

## Tax Alert

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### How Informal Capital Contributions Can Decrease Your Effective Tax Rate in the Netherlands

#### Introduction

In the Netherlands, the effective tax rate can be substantially decreased if a Dutch company receives benefits from an affiliated party because transactions are not adequately compensated through an arm's length transfer price. These benefits must be eliminated from the taxable income by a transfer pricing adjustment in favor of the tax payer. Under Dutch tax law, such a benefit will be re-qualified as an 'informal capital contribution'. Such an informal capital contribution will not be subject to tax. This may be a very interesting tax planning tool when foreign jurisdictions do not make a corresponding transfer pricing adjustment.

For example, if a foreign group company grants a royalty free license to a Dutch company, the Dutch company could be allowed to deduct an arm's length royalty. The benefit that is granted to the Dutch company is considered an informal capital contribution. If the transaction is structured such that the grant of the benefit results in no income pick up in the foreign jurisdiction, an overall tax benefit will be realized, because the effective Dutch tax rate will be reduced. After explaining the technical background of the concept of the 'informal capital contribution', we will elaborate on this example below.

With respect to US groups, this may be useful for the restructuring of offshore IP holding companies. It is not expected that these structures will achieve the envisaged result if a royalty free license is granted by a US company directly, as this could lead to a pick up of royalty income.

#### The Difference between Statutory Accounts and Tax Accounts

A distinction must be made in the Netherlands between the statutory accounts and the tax accounts. The tax accounts must be prepared to determine a company's taxable income. The tax accounts are based on the statutory accounts, but adjustments are made on the basis of the "arm's length principle" and the so-called "sound business principles".

In the context of this memorandum, only the arm's length principle is of relevance. When a tax payer is engaged in transactions with group companies, for tax purposes arm's length transfer prices are taken into account for those transactions (i.e. comparable to conditions that would have been agreed upon between unrelated parties). Generally, a benefit that is granted to the tax payer only because of the group relation must be eliminated from the taxable profit because it does not originate from the tax payer's business. Instead, the benefit is re-qualified as an informal capital contribution because it originates from the group relation.

The abovementioned treatment will result in a difference between the statutory accounts, where the advantage is recognized as profit, and the tax

accounts, where the advantage is recognized as an informal capital contribution. The statutory accounts of the Dutch company will consequently show a lower effective tax rate in the Netherlands.

The principle of the informal capital contribution is well known under Dutch tax law and is confirmed by the Dutch Supreme Court several times and is widely accepted by the Dutch tax authorities. The amount of the informal capital contribution depends on the transfer pricing adjustment. If the amounts involved are substantial, we advise to request the tax authorities to confirm the existence and amount of the informal capital contribution in a private tax ruling. The tax ruling may be subject to disclosure to foreign tax authorities. Obviously, the above would only be interesting to the extent that the informal capital does not result in an income pick up in the foreign jurisdiction.

Below we will give an example of the informal capital contribution in practice.

### **Example: Deemed Royalty Payment**

A Dutch tax payer is granted a royalty-free license of intangibles by a group company. Under Dutch tax law, the tax payer would be deemed to deduct an arm's length royalty from its taxable income. The same amount would be included in the tax accounts as an informal capital contribution. The deemed royalty payment could be profit contingent, thereby creating a deduction that would increase as the profit related to the intangible is higher. Consequently, a relatively small profit could remain in the Netherlands. We recommend that the arm's length character of the profit contingent deemed royalty payment will be discussed with the tax Dutch authorities and be confirmed in a tax ruling. Such a tax ruling would typically apply for a period of 6 to 10 years.

After this period, the Dutch tax authorities will generally take the position that the "old" intangibles have been replaced by "new" intangibles that have been created by or at the expense of the Dutch company. The deemed royalty payment would consequently be lower or no longer exist at all. To mitigate this situation, the royalty-free license could be granted for only a limited period of time (e.g. the duration of the tax ruling). After this period has ended, the Dutch company has not acquired or created any "new" intangibles and the "old" intangibles remain with the original owner.

### **Alternative Approach: Capitalization and Amortization of Licenses**

Alternatively, if a royalty-free license of intangibles is granted to the Dutch tax payer, whether for a limited period or not, the taxpayer could capitalize the license at fair market value and subsequently amortize that intangible. The amortizations could be offset against taxable income. Similar to the example above, it would be recommendable that the license is given for a limited period in order to avoid that a "new" intangible is created by the tax payer. The capitalization and subsequent amortization will be less flexible than a profit contingent payment since the amortization will be for a fixed amount, with the risk of losses in less profitable years and high profits in years that are more profitable than expected.

### **R&D Intangibles**

If "new" intangibles originate from R&D activities (as opposed to e.g. marketing intangibles), it may be possible that the "new" R&D intangibles qualify for the so-called "Innovation Box" regime. In such a case, it could be attractive to grant a perpetual license, or transfer the IP itself in order to achieve that a "new" intangible would be created that could qualify for the

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Innovation Box Regime. Under the Innovation Box regime, qualifying income from certain R&D intangibles is taxed at an effective rate of only 5%. To the extent the Dutch company is no longer allowed to deduct any deemed royalty payments, the income should be considered to result from the new R&D intangibles and could potentially qualify for the Innovation Box.

Please let us know if you would like to discuss in further detail how a transfer of intangibles to the Netherlands may offer significant tax benefits.