for the Primarolo Group to identify the Dutch holding regime as a harmful tax measure. According to the report of the Primarolo Group, a positive evaluation (i.e. as a harmful tax measure) should be given to 'asymmetrical measures where gains are exempt but losses are tax deductible'.[23]

At first, in response to the Opinion of Advocate General Poiares Maduro in the *Marks & Spencer* case,[24] the Under Minister of Finance announced the possibility of forming a fiscal unity with non-resident subsidiaries. Losses attributable to liquidated participations, however, would no longer be deductible. This plan was withdrawn, however, in light of the *Marks & Spencer* decision.[25]

According to the case law of the ECJ, as interpreted by the Under Minister of Finance, the Netherlands is not obliged to permit a fiscal unity to include a non-resident subsidiary. It is obliged however to allow these losses:

> *where the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods and where there are no possibilities for those losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party (...).*

As the Under Minister of Finance sees it, this requirement is met by the provision regarding deduction of liquidation losses. So, ironically, the very element of the deduction of the losses of liquidated subsidiaries, which led the Primarolo Group to consider the Dutch holding regime as a harmful tax measure, has now become the key feature for the Under Minister of Finance to argue that the Dutch tax system is compatible with EC law.

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[23] Report of the Primarolo Group dated 23 November 1999, section 51.
[24] Opinion of 7 April 2005, in Case 446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*.
[25] Case 446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*.

III. Dividend tax (and credit of foreign withholding tax)

a. Outbound dividends (dividend withholding tax)

The topic that is currently the most-discussed in the Netherlands is the potential breaches of EU law contained in the Dividend Tax Act. As a result of the EFTA Court ruling in the *Fokus Bank* case, the ECJ ruling in the *Bouanich* case and the opinion of Advocate General Geelhoed in the *Denkavit* case,[26] the unequal treatment of domestic and foreign shareholders is in the spotlight.

If the shareholder receiving the dividends is eligible for the participation exemption (for corporate income tax purposes), an exemption for dividend withholding tax is also available. This exemption is not available if the shareholder is not subject to corporate income tax in the Netherlands.

In a case in which a Luxembourg company claimed that it should have been eligible for an exemption from Dutch dividend withholding tax had it been resident in the Netherlands, the Court of Appeal of Den Bosch ruled in favour of the taxpayer.[27] The Under Minister of Finance has appealed against this decision before the Supreme Court. In another case, a Portuguese shareholder claimed an exemption from dividend withholding tax. The difference here was the presumption that the Portuguese shareholder was eligible for a full credit in his home country. In this case (*Amurta*, Case C-379/05), the Court of Appeal of Amsterdam referred the following questions to the ECJ:

> *1. Is the exemption (...) compatible with the provisions on the free movement of capital (Articles 56 to 58, formerly Articles 73b to 73d) of the EC Treaty, given that the exemption is applicable only to dividend payments to shareholders liable to corporation tax in the Netherlands or to foreign shareholders with a permanent establishment in the Netherlands, with the shares forming part of the assets of that permanent establishment, to whom the holding exemption (...) applies?*
>
> *2. Does the answer to the question posed at 6.1 depend on whether the State of residence of a foreign shareholder/company to which the exemption under Article 4 of the Law does not apply grants that shareholder/company full credit for Netherlands dividend tax?*

The Opinion of Advocate General Geelhoed in the *Denkavit* case[28] indicates that Dutch tax law may violate the freedom of establishment and the free movement of capital.

Another possible infringement is the following. A refund of dividend tax is available for legal persons resident in the Netherlands that are not subject to corporate income tax (e.g. pension funds) and for investment funds. Investment funds are taxed at a zero percent rate and are obliged to distribute their profits within eight months after the end of each financial year. Generally, no

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[26] Opinion of 27 April 2006 in Case C-170/05, *Denkavit international BV*.
[27] Decision of Court of Appeal of Den Bosch of September 9, 2005, no. 03/1980, V-N 2005/51.20.
[28] *Denkavit International BV*, op cit.

refund is available for non-resident legal persons and investment funds (but this may of course be available under double tax treaties or the EC Parent Subsidiary Directive).

b. Inbound dividends (credit of foreign tax)

A related issue is the credit of foreign withholding tax on inbound dividends. According to Advocate General Geelhoed in the *Kerckhaert & Morres* case,[29] the free movement provisions do not as such oblige home states to relieve double taxation: it is for the home state to decide whether and how it provides double taxation relief. However, Member States may not discriminate between foreign-source and domestic-source dividends. Such discrimination may exist if the home state levies dividend withholding tax itself, and as a rule credits or refunds this withholding tax. In a recent referral from the Dutch Supreme Court,[30] the following question was put to the ECJ: in a case in which no credit was available for Portuguese and German withholding tax,[31] did the refusal to credit this tax infringe the freedom of capital movement?

If a credit is granted, equal treatment of domestic and foreign dividends is not guaranteed, because in the Netherlands a full credit is granted for Dutch dividend withholding tax (which serves as a personal or corporate income tax levied in advance), whereas only an ordinary credit is granted for foreign dividend withholding tax. As can be deduced from the *Verkooijen*,[32] *Lenz*[33] and *Manninen*[34] cases, foreign dividends may as a rule not be treated less favourably than domestic dividends. These cases all dealt with the accumulation of corporate income tax (at the level of the dividend distributing company) and individual income tax (at the level of the shareholder), but the same may be argued with regard to systems for the avoidance of the accumulation of dividend withholding tax and personal or corporate income tax. In the *Manninen* case, regarding the Finnish imputation system, the ECJ ruled that Finland must take the corporate income tax actually paid in other Member States into account. The same may be argued regarding the credit of foreign dividend withholding tax in the Netherlands. Where an imputation system directs that corporate income tax at the company level serves as a prepayment of income tax at shareholder level,[35] the dividend withholding tax serves as a prepayment of the income tax payable by the shareholder.

By contrast, one may argue – with reference to the *Gilly* case[36] – that an ordinary credit instead of a full credit is in conformity with EC requirements. In this case the ECJ held that:

> *if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a*

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[29] ECJ 6 April 2006, Case C-513/04, *Kerckhaert and Morres*.
[30] Supreme Court referral of April 14, 2006, no. 40 037; not yet reported.
[31] In the relevant year, no treaty with Portugal was in force, and the treaty with Germany did not oblige the Netherlands to grant a credit for German withholding tax.
[32] Case C-35/98, *Verkooijen*, [2000] ECR I-4071.
[33] Case C-315/02, *Anneliese Lenz*, [2004] ECR I-7603.
[34] Case C-319/02, *Manninen*, [2004] ECR I-7477.
[35] Cf. the Opinion of Advocate-General Geelhoed of April 6, 2006 in case C-446/04, Test Claimants in the ACT Group Litigation v. Commissioners of Inland Revenue, point 5.
[36] Case C-336/96, *Gilly*, [1998] ECR I-2793.

loss of tax revenue for it and would thus be such as to encroach on its sovereignty in matters of direct taxation.

However, the sovereignty argument was significantly undercut in the *Bosal Holding* case, for example, where the ECJ ruled that the Netherlands should allow the deduction of costs relating to foreign participations, and the *Marks & Spencer* case, where the ECJ ruled that, in some cases, Member States are obliged to take losses of foreign subsidiaries into account.

c. Tax sparing / Most favoured nation

In the *D* case[37], the ECJ ruled that Articles 56 EC and 58 of the EC do not preclude a bilateral convention for the avoidance of double taxation from containing a rule that beneficial regimes will not be extended to residents of a Member State that is not party to that convention. As a result, expectations are that the tax sparing provisions contained in tax treaties do not infringe the freedom of capital movement. (One may also argue that tax sparing credits are generally granted to income from developing countries, as a result of which income from EU Member States is not comparable. However, in some cases, tax sparing credits may also be granted in relation to developed countries.[38])

4. Role of the ECJ with regard to direct taxation

As early as 1996, Willem Vermeend, then the Under Minister of Finance, wrote a critical editorial regarding the ECJ case law on direct taxation.[39] Referring to the *Wielockx* case[40], Vermeend complained that notwithstanding the principle of subsidiarity, the ECJ had seemingly lost its reluctance in its case law in direct tax matters. Furthermore, he suggested that the ECJ lacked sufficient specialist knowledge to rule on matters relating to direct taxation. Evidently, the reluctance of the ECJ has certainly not returned in the past decade. Since 1996, the tax administrations of the Member States have taken quite a few blows from the ECJ. This has not resulted, however, in overt criticism from the Dutch Revenue.

Apart from the occasional criticism of ECJ case law, more in-depth criticism is not very common. Some of these rare examples are the following:
- The ECJ is overstepping its jurisdiction in its case law on personal allowances (such as *Schumacker*, *Gschwind* and *De Groot*) by dictating *how* impediments to the EC Treaty freedoms must be removed.[41] In other words, ECJ case law results in positive harmonisation, whereas it should be limited to negative harmonisation under Article 220 of the EC Treaty.

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[37] *D. v Inspecteur van de belastingdienst*, op cit.
[38] For instance, in paragraphs 4 and 5 of part A of Article 25 of the Dutch/Greek tax treaty, which were deleted only as from 1 July 2006, a tax sparing credit for Greek interest and royalty withholding tax was granted.
[39] Willem Vermeend, "The Court of Justice of the European Communities and direct taxes: 'Est-ce que la justice est de ce monde'", *EC Tax Review*, 1996/2, p. 54-55.
[40] Op cit., footnote 7.
[41] See, e.g., R.A.V. Boxem, "HvJ EG, quo vadis met het paard achter de wagen?" [English: ECJ, Quo Vadis with the Cart Before the Horse?], *WFR* 2003/6540, p. 1231.

- The *Schumacker* criterion is not logical: the personal allowances should be granted by both the source state and the state of residence, on a pro rata parte basis.[42] That way, every State that gets a slice of the tax base also grants a proportional slice of its personal allowances.
- The ECJ is too restrictive in its acceptance of the fiscal cohesion principle in the *Bosal Holding* case, for example, where there was a territorial link between the positive and negative elements of the taxable base of parent companies located in the Netherlands.[43]

5. Future developments

On 24 May 2006, the Under Minister of Finance submitted a legislative proposal to Parliament that included important changes in the taxation of businesses, which should become effective on 1 January 2007. These changes concern regard both the Personal and Corporate Income Tax Acts. The most important objective of the bill is to increase the attractiveness of the Netherlands as a business location. The Under Minister also aims to make the CITA more compatible with EU law. Important elements of the proposal are the introduction of special regimes for income from research and development (R&D), and from group financing activities. Income from R&D will be taxed at an effective tax rate of 10%. Furthermore, upon the joint request of *all* group companies that are subject to corporate income tax in the Netherlands, the balance of interest received from group companies and interest paid to group companies will be subject to an effective tax rate of 5%. According to the Under Minister of Finance, these rules do not constitute state aid prohibited by Articles 87-88 EC Treaty because they are not selective. Discussions between the Dutch Government and the European Commission will determine whether the latter shares this view.

On several occasions, the Under Minister of Finance has stated that he does not envisage a future for the dividend withholding tax. This tax will probably be abolished in the next few years. The above-referenced legislative proposal does not take any steps towards the abolition of the dividend tax, other than the decrease of the tax rate (from 25% to 15%).

6. Conclusion

Dutch direct tax law has been influenced to a great extent by EU law (especially the case law of the ECJ). For instance, non-resident individuals may elect to be treated as residents (although the amendments made to comply with the ruling in the *De Groot* case are not extended to them). Furthermore the payment of exit taxes may in many cases (e.g., those involving unrealised gains on shareholdings, pension rights and annuities) be deferred until sale of the respective rights. It is up to the ECJ to decide whether the levy of exit tax is in these cases is compatible with the EC Treaty freedoms.

No deferment is available if an individual or company terminates an enterprise in the Netherlands. This exit tax is a hindrance to emigration, and although it seems justified in view of the territoriality and coherence principle, it seems disproportionate to levy this tax on unrealised

[42] See, e.g., Ben J.M. Terra and Peter J. Wattel, op cit., p. 97, and Peter J. Wattel, op cit.
[43] See, e.g., Ben J.M. Terra and Peter J. Wattel, op cit., pp. 130-132. See also Dennis Weber, "The *Bosal Holding* Case: Analysis and Critique", *EC Tax Review* 2003-4, pp. 220-230.

gains without any deferment. This may be different for legal persons (in view of the *Daily Mail* and *Überseering* cases).

Another discussion point with respect to the Corporate Income Tax Act's (in)compatibility with EU law is the provision directing that, in some cases, interest is only deductible if the amount of tax the creditor owes on the interest is reasonable according to Dutch standards.

The most-discussed issue in the Netherlands right now is the potential violations of EU law contained in the Dividend Tax Act in the form of unequal treatment of domestic shareholders and foreign shareholders. This particularly regards not only the levy of dividend tax on non-resident taxpayers, whilst resident taxpayers are exempt, but also the restrictions on crediting the crediting foreign tax while not imposing any limits on the crediting of domestic dividend tax.