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Capital Income Taxation in the Netherlands

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Abstract

This paper looks at capital income taxation in the Netherlands from an international and domestic perspective. The Netherlands is a major conduit country for FDI. Recent reforms taken by the Dutch authorities as well as public statements represent a strong move to address international tax avoidance, but it is too early to be able to detect the impact in the data, and measuring tax avoidance even in the past is fraught with difficulties. Domestically, the unique system, which for many financial assets effectively taxes wealth rather than capital income, leads to inequities and distortions. Owner-occupied housing is strongly tax-favored and in many cases effectively subsidized. Various reforms, not necessarily of a fundamental nature, would improve efficiency and equity.

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I. INTRODUCTION¹

1. The Dutch corporate income tax (CIT) is under multiple pressures, from profit shifting, tax competition, and international reform efforts. Most of these pressures are not unique to the Netherlands but rather typical for a small open economy, which is moreover fully integrated in the European economy.² A more country-specific issue is the relatively large sector of special financial institutions (SFIs) that are owned by foreign investors and play roles as holding companies and conduits. These have long benefited from favorable taxation, but in line with a policy goal to address international tax avoidance, recent and announced Dutch reforms are tightening the rules. The Dutch SFI sector and the tax system more generally are also affected by international initiatives, such as the G20/OECD Base-Erosion and Profit Shifting (BEPS) project and the European Anti-Tax Avoidance Directive (ATAD).

2. Broader capital taxation is marked by multiple inefficiencies. As in most countries, capital income taxation creates a debt bias, because interest is taxed more favorably than dividends mainly through deductions for interest expense. A unique issue at the individual level taxation in the Netherlands is that capital income (depending on its type) can be taxed under three different schedules, one of which has a progressive rate, one a flat rate, and one effectively taxing the asset rather than the return on it. This creates ample scope for tax optimization.

3. The Dutch authorities are actively looking into reform options of their tax system, supported also by a very active research community. The Ministry of Finance (2020) prepared a published parliamentary report on building blocks for a better tax system, with 14 attachments covering for example taxation of income, taxation of wealth, taxation of the sharing economy, health taxes, green taxes, and tax simplification. Also, in 2020, the Ministry of Finance published the study of an advisory committee led by Mr. Ter Haar (Advisory Committee on the Taxation of Multinationals 2020), that looked into the taxation of multinational enterprises (MNEs). This is currently being followed by another advisory committee under Mr. Ter Haar looking specifically at conduit companies. Many Dutch academics have studied international tax avoidance and the impact of the capital income tax system, and many of their studies are cited later in this paper. Moreover, Cnossen and Jacobs (2019) published a major book on improving the tax design in the Netherlands with chapters commissioned from local and international tax experts and covering all aspects of domestic and international taxation.

4. The aim of this paper is to provide an international perspective on the Dutch capital income tax system and point to possible reform directions. The key aspects of interest are

¹ This paper has been prepared as part of FAD's initiative to support IMF surveillance with analyses of international tax issues. It has benefited from discussions with the Dutch authorities, business representatives, and tax experts. We gratefully acknowledge inputs from Oana Luca and useful comments from Alfredo Cuevas, Geerten Michielse, Victoria Perry, Dinar Prihardini, FAD seminar participants, and the Dutch Ministry of Finance.

² General international tax reform pressures are discussed in IMF (2019) and De Mooij, Klemm, and Perry (2021). The specific challenges in Europe are discussed in Crivelli and others (2021).

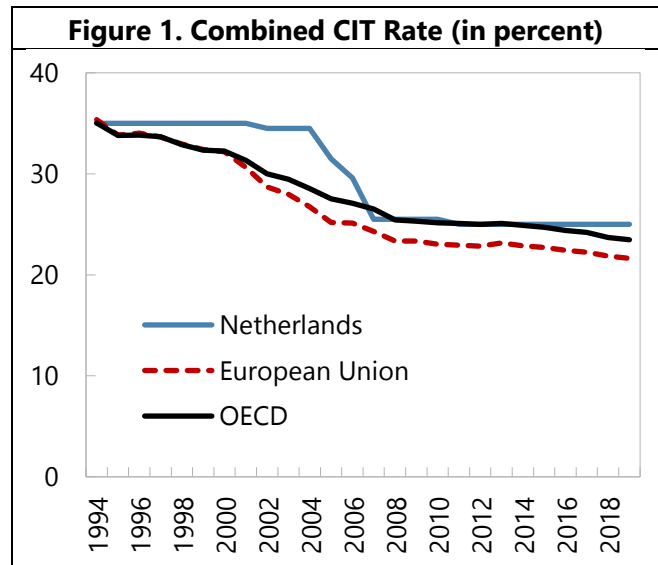
international corporate taxation and taxation of capital income at the individual level. On international corporate tax, the paper provides an overview of existing studies on the likely amount of profit shifting from and through the Netherlands and uses this as a backdrop to describe and discuss the latest measures taken by the Dutch authorities to fight international tax avoidance. In this respect, the paper also discusses international reform efforts and ideas led by the OECD and the EU, as well as more speculative reform proposals, and their likely impact on the Netherlands. On capital taxation at the individual level, the paper points to the main distortions in the system and ways they could be addressed. The key inefficiencies covered are the unique way of taxing individual capital income in the Netherlands—which for most financial assets is based on stocks rather than flows—and the generous taxation of owner-occupied housing.

5. This paper is structured as follows. Section II provides a description of the main features of the current capital income tax system in the Netherlands. Section III turns to international tax avoidance, covering recent and potential future reforms to address this. Section IV discusses international tax reform efforts and their likely impact on the Netherlands. Section V considers the broader domestic capital income taxation, including the interaction between corporate and personal capital income taxes and the differences in treatment across different types of capital income.

II. THE MAIN FEATURES OF THE CURRENT CAPITAL INCOME TAX SYSTEM

A. Corporate Income

6. The main features of Dutch corporate income tax are similar to the characteristics of the systems of most advanced countries. The statutory tax rate, at 25 percent, is slightly above the OECD average of 23 and the EU average of 22 percent (Figure 1). In 2021, for incomes up to €245,000, a reduced rate of 15 percent applies.³ Depreciation is aligned with commercial accounts and most standard methods are permissible. Loss carry forward is currently restricted to six years. From 2022 onwards, it will be unlimited, but utilization will be restricted to 50 percent of profits (except for losses



³ From 2022, the threshold of €245,000 will be increased to €395,000.

up to €1 million). Interest deductibility is restricted to 30 percent of EBITDA with unlimited carry forward and an exemption of €1 million.

B. Personal Income

7. Personal income is taxed under a schedular system, with most investment assets effectively facing wealth rather than income taxation. As in a dual income system, labor is subject to a progressive schedule. Unlike in a dual income tax system, capital is not subject to one different flat rate, but can fall into any of the three schedules (known as boxes), depending on the type:

- Box 1 includes labor and business income and some capital income, such as pensions and imputed rents from owner-occupied housing. Social security is perfectly aligned (in terms of base and thresholds) so that the sum of both determines the overall tax rate.⁴ This is progressive with rates ranging from 37.1 to 49.5 percent. Even within Box 1, tax rates are not effectively the same across all income types:
 - 14 percent of entrepreneurial income is exempt. The maximum rate against which income can be deducted is being gradually reduced from the top to the starting rate and stood at 43 percent in 2021. The resulting effective tax rates for such income are thus currently between 31.9 and 43.5 percent.
 - The effective rate on owner-occupied housing deviates from the statutory one, because imputed rents are calculated by a formula that likely underestimates their true value: the imputed rent is calculated as 0.5 percent of the property value up to €1.11 million, and 2.35 percent on the excess.
- Box 2 covers income (dividends and capital gains) from substantive shareholdings (defined as owning, as an individual or among spouses, at least 5 percent of a firm's stock capital) and is taxed at 26.9 percent. This is in addition to corporate level taxes.
- Box 3 covers financial assets, which are effectively taxed through a net wealth tax of 0.59 to 1.764 percent, depending on the amount of assets. The effective rates represent the product of a notional return ranging from 1.90 to 5.69 and a tax rate of 31 percent. There is, moreover, a tax-exempt amount of €50,000 (€100,000 for married couples/partners).

III. CORPORATE INCOME TAX EVASION AND AVOIDANCE

A. How Much Is at Stake?

8. The Netherlands is a major conduit for international investment flows. In 2019, its shares in total global inward and outward FDI reached 12 percent and 15.3 percent, respectively (Table 1). FDI inflows exceed 400 percent and outflows exceed 600 percent of the Dutch GDP. In terms of bilateral flows, the United States is the major FDI partner for the Netherlands with a

⁴ This does not include compulsory contributions to private occupational pensions.

share of 22 percent of total inward FDI (Table 2). Likewise, notably, the Netherlands is the top destination for US outbound FDI with a share of 14 percent, topping the list just slightly above the United Kingdom and Luxembourg with shares of 14 and 13 percent, respectively.

Table 1. Top FDI Investor and Recipient Countries, 2019

	<i>US Dollars, Billions</i>	<i>% of GDP</i>	<i>% of World FDI</i>
<i>Inward Direct Investment Positions</i>			
United States	4,458	20.8	12.3
Netherlands, The	4,370	481.7	12.0
Luxembourg	3,495	4915.1	9.6
China, P.R.: Mainland	2,938	20.4	8.1
United Kingdom	1,974	69.8	5.4
<i>Outward Direct Investment Positions</i>			
United States	5,960	27.8	16.4
Netherlands, The	5,582	615.4	15.3
Luxembourg	4,360	6131.0	12.0
China, P.R.: Mainland	2,199	15.3	6.04
United Kingdom	1,896	67.0	5.2

Source: Coordinated Direct Investment Survey (CDIS)

Table 2. Main FDI Partners of the Netherlands, 2019

<i>Inward FDI partners (Share in Total, %)</i>		<i>Outward FDI partners (Share in Total, %)</i>	
United States	22	United States	16
Luxembourg	12	United Kingdom	12
United Kingdom	9	Switzerland	7
Germany	7	Luxembourg	6
Switzerland	6	Germany	5

Source: Coordinated Direct Investment Survey (CDIS)

9. 'Transit' flows by Special Financial Institutions (SFIs) set up by multinationals comprise a significant share of FDI through the Netherlands of between 60 and 70 percent.

SFIs transact mainly with nonresidents and typically have little (or no) physical production or employment in the Netherlands, with a large part of their financial balance sheets consisting of cross-border claims and liabilities. The Netherlands hosts over 12,000 SFIs, including holding companies and intragroup lending vehicles with their combined assets reaching €3.37 trillion—almost four times GDP and larger than the banking sector of €2.2 trillion (DNB 2020).⁵ The FDI position of SFIs in the Netherlands comprised about 43 percent of total direct investment assets in 2019 in the Netherlands.

⁵ For a comparison of Dutch and Luxembourgish SFIs, see De Mooij and others (2020).

10. Despite their large aggregate size, the contribution of SFIs to the Dutch economy remains relatively modest. For instance, in 2016, the sector was responsible for between 8.8 and 13 thousand jobs (direct and indirect) and SFIs spent between €0.65 and €1 billion on salaries and business services.⁶ They also paid €2.3 billion (0.3 percent of GDP) in tax revenue (DNB 2018). While the contribution by SFIs is modest, multinationals more broadly are important for the Dutch economy, contributing steadily about 50 percent of total CIT revenue in the Netherlands (Advisory Committee on the Taxation of Multinationals 2020), which is significant but close to that in other countries such as the United Kingdom (Bilicka 2020).

11. The literature on ‘treaty shopping’ clearly points to the importance of the Netherlands as a conduit for FDI to minimize cross-border withholding taxes (WHTs). For example, Garcia-Bernardo and others (2017) analyze global multinational ownership networks and report that the Netherlands is on the top of the list. Van ‘t Riet and Lejour (2018) use network analysis and rank the Netherlands as number two conduit for dividends and number four for interest and royalty. Notably, Van ‘t Riet and Lejour (2019) find that developing countries are particularly impacted by treaty shopping through the Netherlands. Weyzig (2013) finds that FDI flows through Netherlands are significantly affected by tax treaties. But none of these studies estimate the implied base erosion and revenue impact on other countries as a result of the indirect FDI structures through the Netherlands.

12. The empirical literature provides evidence on profit shifting by multinationals, but without agreement on the magnitude. Especially the country-specific evidence is mixed and strongly depends on methodology. Tørsløv, Wier, and Zucman (2018) estimate inward profit shifting in low tax jurisdictions as the excess of profitability (profit-wage ratio) of foreign MNEs compared to domestic firms using macro-level foreign affiliate statistics. This excess profit is then allocated proportionally to countries of origin using data on service exports and intra-group interest receipts. They estimate that the Netherlands gains about 32 percent of CIT revenues from attracting tax base of foreign multinationals (column (5) in Table 3). Clausing (2016) computes an effective tax on US multinationals in the Netherlands of less than 5 percent and reports that excess gross income booked in the Netherlands was \$139 billion in 2012 (which was 23 percent of total excess gross income of US multinationals).⁷ In contrast, the elasticity approach suggests a modest loss of CIT revenues for the Netherlands (columns (1), (3), and (4) in Table 3). This finding is largely driven by the full reliance of the methodology on estimating the sensitivity of reported profits (in the financial accounts) to the statutory CIT rate, which for the Netherlands is slightly above the OECD average.

⁶ For reference, the total number of employed people in 2016 in the Netherlands was 8.427 million.

⁷ Clausing (2016) uses data from the Bureau of Economic Analysis and defines the effective tax rate as foreign income taxes paid by all affiliates in a given country relative to their gross income (net income plus foreign tax payments).

**Table 3. Estimates of CIT Revenue Losses from Profit Shifting
(percent of National CIT Revenue)**

	(1)	(2)	(3)	(4)	(5)
	Estimates based on Beer, de Mooij and Liu (2020)	Clausing (2016)	Crivelli and others (2016)	Cobham and Jansky (2018)	Tørsløv, Wier, and Zucman (2018)
Year of data	2016	2012	2013	2013	2015
France	19	23	22	28	21
Germany	10	28	15	23	28
Spain	2	24	19	20	14
Greece	8	26	9	16	7
Portugal	9	19	8	15	9
Italy	13	16	10	10	19
Austria	1.7	...	9	6	11
Denmark	-2	13	7	5	8
Finland	-5	18	7	5	11
UK	-5.6	...	5	2	18
United States	29	26	14	54	14
Netherlands	1.7	**	5.4	8	-32
Global	5.1	15	6	23	10

** Excess gross income of \$139 billion (Table 3 in the Clausing, 2016). The revenue impact of this number is not clear as an assumption needs to be made about the applicable tax rate. Note: Estimation methods based on the cited papers.

13. Evidence generally suggests that the Netherlands is more important as a location for funneling rather than parking profits. For example, recent empirical evidence using firm-level country-by-country (CbC) data points to a relatively modest share of profit located by German multinationals in the Netherlands. Fuest and others (2021) find that 7.6 percent of profits of German multinationals are booked in a group of European investment hubs (that include Ireland, Netherlands, and Switzerland, among others). Their results suggest that less than 3 percent of total profits of these multinationals are shifted to these countries for tax reasons.⁸ In contrast, Mintz and Weichenrieder (2010) provide evidence that the Netherlands is an important location for German holding companies abroad to funnel FDI to other countries. Thus, taken together, the literature indicates the importance of the Netherlands in facilitating indirect FDI rather than as a final location for reported profits.

14. Firm-level data suggest that the average tax paid by multinationals in the Netherlands is close to that of non-multinationals. Advisory Committee on the Taxation of

⁸ It is important to note that the analysis considers only multinationals with ultimate owners in Germany and subject to CbC reporting (333 companies). For a study using Italian CbC data, see Bratta and others (2021). Thus far, no similar published studies exist for the Netherlands.

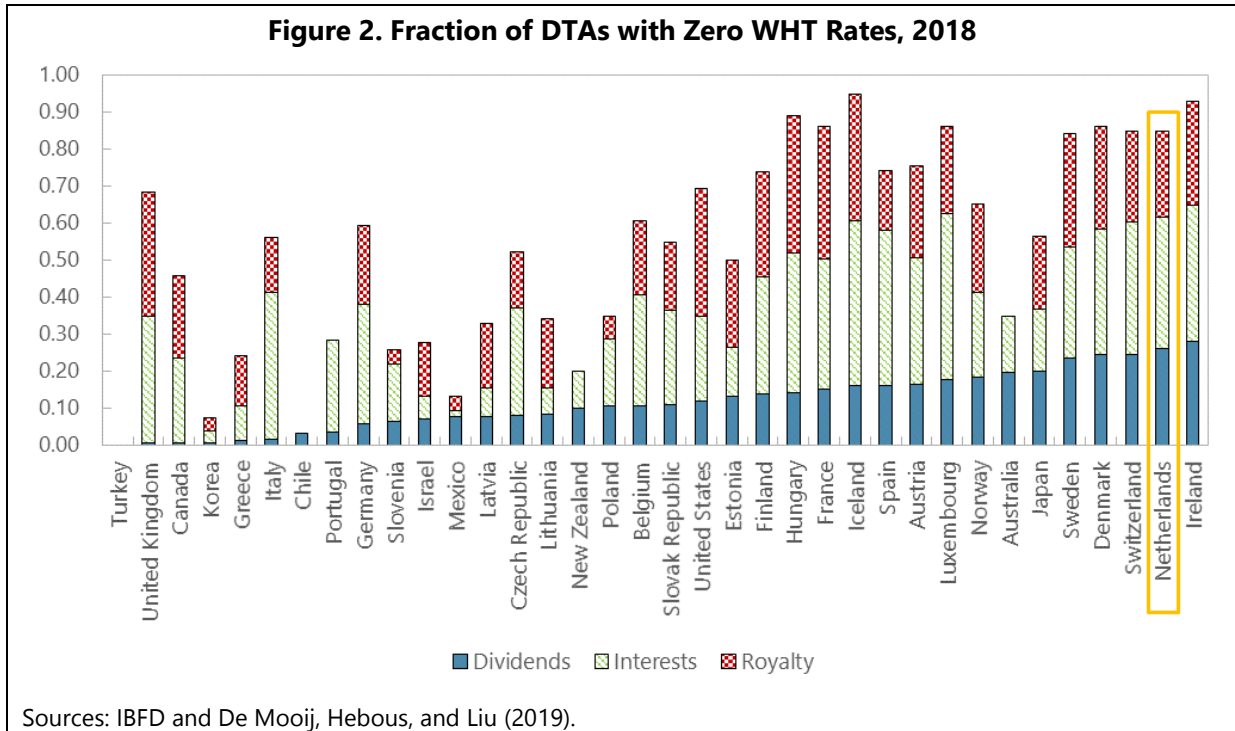
Multinationals (2020) reports that the ratios of tax payment over before-tax profit are 24.5 percent and 24.8 percent for multinationals and non-multinationals, respectively. Dutch multinationals pay somewhat less on average (19 percent). These figures ignore loss-making firms in particular years and losses carried forward. Furthermore, one important caveat is that the before-tax profit of multinationals in the financial accounts can differ from the tax accounts; for example, the latter do not include exempt income such as dividends from participation in foreign affiliates. Evidence from other countries suggests that multinational affiliates pay less taxes than domestic firms. Using matching techniques, Egger and others (2010) find in a panel of firms from the ORBIS database that multinational affiliates, on average, pay 32 percent lower taxes than 'comparable' domestic companies. Bilicka (2019) finds large bunching around zero reported profits in the tax returns of multinationals in the United Kingdom. The study also uses matching techniques and finds that multinational affiliates in the United Kingdom report 50 percent less taxable profits than comparable domestic firms.

B. What Are/Were the Attractive Tax Aspects in the Netherlands?

15. Specific tax features in the Netherlands were, and some remain, particularly attractive for multinationals. These include:

- I. A relatively generous participation exemption regime: While qualifying dividends and capital gains received from foreign affiliates are exempt from tax to prevent international double taxation, in the Netherlands, investors qualify at a 5 percent minimum participation share, which is relatively low compared to other countries; and the 100 percent exemption is marginally more generous than, for instance, the 95 percent in Germany and France. There is also no minimum holding requirement, while many countries typically have a 1-year requirement.
- II. A rich network of 94 bilateral tax treaties, several of which have no (or relatively low) WHTs on royalties, interest, or dividends (Figure 2). Beyond WHTs, other provisions in tax treaties can be important for providing tax reliefs—for example, the allocation of exclusive taxing rights for capital gains from offshore indirect transfers of immovable assets to the residence country of the investor (Platform for Collaboration on Tax 2020).
- III. A practice of Advance Pricing Agreements (APA) and Advance Tax Rulings (ATR), which offer tax certainty, for example in relation to arm's length remuneration for finance and royalty activities and the application of the participation exemption for holding companies. While not providing a tax advantage in and of themselves, especially pre-reform, rulings could be used to obtain certainty about the effectiveness of tax planning structures. Box 1 provides examples.
- IV. The innovation box regime that provides a reduced CIT rate on qualified income from know-how assets such as patents and trademarks. This regime was introduced in 2007 and includes a nexus rule ('substance requirements'), which has been later modified in

line with the G20-OECD BEPS minimum standard as discussed below. Several countries offer similar regimes.⁹ Pre-reform, at a tax rate of 5 percent, its budgetary cost was increasing reaching €700 million in 2012. Generally, in countries without a nexus-rule, a common practice by multinationals was to reallocate the know-how asset (e.g., a patent) within the multinational group to benefit from such a regime—i.e., shifting the asset after development in one country to the country of the innovation box regime.



C. What Are the Recent Tax Measures?

16. Several measures have been recently adopted to curb tax avoidance through the Netherlands. These include:

- I. *Conditional cross-border WHT*: As of 2021, a Dutch resident entity that makes interest or royalty payments, or (as of 2024 also) dividends to an affiliated entity in a 'listed' country is liable to a WHT at the full CIT rate of 25 percent. The list of countries includes those on the EU list of non-cooperative jurisdictions for tax purposes and countries with a statutory CIT rate below 9 percent.¹⁰ Thus, by design, the list does not include any EU member state. The application of the WHT stipulates anti-abuse rules to counter artificial

⁹ Cost-based R&D incentives are found to be more effective and efficient in encouraging R&D investment than innovation box regimes (IMF, 2016a).

¹⁰ For 2021, the list of countries includes: Anguilla, Bahamas, Bahrein, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Fiji, Guam, Guernsey, Isle of Man, Jersey, Oman, Samoa, Seychelles, Trinidad and Tobago, Turkmenistan, Turks and Caicos Islands, United Arab Emirates, US Samoa, US Virgin Islands, and Vanuatu.

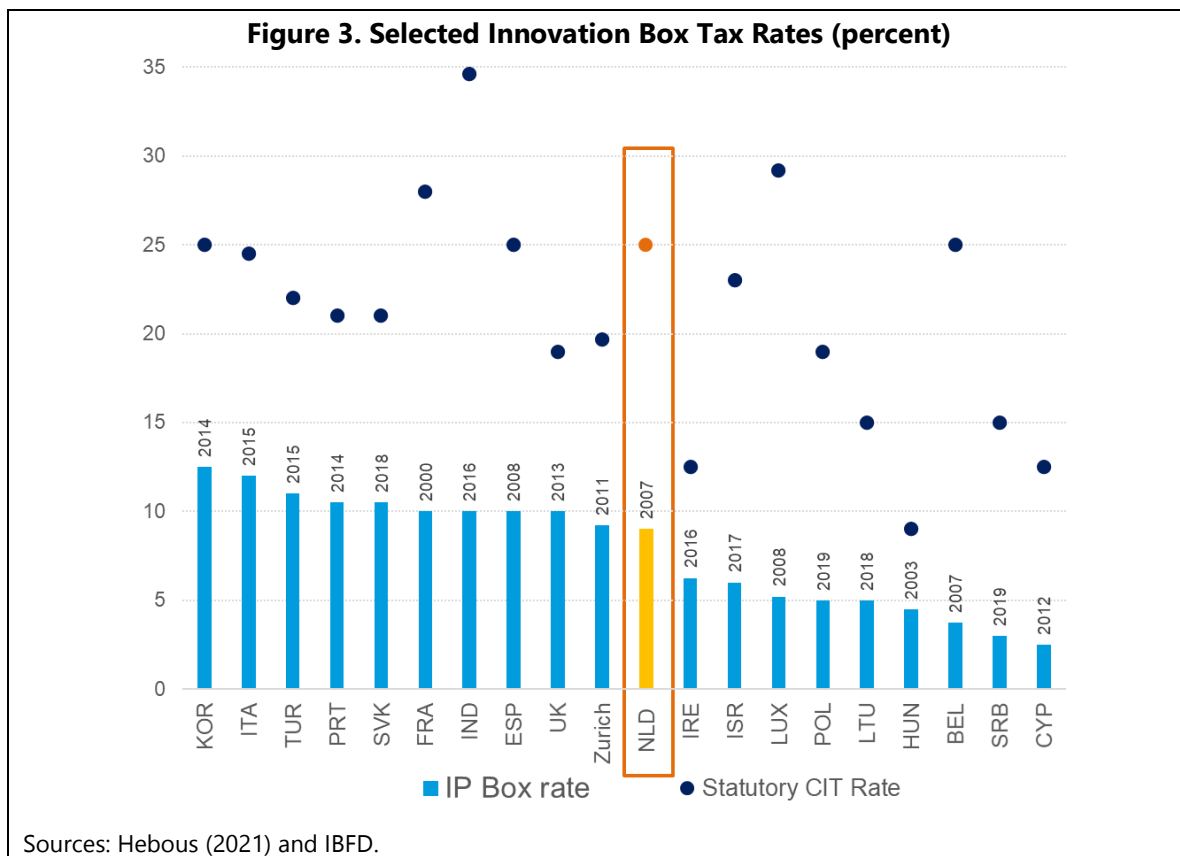
structures or transactions the main purpose of which is to avoid the WHT (through indirect payments to a listed country via a non-listed one).

- II. *Revised practice of APAs and ATRs.* Since 2019, the Netherlands have strengthened i) substance requirements (for example, by introducing a minimum salary payment of €100,000 and minimum office space, among other requirements); and ii) the purpose test, thereby denying advance rulings when the primary purpose of a proposed structure is to avoid Dutch or foreign tax, or which involve transactions with listed jurisdictions. Moreover, validity of rulings is generally limited to 5 years, and transparency has been enhanced by publishing summaries of individual tax rulings and a yearly report analyzing main trends¹¹ (see also Box 1).
- III. *Modified innovation box:* First, the modified nexus requirement of BEPS Action 5 has been implemented in the Netherlands, thereby linking the expenditures to develop the income generating know-how asset to the tax benefit from the innovation regime. This modification tackles the practice of shifting the legal ownership of patents and similar intangible assets for the main purpose of reducing the tax on royalties. Second, the tax rate of the innovation box has been raised to 7 percent in 2018 and 9 percent in 2021, aligning the rate with that for the listed countries for the application of the conditional WHT (and the controlled foreign corporations (CFC) rules). As of 2021, the Intellectual Property (IP) regimes of several countries offer a tax rate below 9 percent (**Figure 3**).
- IV. *Revisited the tax treaty policy, in particular with developing countries:*
 - The 2020 Dutch Memorandum on Tax Treaty Policy foresees a negotiating position for the Netherlands in line with the OECD Model Tax Convention of 2017 and BEPS Action 15. For developing countries, the negotiating position concerning certain sources of income is in line with the UN Model Tax Convention of 2011 that grants source countries more taxing rights regarding, for example, interest, dividends, and royalty payments, including a willingness to accept higher WHT rates on those, as well as a willingness to accept a services permanent establishment. In relation to the poorest countries the updated policy also expresses a willingness to accept source country taxing rights over fees for technical services subject to those being performed in the source country.¹²
 - The Netherlands is implementing the minimum standard on preventing tax treaty abuse through the inclusion of the preamble statement and the adoption of the principal purpose test, either through the multilateral instrument (MLI) (covering 81

¹¹ https://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/standaard_functies/prive/contact/rechten_en_plichten_bij_de_belastingdienst/ruling/ruling

¹² However, these benefits may be eroded if the relevant treaty also includes a most favored nations (MFN) clause, which would extend to the Netherlands a more favorable treatment that the other treaty party has agreed to extend to any other country with which it has concluded a treaty.

of its 95 DTAs) or through bilateral negotiations (OECD 2020c). This is also reflected in the Netherlands' updated tax treaty policy (*Notitie Fiscaal Verdragsbeleid 2020*).



17. Moreover, further recent measures target possible erosion of the Dutch CIT base.

These include:

- I. Rules in line with ATAD (see Section IV-B), inter alia, to:
 - deny the participation exemption for passive income in the listed countries—so-called CFC rules; and
 - deny deductions for interest expenses if net interest exceeds 30 percent of Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). The application of this rule is relatively broad covering all business with net interest exceeding €1 million and does not provide for a 'group escape' (i.e., affiliates of multinationals will be subjected to this rule even if they make the case that their debt is in line with the multinational group).
- II. Limiting carryforward of losses to 50 percent of profits in a particular year.

18. In addition to legal changes, public statements about the intent to discourage tax avoidance, send a strong signal against tax-avoiding structures. In a 2017 F&D interview Finance Secretary Snel stated that letterbox companies were "not welcome anymore," and in

February 2021, Finance Secretary Vijlbrief, his successor, stated in a newspaper interview¹³ a desire to move “away from the dark side to prevent tax avoidance.”

19. The Netherland is also committed to EU and G20-OECD Base Erosion and Profit Shifting Initiatives. The Netherlands has implemented all the minimum standards of the 2015 BEPS package as well as most BEPS recommendations and best practices. The measures are discussed in Section III.

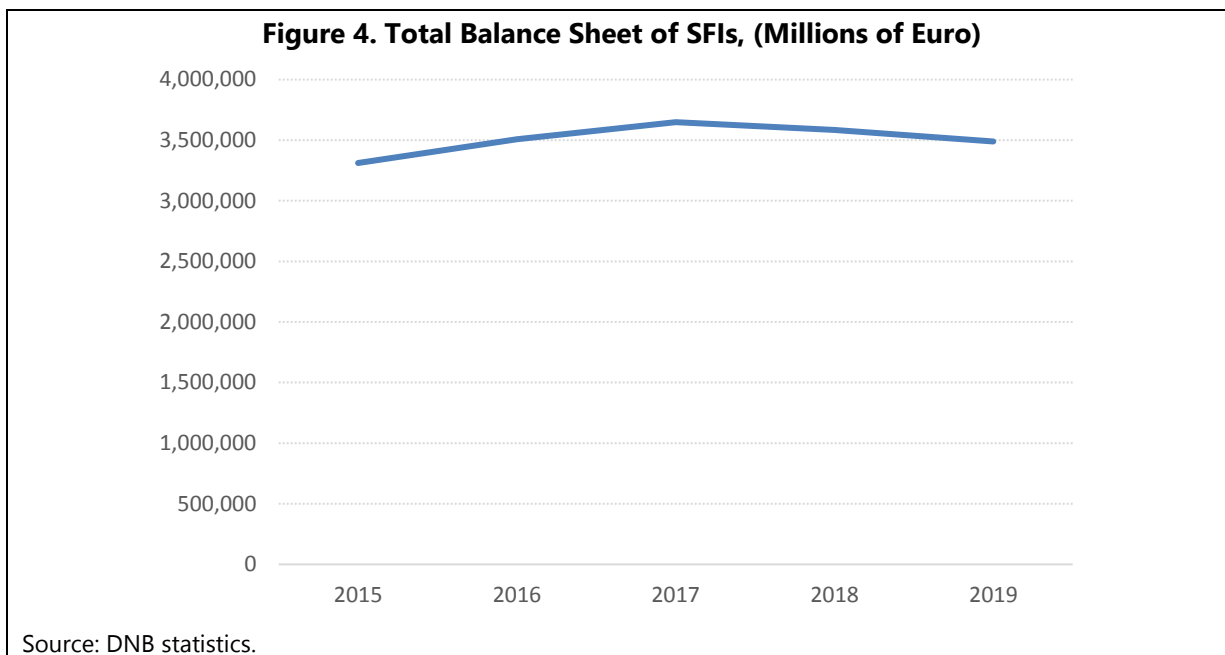
D. What Are the Impacts of the Recent Tax Measures?

20. It is too early to quantify the effects of recent tax reforms in the Netherlands on the activities of MNEs. As most measures have just recently entered into effect or are yet to be implemented in the near future (such as the conditional WHT on dividends), and in the presence of temporary grandfathering of some arrangements, and reforms in other countries, estimating the effects of each of these measures, at this point, is challenging.

21. However, an initial assessment of the new conditional WHT indicates that it reduces the benefits from using the Netherlands as a conduit. Van ‘t Riet and Lejour (2020) simulate the effect using a counterfactual network analysis and find that the conditional WHT will lower the attractiveness of the Netherlands as a conduit especially for interest and royalties, but the possibility for treating shopping is not eliminated. For example, Bermuda has been found to be an important destination for royalties coming from Ireland and the United States through Netherlands (Lejour and others, 2019). The conditional WHT applies because the treaty with Bermuda does not limit the WHT on these flows. However, in four cases—Barbados, Bahrain, Panama, and the UAE—, the conditional WHT is incompatible with the bilateral treaties. In those circumstances the law provides for a 3-year delayed entry into force of the conditional WHT to allow for the relevant treaty to be renegotiated, as is intended.

22. Most recent data indicate a slight decline in the number of SFIs. A deterring effect is expected to be particularly relevant for ‘letter box’ companies that cannot satisfy the nexus and purpose tests. However, in part the decline in the number of SFIs could be driven by reclassification of SFIs. Reforms in other countries, notably in the United States, appear to have impacted the activities of SFIs in the Netherlands as reflected by a decline in SFIs FDI flows. The total balance sheet of SFIs has slightly declined recently (**Figure 4**). However, detailed analysis by the DNB (2020) suggests that the decline is mainly driven by smaller SFIs and that the balance sheets of the largest 400 SFIs do not show a noticeable change. It remains to be seen how this sector will respond to all new tax measures.

¹³ AD of February 10, 2021.



23. Limiting loss carryforward can help address tax avoidance but comes at an economic cost. While there may be genuine economic reasons for businesses to be in a loss position over several accounting years,¹⁴ reported corporate losses appear to be relatively large and persistent in the Netherlands. The Advisory Committee on the Taxation of Multinationals (2020) finds that 13 percent of the companies in the dataset made a loss every year in the sample and 38 percent of entities made more losses than profits over the entire sample period (2010-2017). These numbers are puzzling as firms that are unable to achieve viable returns (i.e., incur losses repeatedly) are expected to exit the market. In those circumstances—and until more is known about the source of these persistent losses—limiting loss carry forward is an appropriate policy response.

E. Taking Stock of Tax Avoidance

24. The Netherlands has undertaken several concrete measures and made public announcements, in a clear political signal, to reduce the potential spillovers of its international corporate tax system on tax bases of other countries. While it is too early to see the effects of these measures on tax avoidance in the data, they can be expected to help. Further measures might be necessary or advisable, but until international consensus is reached on some key multilateral reforms (see Section IV) and until more data become available to study the impact of recent measures, the focus should remain on enforcing and refining existing measures as well as closing loopholes as they are detected. Potential directions for this are the substance and purpose tests, which could be strengthened, for example, by increasing the

¹⁴ For example, startups are typically in a loss-making position in earlier phases of the business and denying loss carryforward would discourage entrepreneurship. More generally, efficiency requires a symmetric tax treatment of losses and profits.

minimum amount of salary. Regarding the conditional WHT, it will be necessary to carefully monitor the list of countries and ensure that the focus on statutory tax rates does not allow abuse. In taking all these measures, it should also be remembered that some of them do have efficiency costs and therefore cannot be tightened without limit (for example restrictions on loss carry forward). The Netherlands should continue its efforts to bring its tax treaty network into line with its new tax treaty policy in particular in relation to developing countries with a view to strengthening their source country taxing rights and further minimizing potential negative spillovers on these countries.

Box 1. Examples of Tax Planning, Tax Rulings, and Recent Developments

Informal Capital

Description: Consider an interest-free loan provided by a company in a foreign country to a related Dutch company within the group. The idea is that if it had been a loan from an unrelated party, an interest rate would have been charged on this the loan, following the transfer pricing principles. Thus, the Dutch law allows the Dutch company to deduct interest expense on this loan even though de facto no interest payments were made. This situation creates a mismatch in that the foreign country does not include those Dutch tax-deductible costs in its tax base (i.e., it is an arrangement of deduction in one country without income inclusion in the other country). Advance rulings were granted to provide certainty to such structures involving companies specialized in financing and royalty activities ('dienstverleningslichamen').

Recent developments: Foreign tax authorities can obtain more information about such arrangements through country-by-country reporting for large multinationals and, importantly, the automatic exchange of relevant international tax rulings. Being informed about the structure gives the foreign country the opportunity to tax the informal capital component. Moreover, the revised Dutch practice no longer offers advance rulings if the main purpose of the arrangement is to avoid Dutch or foreign taxes. However, to the extent that taxpayers abstain from the quest for certainty in advance, the use of the informal capital arrangements in the Netherlands could continue as it follows from Dutch the transfer pricing rules. To counter this, in March 2021, the Dutch government launched a public consultation on a draft for amending transfer pricing rules to limit deductions that lead to a downward adjustment to Dutch profits without a corresponding adjustment abroad.

Intermediate Holding Companies

Description: Consider a parent company in a foreign country that owns an affiliate in another foreign country through an intermediate holding company in the Netherlands. The idea is: 1) the affiliate below the holding company pays out dividends to the holding company with no (or reduced) WHTs; 2) the participation exemption means these dividends are not subjected to CIT in the Netherlands; 3) the Dutch holding pays out these dividends to the parent company with no (or reduced) WHTs. But there can be uncertainty surrounding such a structure, for example whether or not the company below the Dutch holding is deemed as generating active income and was subjected to a tax in the host country. The Dutch holding could seek certainty through advance rulings with respect to: i) the application of the participation exemption regime, which means that received dividends are exempted from the CIT in the Netherlands; and ii) the exemption from the WHT, which means that the paid-out dividends are exempted from a cross-border WHT. In some cases, the legal form of the Dutch holding is cooperative to avoid a Dutch WHT on distributed dividends to the parent company.

Recent Development: Imposing substance requirements on the holding company in the Netherlands tackles concerns about shell companies that have little (if any) real activities in the Netherlands and are set up as conduits. Moreover, the inclusion of anti-abuse provisions in bilateral tax treaties (for example through bilateral renegotiation or under the recent G20-OECD BEPS action 15) can give the right to the host country (below the Dutch holding) to impose a WHT on distributed dividends to the Netherlands. In addition, the revised Dutch practice no longer offers an advance ruling if the main purpose of the arrangement is to avoid Dutch or foreign taxes.

IV. INTERNATIONAL REFORM PROPOSALS AND THEIR IMPACT ON THE NETHERLANDS

A. Proposals from the OECD and the Inclusive Framework (IF)

25. As a founding OECD member, the Netherlands is committed to participating in the development and implementation of OECD standards on international taxation. The Netherlands actively participates in the OECD/G-20 BEPS project and has implemented all the minimum standards of the 2015 BEPS package as well as most BEPS recommendations and best practices. In particular, with respect to the BEPS minimum standards, the Netherlands has been found to (i) not have harmful tax regimes¹⁵ and to effectively exchange information on tax rulings¹⁶ (BEPS Action 5), (ii) be committed to preventing tax treaty abuse¹⁷ (Action 6), (iii) having implemented CBC and participating in the exchange of CBC information (Action 13),(OECD 2020d) and (iv) be committed to effective tax treaty dispute resolution (Action 14).

26. The Netherlands is also participating in the ongoing discussions in the OECD/IF towards further international corporate tax reform. Current discussions revolve around a so-called “two-Pillar approach” for addressing the remaining BEPS challenges arising in particular from the digitalization of the economy. While “blueprints” for both pillars (see hereafter) have been released for public consultation, multilateral negotiations remain ongoing in view of reaching a consensus-based solution by mid-2021.¹⁸

Pillar One

27. Pillar One seeks to reallocate a share of global residual profits of in-scope multinationals to market (or ‘destination’) countries (OECD 2020e). The profit reallocation under Pillar One would be based on a new ‘nexus’ based on significant market presence (essentially sales) as opposed to physical presence as under the current system. The reallocation of global consolidated residual profits would also be based on a formulaic approach as opposed to the current entity-by-entity based arm’s length pricing (ALP). Only large MNEs¹⁹ would be in scope, with further narrowing to ‘digitally-intensive’ and ‘consumer-facing’ businesses—with

¹⁵ As discussed above, the Dutch Innovation Box regime has been modified to comply with the nexus approach so meets the substance requirements, with any grandfathering being accordance with Forum for Harmful Tax Practice timelines (OECD 2020a).

¹⁶ The reformed Dutch tax ruling practice meets all relevant requirements (OECD 2020b).

¹⁷ The Netherlands is implementing the minimum standard on preventing tax treaty abuse through the inclusion of the preamble statement and the adoption of the principal purpose test, either through the MLI (covering 81 of its 95 DTAs) or through bilateral negotiations (OECD 2020c). This is also reflected in the Netherlands’ updated tax treaty policy (*Notitie Fiscaal Verdragsbeleid 2020*).

¹⁸ See Communiqué of the G20 Finance Ministers and Central Bank Governors of February 26, 2021.

¹⁹ The proposal suggests a global revenue threshold of at least €750 million, the threshold currently used for CBC reporting purposes.

exclusions and carve-outs for specific activities such as natural resources and financial services—being proposed. The Pillar One proposal has two main elements:

- *Amount A*, representing the new taxing right for market countries over a share of residual profits, defined as any excess profits over a fixed percentage return on sales to unrelated parties; and
- *Amount B*, representing a fixed return for defined baseline activities in the nature of marketing and distribution, effectively to ensure a minimum routine return from such activities under current nexus and ALP principles.

28. Pillar One operates as a ‘correction’ to the current system, which is otherwise left intact. This means that the current system—based on the separate entity approach, physical nexus and profit allocation using ALP—continues to operate for both in-scope MNEs and others. Given that the current rules already fully allocate taxable profits, where a reallocation occurs as a result of Pillar One relief from double taxation will need to be provided. The proposals also provide for (i) a mechanism to identify the ‘paying entity (or entities)’—and thus the jurisdiction(s) where relief from double taxation will be provided in relation to Amount A, and (ii) the method (exemption of credit) for providing such relief.²⁰

Pillar Two

29. Pillar Two seeks to ensure that in-scope MNE profits are taxed at a globally agreed minimum level (OECD 2020f). While the minimum rate remains to be agreed, a range of 9 to 12.5 percent has been suggested. The proposals under Pillar 2 comprise three interlocking rules that would apply to large MNEs:²¹

- *An income inclusion rule (IIR) in relation to outbound investments*, according to which the residence country of the ultimate shareholder of the MNE group collects a ‘top-up’ tax on foreign earnings when tax paid abroad on those earnings is below the agreed minimum.
- *An undertaxed payments rule (UTPR) in relation to inbound investments*, effectively imposing a minimum tax on resident affiliates of foreign MNEs targeting base-eroding payments serving as a ‘backstop’ to the IIR to mitigate the inversion risk that would otherwise arise from the application of the IIR; and
- *A subject to tax rule (STTR)*, to complement the UTPR by permitting source countries to impose, under their double taxation agreements (DTAs), additional tax on certain payments up to the agreed minimum rate.

30. Importantly, the proposed rule order means that the IIR is likely to operate as the main rule. This is because the application of the STTR will, first, depend on treaty change (and

²⁰ No special double tax relief rules are required in relation to Amount B as this simply ensures a return for activities already taxed under the current rules.

²¹ The Pillar One global revenue threshold of at least €750 million would apply; see above.

therefore its application depends on all relevant jurisdictions choosing to implement the rule) and, second, be of limited application (targeting mostly interest and royalties but no other kinds of base-eroding payments). This means that in practice the IIR is likely to be the main rule that will ensure group level minimum taxation by applying any top-up tax due in the country of the ultimate shareholder of the MNE group. The UTPR will only apply as a backstop in case no IIR applies (for example, when none of the (intermediate) holding companies is based in a country applying the IIR).

31. The minimum tax will be applied on a jurisdictional basis and by reference to effective tax rates. For this purpose, the proposal includes a broad notion of covered taxes, and contains rules for allocating taxes paid and tax bases to each jurisdiction in which in-scope MNEs operate. The proposals also include a 'carve out' for some share of profits that reflect substantive activities on a formulaic basis that will likely involve tangible assets and payroll to target the operation of the minimum tax to excess profits.

Expected impact of the two-Pillar approach

32. The two-Pillar approach is expected to increase global CIT revenue by less than 4 percent. According to OECD (2020g) estimates, Pillar One would reallocate about \$100 billion of profits to market jurisdictions. Given that these profits are, in principle, taxed already under the current system, Pillar One is only expected to raise modest additional CIT revenue (by less than 1 percent globally). Additional revenue would therefore primarily come from the combined effect of Pillar Two and the US GILTI provision,²² which are estimated to raise global CIT revenues by additional 0.9 to 1.7 percent. Pillar Two can also be expected to generate indirect revenue gains from reduced tax competition as effective tax rates across jurisdictions can be expected to converge, which may result in an additional revenue gain by 0.8 to 1.1 percent in global CIT to a combined CIT increase of 1.7 to 2.8 percent from Pillar Two.

33. The impact on Dutch CIT revenue remains highly uncertain, with much depending on ultimate design parameters and complex dynamic effects. The Ministry of Finance has modeled the expected impact on Dutch CIT revenue using the tool developed by the OECD.²³ These estimates necessarily contain a high degree of uncertainty given the many critical design parameters—in particular the level of the global minimum—that remain to be decided, in addition to the limitations of the underlying data and the effect of behavioral responses from

²² GILTI (or Global Intangible Low Taxed Income) is the IIR equivalent provision introduced in the US Internal Revenue Code by the 2017 US TCJA. Similar to the IIR under Pillar Two, it operates to include in US profits foreign excess returns earned by US firms that were lowly taxed abroad. Unlike the IIR, however, GILTI currently operates on a global rather than a jurisdictional level by blending all foreign income and taxed paid abroad by US firms. However, in its recently announced 'American Jobs Plan', the US administration announced its intention to not only increase the rate on GILTI income from effectively 13.5 percent now to 21 percent, but to also calculate GILTI on a country-by-country rather than a global basis.

²³ See letter of 29 September 2020 from the State Secretary of Finance to Parliament on the blueprints for reform of the international corporate tax system.

MNEs and other countries' policy responses. The estimates show a combined effect of both Pillars ranging from a CIT revenue loss of up to \$711 million to a gain of up to \$880 million. Pillar Two is expected to have a positive effect on CIT revenue (ranging between \$456 and \$857 million)—after taking account of behavioral responses including government responses (for instance, by increasing effective tax rates to the minimum), but Pillar One may lead to a CIT revenue loss of up to \$1.167 billion (or up to 3.4 percent of total CIT).

34. Despite these uncertainties, the broad direction of the Dutch estimates is in line with expectations. It is also in line with the global estimates published by the OECD, in particular for “investment hubs” (noting that this is a heterogeneous group), that is (i) additional revenue directly or indirectly generated mostly from Pillar Two, and (ii) revenue loss from Pillar One to the extent that more tax base of resident affiliates is reallocated abroad through Amount A than is allocated to the Dutch market from affiliates abroad.

35. The revenue impact from Pillar Two is highly dependent on the yet to be agreed level of the global minimum, as well as on current effective tax levels of Dutch affiliates of in-scope MNEs, including their global structure and the policy responses of other relevant jurisdictions—which in turn may impact behavioral responses by taxpayers. To preserve Pillar Two revenue gains, the Innovation Box rate may need to be revised upwards in case of an agreed global minimum above 9 percent, so as to avoid the ultimate parent jurisdiction ‘taxing away’ the tax differential enjoyed by its Dutch Innovation Box affiliate. Similarly, the conditional WHT can be redesigned to operate as a STTR for Pillar Two purposes, including potentially in situations where currently a DTA would prevent the conditional WHT from applying.²⁴

B. European Union

Anti-Tax Avoidance

36. The Netherlands is also committed to all EU anti-tax avoidance measures. Under EU law, all EU member states are required to implement within prescribed time limits the measures prescribed in the Anti-Tax Avoidance Directives (ATAD I & II) (Table 4).²⁵ ATAD I & II seek to ensure a coordinated EU implementation of some of the recommendations from the 2015 OECD BEPS package (see above), beyond the BEPS minimum standards (in particular with respect to interest limitation, GAAR and exit taxation).

²⁴ To the extent that implementation of the two-Pillar approach would enable a more efficient way to amend relevant DTAs, for instance through another multilateral instrument like the MLI.

²⁵ Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, as amended by Council Directive (EU) 2017/9522 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries. ATAD I was adopted under the 2016 Dutch presidency of the Council of the European Union.

Table 4. ATAD I and II

ATAD measure	Application date
<i>Interest limitation, GAAR and CFC</i>	January 1, 2019
<i>Exit taxation, Hybrid mismatches (except for reverse hybrids)</i>	January 1, 2020
<i>Reverse hybrid mismatches (with non-EU countries)</i>	January 1, 2022

37. The Netherlands has accordingly introduced interest limitation, CFC, exit tax and hybrid mismatch rules. A judicially developed GAAR was already part of the Dutch tax system. Notably, and in line with design options offered by ATAD I, the Netherlands now has:

- An *interest limitation rule* of 30 percent of EBIDTA with a safe harbor threshold of €1 million, with unlimited carry-forward (but no carry-back) of excess interest, but without a group escape clause; and
- A *CFC rule* that combines the entity-based (model A) and transaction-based (model B) approach of ATAD I, by applying only to entities in listed jurisdictions and to specified types of (passive) tainted income, unless the entity mostly earns non-tainted income and performs genuine economic activities.

Proposal for a Common (Consolidated) Corporate Tax Base

38. In 2016, the EU Commission re-launched its longstanding proposal for closer coordination and harmonization of corporate tax systems in the EU.²⁶ The proposal is based on a two-step approach (see Box), starting with common rules for determining EU corporate tax bases (CCTB), to subsequently lead to the adoption of a Common Consolidated Corporate Tax Base (or CCCTB) (see Box 2). Despite lack of progress on these proposals in recent years—partly because of the intervening discussions in the context of the OECD/IF (see above)—they remain on the EU Commission’s agenda. Most recently, a renewed commitment to a system of a common tax base with formulary apportionment was published, now renamed as “Business in Europe: Framework for Income Taxation” (BEFIT).²⁷

²⁶ Proposal for a Council Directive on a Common Corporate Tax Base, COM(2016)685 final.

²⁷ European Commission, Communication from the Commission to the European Parliament and the Council: Business Taxation for the 21st Century, COM(2021) 251 final.

Box 2: C(C)CTB

The C(C)CTB proposal envisages two elements, which could be implemented consecutively:

Step 1: A common base. A common CIT base would be established in all EU member states (mandatory for the largest companies, optional for others). This would set, for instance, depreciation and anti-avoidance rules to address BEPS issues. Other notable features of the common CIT base include:

- *R&D incentives:* all existing tax incentives for R&D, including patent boxes and R&D tax credits, would be replaced by a ‘super-deduction’ of between 125 and 200 percent of actual costs (with the percentage being larger for smaller firms).
- *Debt bias:* to neutralize the favorable tax treatment of debt over equity, the proposal includes a deduction for a notional return on equity.

Step 2: Consolidation and formula apportionment. Profit and losses will be consolidated for a group’s operations within the EU and then allocated across EU member states on the basis of a formula intended to reflect the extent of its activities in each. The proposal envisages four factors (with weights in brackets): assets (1/3), sales (1/3), number of employees (1/6) and payroll (1/6). Importantly, there is no harmonization of rates: each member state will apply its own CIT rate to the apportioned share of the profit.

39. While the C(C)CTB proposals could be further tweaked to address digitalization concerns, doing so may come at a cost. The European Parliament, for instance, has proposed a number of changes to the Commission’s 2016 C(C)CTB proposals, including to address digitalization concerns by: (i) introducing a digital permanent establishment based on a significant digital presence, and (ii) adding a “data factor” in the profit allocation formula.²⁸ The data factor would itself consist of two equally weighted components consisting of collected personal user data and exploited personal user data. While this could go some way to addressing (perceived) digitalization concerns, it also risks complicating and potentially distorting the application of the formula in circumstances where the value of digital user data is not always easily observable—thereby undoing one of the key advantages of formulary apportionment (Aslam and Shah 2021).

Digital Services Taxes (DSTs)

40. The Commission launched two other proposals in 2018 to specifically address digitalization, most prominently through an EU DST. One proposal would be to introduce a “digital permanent establishment” to ensure that profits are taxed where companies have

²⁸ European Parliament legislative resolution of 15 March 2018 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2016)0683). The revised formula would therefore consist of assets (1/4), sales (1/4), number of employees (1/8), payroll (1/8) and the new data factor (1/4).

significant interactions with users through digital channels.²⁹ While this proposal was the Commission's preferred long-term option at the time, it was also accompanied by a proposal for an EU DST,³⁰ to apply on an interim basis so that activities deemed not effectively taxed in the EU could generate immediate revenue for the member states. This proposal is now foreseen to be withdrawn and replaced by a digital levy.³¹

41. Neither proposal has so far received sufficient support from member states—also pending OECD/IF discussions—but the pandemic may give new impetus for an EU DST. In July 2020 the European Council tasked the Commission to propose new “own resources”—that is revenues that accrue directly to the EU budget—to support the EU's borrowing and repayment capacity, including a digital levy with a view to its introduction by January 1, 2023 at the latest.³² The Commission has launched a public consultation on various options—including a CIT top-up tax on digital companies, a tax on certain digital activities or a tax on digital business-to-business transactions in the EU—each of which would need to be designed to be compatible with international norms, including any consensus based on the two-Pillar approach currently under discussion in the OECD/IF.³³

42. Several EU and other European OECD countries have already implemented or announced forms of DST—but not the Netherlands. Austria, France, Hungary, Italy, Poland, Spain, Turkey, and the United Kingdom have implemented a DST—although rates range from 3 percent to 7.5 percent and some are imposed on a narrow (for instance, revenue from online advertising) or a somewhat broader base (for instance, also including revenue from user data). Belgium, the Czech Republic, and Slovakia have published proposals to enact a DST, and Latvia, Norway, and Slovenia have either officially announced or shown intentions to implement such a tax (Asen 2021).

43. While some see DSTs as an alternative to Pillar One, there are important differences between both approaches. First, the scope of Amount A under Pillar One—automated digital services and consumer facing businesses—is much broader than even the most broadly designed DSTs. DSTs therefore typically raise very little additional revenue—around 0.02 percent of GDP or less (Aslam and Shah 2021). Second, Amount A represents a notion of excess profits from in-

²⁹ Proposal for a Council Directive laying down rules relating to the corporate taxation of a significant digital presence, COM(2018)147 final of 21 March 2018.

³⁰ Proposal for a Council Directive on the common system of a digital services tax on the revenues resulting from the provision of certain digital services, COM(2018)148 final of 21 March 2018.

³¹ European Commission, Communication from the Commission to the European Parliament and the Council: Business Taxation for the 21st Century, COM(2021) 251 final.

³² Other new own resources include a levy on non-recycled plastic waste, a carbon border adjustment mechanism and, in the medium term, perhaps a financial transactions tax; European Council, Special meeting of the European Council (17, 18, 19, 20 and 21 July 2020) – Conclusions, EUCO 10/20.

³³ EU Commission, Inception Impact Assessment on a legislative proposal for a digital levy (Ares(2021)312667).

scope activities, while DSTs are typically imposed on gross revenue,³⁴ irrespective of whether (or the extent to which) the taxed activity is profitable. DSTs therefore also exhibit all the flaws of gross turnover taxes.³⁵ Finally, and relatedly, Pillar One contains a mechanism for relieving double taxation for any tax base reallocated under Amount A, while it is unlikely that any residence jurisdiction will provide such relief for DST paid by their residents abroad.³⁶ Nonetheless, both approaches have become politically linked and their fate may be decided together.³⁷

C. Impact of Other Potential Directions for Reform

Formulary Methods

44. The CCCTB proposal is part of a family of unitary methods for taxing MNE profits based on formula apportionment (FA). FA is a form of unitary taxation where MNE profits are consolidated and apportioned across jurisdictions on a formulaic basis, reducing opportunities for profit shifting and tax competition. The allocation formula is typically a combination of production factors or resources (employment, payroll, fixed assets) and sales (usually by destination) (Matheson and others 2021).

45. Residual Profit Allocation (RPA) is a variant of FA, which maintains the allocation of routine profits in source countries. These schemes divide consolidated MNE profits into routine and residual components. Routine profits are then allocated for tax purposes where the associated costs (purchases from third parties) are incurred—similar to some of the traditional methods—while residual profits are allocated on a formulaic basis as under FA. The Pillar One proposal currently under discussion in the OECD/IF contains echoes of RPA.

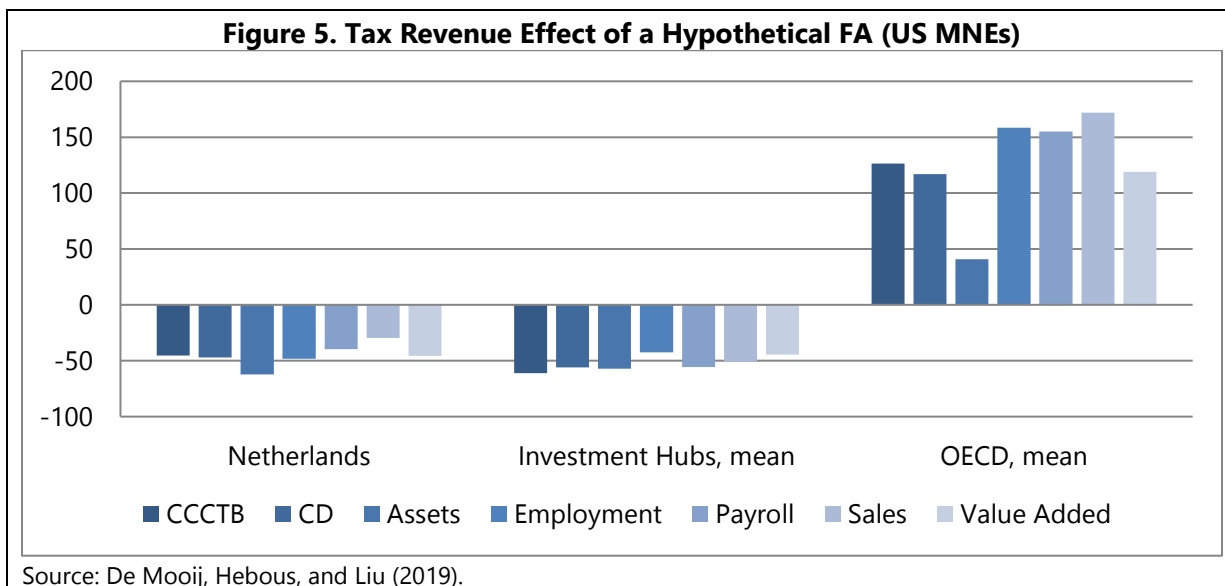
46. The Netherlands is likely to lose CIT revenue under either FA or RPA. The adoption of FA in the Netherlands—for instance in the context of the EU CCCTB (see above)—will reduce CIT revenue irrespective of the allocation formula used, in particular when profit allocation is based on assets and payroll, but less if based on sales by destination (**Figure 5**). Recent IMF research also shows that investment hubs are likely to lose CIT revenue from reallocating excess profits under RPA (Beer and others 2020). This is consistent with the estimated revenue impact from Pillar One on the Netherlands (see above).

³⁴ This legal design would generally also allow DSTs to be imposed on non-residents without a permanent establishment in the country of source where a DTA would otherwise prevent the source country from imposing its business profits tax.

³⁵ Furthermore, because of their narrow scope and high revenue thresholds, DSTs have also been accused as being discriminatory in nature, raising the prospect of trade retaliation.

³⁶ It is noteworthy in this respect that a recently proposed Article 12B for inclusion in the UN Model Tax Convention would provide for a treaty-based framework in which countries can bilaterally agree to provide for optional net-basis taxation of digital services by the source country with double tax relief being provided by the residence country.

³⁷ For instance, agreement on Pillar One may make a profit allocation under Amount A conditional on the market jurisdiction phasing out its DST.

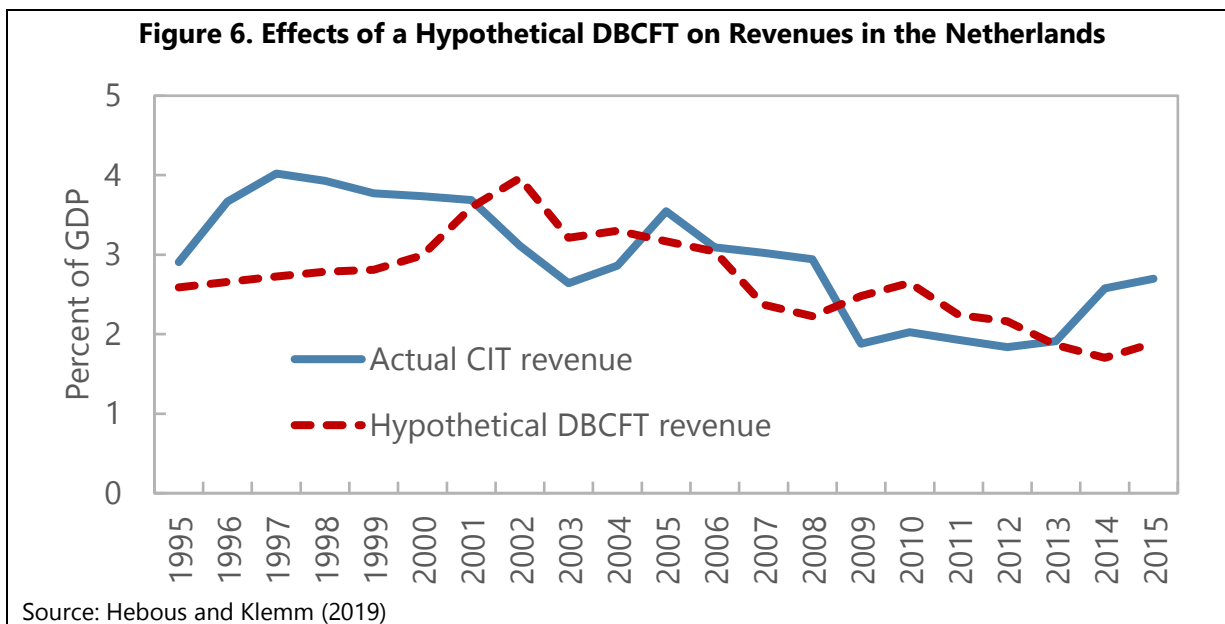


47. However, dynamic effects from FA or RPA can be important and could significantly alter their static revenue effects. While these systems are significantly more robust to profit shifting than the current system, they do not eliminate tax competition. This is because, depending on their design features, these systems may still incentivize countries to attract production factors through the tax system, in particular where these are reflected as factors in the formula to allocate profits under FA—or residual profits under RPA, with tax competition for routine activities also continuing under RPA (unless mitigated through an agreed minimum tax)³⁸.

48. Destination Based Cash Flow Taxation (DBCFT) is the furthest removed from the current system. A DBCFT combines destination-basis taxation through border adjustment with cash-flow treatment, effectively imposing a destination-based tax on rents. In addition to having attractive efficiency properties, a universally adopted DBCFT would also largely eliminate both profit shifting and tax competition (IMF 2019). While a DBCFT is not currently under active consideration—in the Netherlands or elsewhere—the Pillar One proposal being considered at the OECD/IF would go into this direction through a partial profit reallocation based on sales by destination of Amount A.

49. A hypothetical DBCFT, at the current CIT rate, would reduce Dutch revenues, largely because of positive trade surplus of the Netherlands. Given that imports are taxed but exports are not under a DBCFT, countries with a negative trade balance tend to gain while others tend to lose revenue under a CIT. This would also have been the case, had the Netherlands adopted a DBCFT, with the effect estimated to be below 1 percent of GDP for 2015 (Figure 6).

³⁸ IMF (2019).



D. Conclusion

50. Further international tax changes will necessarily impact the Dutch CIT. This is inevitable in the 21st century global digital economy. The Netherlands should therefore continue to actively participate in ongoing discussions at EU and OECD/IF level as well as anticipate the impact on its CIT of any internationally agreed changes—whether they be incremental such as those currently under discussion at the OECD/IF or more fundamentally depart from the current system. These changes may present both threats—such as a potential revenue loss from some measures (e.g., from a reallocation of tax base under Pillar One)—and opportunities, for instance to further strengthen its arsenal of anti-base erosion measures (e.g., a more finetuned conditional WHT applied by reference to effective tax rates). Other structural changes may also need to be considered, including in anticipation of actions taken by other countries imposing more binding minimum taxation, for instance by reforming the Innovation Box regime if its tax benefit would otherwise be taxed away by other countries’ income inclusion type rules.

V. INTERACTION OF CORPORATE AND PERSONAL CAPITAL INCOME TAXATION

51. The interaction of corporate and personal income taxes often creates distortions and different treatment of similar incomes, and in countries with schedular systems such as the Netherlands, these can be particularly strong. A common difficulty is the taxation of owner-run firms, where the distinction between capital and labor income is difficult, but crucial because capital income is subject to a different—or in the case of the Netherlands, various different—tax rates. An issue that occurs even without schedular taxation is debt bias, which is the result of interest being taxed once only (at the personal level), while dividends are taxed twice (both at the firm and the owner level). While this occurs in the great majority of tax

systems,³⁹ its interactions with the schedular system can exacerbate the problem. This section discusses various of the inefficiencies and distortions in the broader capital income tax system.

52. A clear vision of the desired overall tax system would help in guiding future reforms. One possible direction is a comprehensive income tax system, which would mean aggregating all incomes at the taxpayer level and subjecting the sum to a progressive rate structure. The advantage of such a system is that it is equitable and covers well all sources of income, including economic rents and returns from endowments. The opposite is a consumption tax, which would exempt savings, and which can be equivalently implemented by exempting all capital income. The advantage of this approach is that it leaves the savings decisions of agents unaffected and achieves the same tax levels irrespective of the lifetime distribution of real incomes. In between these extremes, a dual income tax system taxes both types of income, but applies a lower rate to capital income, thereby achieving a compromise. While no system is clearly dominates (see summary in Table 5), most economists would favor dual or comprehensive income tax systems, with a minority favoring pure consumption taxes. While no country implements any of these systems in a pure form, knowing the overall targeted system helps in identifying reforms that move toward the desired direction. The current Dutch system resembles a dual income tax, except that capital is taxed at multiple rates, and in some cases exceedingly low ones. Hence, it distorts investment decisions between assets classes.

Table 5. Capital Income Taxation under Different Stylized Systems

	Comprehensive income tax	Dual income tax	Consumption tax
Key feature	All income (labor and capital) taxed at same rate	Midway solution: capital income taxed, but at lower rate	Only consumption taxed – equivalent to exempting capital income
Pros	Taxes returns from endowments and economic rents	Compromise solution	Does not distort savings decisions

A. Owner-Managed Businesses

53. In the Netherlands—as in all schedular tax systems—taxing mixed income of an owner-run businesses⁴⁰ encounters the difficulty of splitting such income into a wage and profit component. Given the different—typically lower—taxation of capital income, this distinction has relevance for determining tax levels and creates an incentive for the owner to minimize their salary and treat most income as profit. Indeed, unless there are valuable social security entitlements linked to a salary, the incentive is to report no salary, otherwise the

³⁹ See IMF (2009, 2016b).

⁴⁰ An owner-run business is one where the manager and (majority) owner is the same person (or family). It is the generic term covering sole traders as well as owners running firms that are set up separate legal entities.

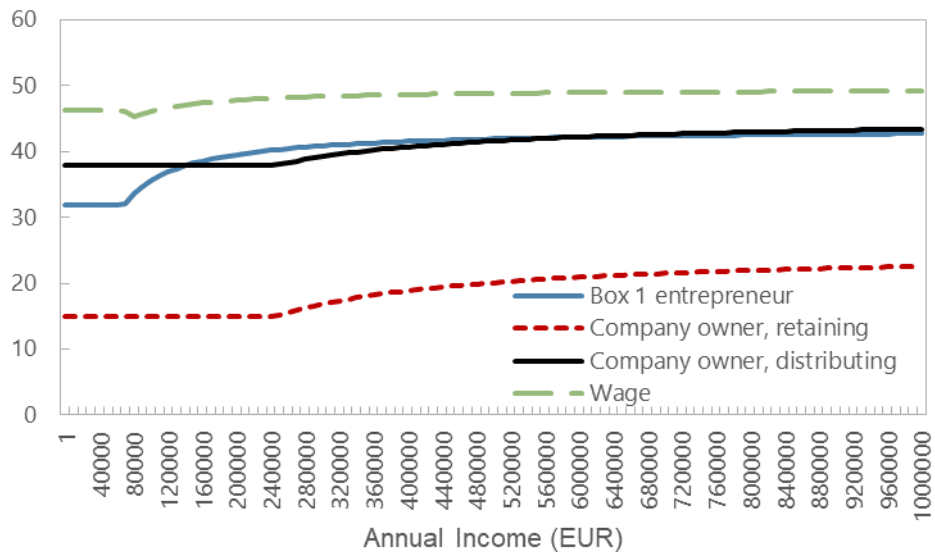
minimum required to qualify for entitlements. To prevent this, most countries with dual income tax systems have rules to determine the split of mixed income. Some define the salary (e.g., with reference to comparators or by setting a minimum salary), treating the rest as profit. Others calculate the profit as a return on paid-in capital, treating the residual as salary. The Netherlands has rules determining the minimum salary, which must not be set below the salary of the highest paid employee, 75 percent of the salary of the most similar employment, or €47,000, whichever is highest.

54. An additional issue arises because taxation differs across legal forms. While sole traders are typically taxed once under the standard tax system—in the Netherlands under Box 1—incorporated firms are taxed at the firm level, with additional tax on distributions. For an incorporated owner-run firm, income can be taxed in three ways: as salary if paid to the owner for labor input, as distributed profit, or as retained profit if kept in the firm. In the Netherlands, all three parts are taxed differently: salary is taxed under Box 1, distributed profits is taxed at the corporate rate and then again at the Box 2 rate on dividends, and retained earnings are taxed only at the corporate level, as the resulting capital gain at the personal level is not taxed (unless realized, which would imply selling the firm or otherwise delinking it from the owner). While there may eventually be additional tax liability if such profits are distributed later, there is a real tax saving because such funds compound more quickly inside the firm (with the rate of return reduced just by the corporate income tax).

55. The differences in effective tax rates across types of income and firms are complicated and depend on the expected profit level. Figure 7 provides an overview revealing large differences in average tax rates.⁴¹ The simple case is a Box 1 entrepreneur who faces the progressive schedule (with the 14 percent reduction compared to a worker). For an owner-run firm, some income will be paid out as salary—drawing the highest tax rate of the comparison. This figure also includes employer-paid social security contributions (applied until income reaches €58,311). The owner has an incentive to keep the salary to the minimum required by law. Distributed profits face relatively similar tax rates as Box 1 income, except for very low profits, which are taxed less under Box 1. Retained earnings, however, face much lower taxation, creating a strong incentive to keep savings inside the corporations. To benefit from this lower tax rate even in case funds are needed for spending, some owners take loans from their companies, which is proposed to be capped to €500,000 from 2023 onwards.

⁴¹ The figure abstracts from tax credits, some of which depend on personal circumstances (e.g., age) or type of investment (e.g., R&D). Where applicable, the credits can wipe out the tax liability for low incomes.

Figure 7. Average Tax Rates of Entrepreneurs (in percent), 2021



Source: IMF staff calculations.

56. Removing distortions to the choices of owner-managers comprehensively would require major reforms. To address the difference between Box 1 and Box 2, it would be necessary to integrate the corporate and personal tax of Box 2 firms. This could be done in various ways. One would be to charge a progressive tax on distributions, set such that the sum of the CIT and the distribution tax equals the Box 1 rate (with the additional difficulty of needing to heed also any labor income so that lower tax rates are not granted more than once). Additionally, capital gains would need to be taxed at accrual and at the Box 1 rate. An equivalent solution would be to treat Box 2 firms as passthroughs, with their profit attributed to owners and taxed under Box 1 irrespective of retention or distribution. Both reforms would imply a major deviation from the current approach. Additionally, if there is also a desire to achieve neutrality between employed labor and entrepreneurial profits, the 14 percent discount would need to be abolished, but if the ultimate goal is a dual income tax system then it should be kept.

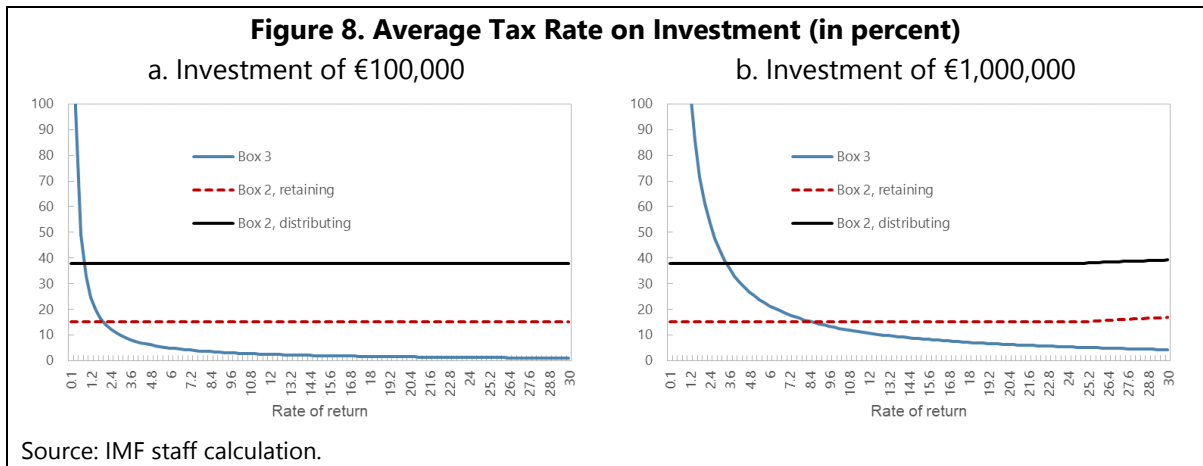
57. More limited reforms could be taken to improve the efficiency of the system while not achieving full neutrality.

- The simplest of these would be to tighten the rules for loans to owners by significantly reducing the proposed €500,000 limit. There is no justification for such loans (beyond possibly a very small exception of a few thousand euros): they are granted by companies having the cash to their owners who need it, and who could just take out profits as dividends, if they did not wish to avoid the resulting tax.
- Another option is the abolition of the reduced CIT rate for profits up to €245,000. Reduced CIT rates have the disadvantage of discouraging firm growth (IMF 2016a) or triggering avoidance activities such as splitting firms into smaller units. They are also not well aligned with equity considerations, because they reflect the fortunes of a firm, not its owner, who

could be very rich and have other incomes or be relatively poor if owning just the minimal 5 percent share to be considered a substantial owner. A side effect of abolishing the reduced rate is that it would allow a reduction in the tax rate on dividends thereby mitigating the tax preference for retentions over distributions.

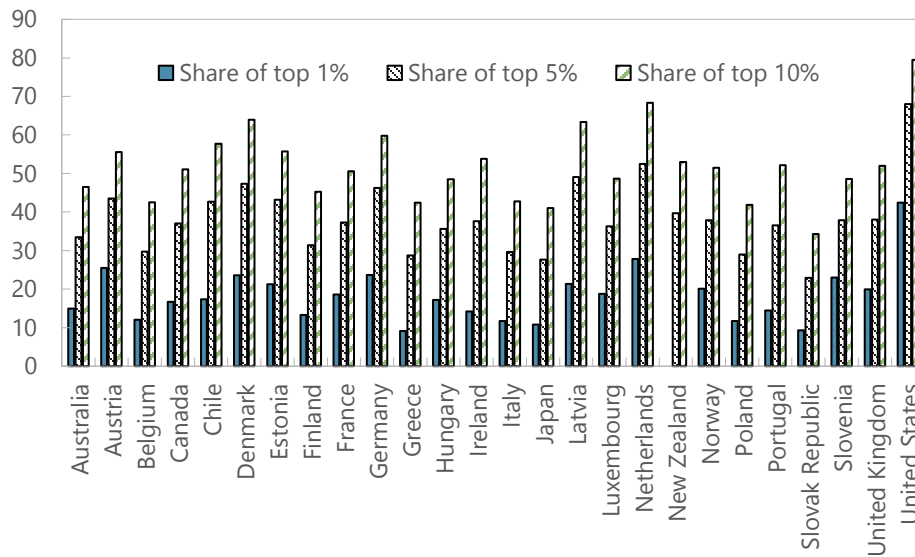
B. Passive Investment

58. Financial assets are in general subject to wealth rather than income taxation, leading to a wide range of effective tax rates on the resulting returns. As shown in **Figure 8**, for assets held in Box 3, the effective tax on low returns far exceeds 100 percent and would even be charged in case of losses, but rapidly drops as the return increases. As the notional return for high wealth is greater, and given the €50,000 exemption, there is some progressivity in this tax (comparing panels a and b of **Figure 8**), but there is an arguably greater regressive effect, when taking into account that people with small fortunes are likely to favor low-return risk-free assets, while those with high wealth can afford strategic financial advice. This is particularly problematic, given that wealth inequality is among the highest of advanced economies (Figure 9).⁴² A very different, but equally important disadvantage of the taxation of notional returns is that it works against automatic stabilization of the economy, as effective tax rates on actual returns rise in recessions and fall in economic booms (to the extent that those are aligned with financial cycles).



⁴² According to CBS (2020), the top 10 percent of wealthy households held 62 percent of the total assets in 2018. Including pension assets in the calculation reduces this share to 48 percent.

Figure 9. Wealth Shares (2013-2016, latest available year shown)



Source: OECD Wealth Distribution Data.

59. Completely different tax levels can be achieved by holding financial assets inside owner-run firms rather than directly. In that case, the taxation discussion in Section V-A applies, which can be very attractive, especially under the 15 percent rate for small profits. As shown in **Figure 8Error! Reference source not found.**, for large fortunes, this reduces tax rates provided distributions are avoided, and unless returns are very high, in which case nothing beats Box 3. The advantages of holding assets inside a firm are also likely regressive, as only better off people are likely to own firms or find it worthwhile to pay to set one up for that purpose.

60. Even more attractive taxation is available by investing in pension funds, but this is possible only within limits and fulfils a more obvious policy rationale. The generous treatment of pensions (exempt contributions, exempt accumulation, taxed distributions) fulfils the policy objective of allowing efficient savings choices over the lifecycle. Most individuals participate in mandatory pension fund established in the industries they work in. The tax system therefore does not affect incentives so much at the individual level, but still affects the collective choice to set up such pensions in an industry. There are also voluntary pensions, but according to CBS data, they make up only about 4 percent of total pension savings (2018).

61. Replacing the taxation of wealth stocks by a capital income tax would be straightforward, with the only (common) difficulty the taxation of capital gains. Indeed, the current system was introduced to address rampant tax avoidance through turning financial flows into capital gains, which were untaxed then, but are notionally covered under the assumed return. Capital gains can be taxed in various ways:

- On accrual: this is theoretically the efficient way achieving equal treatment with other returns. The drawbacks are that estimation is difficult for nontraded assets and that taxpayers may not have the liquidity.
- On realization: this is the most common approach and is relatively easy to implement. Its drawback is a lock-in effect: effective tax rates drop the longer an asset is held following a large gain.
- On realization, but based on holding period, as suggested by Auerbach (1991): This avoids a lock-in effect, but it has never been tried in practice. It is also arguably again a system based on ex ante expected returns and thereby somewhat similar to the current approach.

62. The difficulty of implementing perfect capital gains taxation should not prevent a compromise solution. Most countries tax capital gains on realization, which is still better than exemptions. Moreover, they typically have rules to prevent the most obvious avoidance strategies, for example discounted bonds, and notably zero-coupon bonds, can be required to be taxed on the implicit annual capital gain.

C. Owner-Occupied Housing

63. Neutral taxation of owner-occupied housing would be achieved by taxing the imputed rent and granting deductions for all costs, including mortgage interest. Under such a system there is no incentive to overinvest in housing compared to other assets, and no incentive to use excessive mortgages, as the tax rate on the benefits and costs are aligned. Many countries find it difficult, politically, or practically, to tax imputed rents of owner-occupiers. In those cases, a pragmatic second-best solution is not to allow mortgage interest deductibility either.

64. In the Netherlands, imputed rents are in theory part of the tax base, but in practice hardly taxed. First, they are systematically underestimated, given the low rate of return of just 0.5 percent of home value (except for high value properties). Second, they are eroded by a deduction, that currently forgives 90 percent of the imputed rent (unless already covered by the mortgage interest deduction). While this deduction is being phased out, this is scheduled to be complete only in 2049. Mortgage interest is deductible, and in many cases exceeds the imputed rent, leaving taxpayers with a net housing subsidy—which is not unique to the Netherlands, as some other countries also allow mortgage interest deductibility without taxing imputed rents.

65. As a result, there is an incentive to overconsume housing and to use excessive mortgage financing. The under-taxation of housing compared to other goods (and indeed the net subsidy in case of debt-financing) increases demand for housing beyond its natural level. With a supply-constrained sector, it is likely that this has strong price effects rather than helping access to housing (also given that the poorest households are unlikely to be homeowners). Even if subsidization were politically desired, doing it through mortgages has the disadvantages of encouraging indebtedness (see also Section V-D).

66. Various measures have been taken to reduce the housing subsidy through mortgages, but they address symptoms rather than the underlying cause. For example, the creditable rate on mortgage interest has been reduced below the maximum Box 1 rate to currently 43 percent, and further gradual reductions to 37.05 percent (the basic Box 1 rate) are underway. Additionally, regulations put upper limits and other constraints on mortgages, for example prohibiting previously popular interest-only mortgages and requiring regular payoff over a maximum of 30 years. While these reforms reduce the distortion, they do not eliminate it, as the tax rate on interest deduction remains high compared to some of the alternative investments, and as the imputed rents remain undertaxed.

67. Various reform options could be considered to reduce distortions related to owner-occupied housing.

- Raising the value of imputed rents to realistic levels would address the incentive for overconsumption of housing. Such reform would have to be phased in over time, to avoid sudden movements in the housing market and reduce financing difficulties of owners who recently bought properties with financing assumptions based on the old system. If taken by itself, this reform would not address the incentive for excessive mortgages while simultaneously saving in tax-favored vehicles such as pension funds or Box 3 (for investors expecting high returns).
- Another reform option is to shift housing to Box 3. This would automatically increase imputed rents (assuming the same return applies as on other assets) and thereby notionally incorporate the reform option above. Additionally, this would remove the incentive to go into mortgage debt while investing in financial assets (although it would remain for savings in pension funds, which are, however, limited as noted).
- If combined with a broader reform of Box 3 that moved to taxing actual rather than notional returns, this would also allow achieving more equitable taxation across different housing markets and more generally different assets. As noted above, taxing capital gains is important in such a reform. While taxing them on accrual is particularly sensitive for owner-occupied housing, at least they should apply on realization (including in case of bequests and gifts).⁴³ While this would mean some lock-in effect and remaining undertaxation of housing, the tax preference for housing would be much reduced compared to the current system.
- Finally, if taxing imputed rents at a realistic level is considered politically too difficult, another option would be to follow the practice in most countries and exempt them. In turn, it would then be important also to disallow any deductions of costs related to home ownership, including most importantly mortgage interest.

⁴³ To address liquidity concerns in case of bequests or gifts, provisions could be added to allow gradual payment over time.

D. Debt Bias

68. Debt bias a common feature of tax systems around the world, but might be more severe in the Netherlands, given the full double taxation of dividends. The general debt bias is caused by the asymmetry of allowing deduction of interest, but not dividends from the corporate tax base. In most countries this asymmetry at the corporate level is mitigated at the personal level through lower taxation of dividends than interest in the income tax. 62 percent of OECD countries have some mechanism in place to mitigate, or in some cases eliminate, the double taxation of dividends, either by granting a credit for CIT paid or by applying a lower tax rate on dividends. Such approaches mitigate the debt bias, although they do not completely eliminate it, either because the integration is partial or because for many firms the marginal shareholder will not pay such individual-level taxes, for example, because it is a tax-exempt shareholder (such as pension funds) or a foreign investor (subject to a lower or zero WHT).

69. Additional distortions arise from the different taxation across assets. As noted with regards to owner-occupied housing, it is very attractive to have mortgage interest deductibility at a relatively high rate compared to the rate applicable to (high-yielding) financial assets or assets held in a business. Similarly, an owner of two Box 2 businesses, one of which paying CIT at the higher and one at the lower rate, would have an incentive to maintain high debt in the former and accumulates assets in the latter.

70. Effective tax rates confirm the presence of a debt bias. As shown in Table 6, in the case of a corporation whose marginal shareholder is a tax-exempt entity (such as a pension fund or a foreign investor benefiting from a zero-WHT), there is a strong debt preference over all types of equity. For an owner-run Box 2 firm, there is a strong debt preference compared to new equity, but retained earnings are the tax-preferred source of finance.⁴⁴

71. The very high private debt levels in the Netherlands suggest that debt bias is indeed a concern. Figure 10 shows that private debt as a share of GDP exceeds by far the averages of other advanced economies. Debt bias leads to efficiency costs by distorting risk behavior and investment decisions and intensifies macroeconomic vulnerabilities, for example it increases the probability and length of macroeconomic and financial crises (Bernanke and Campbell 1988, Bianchi 2011).

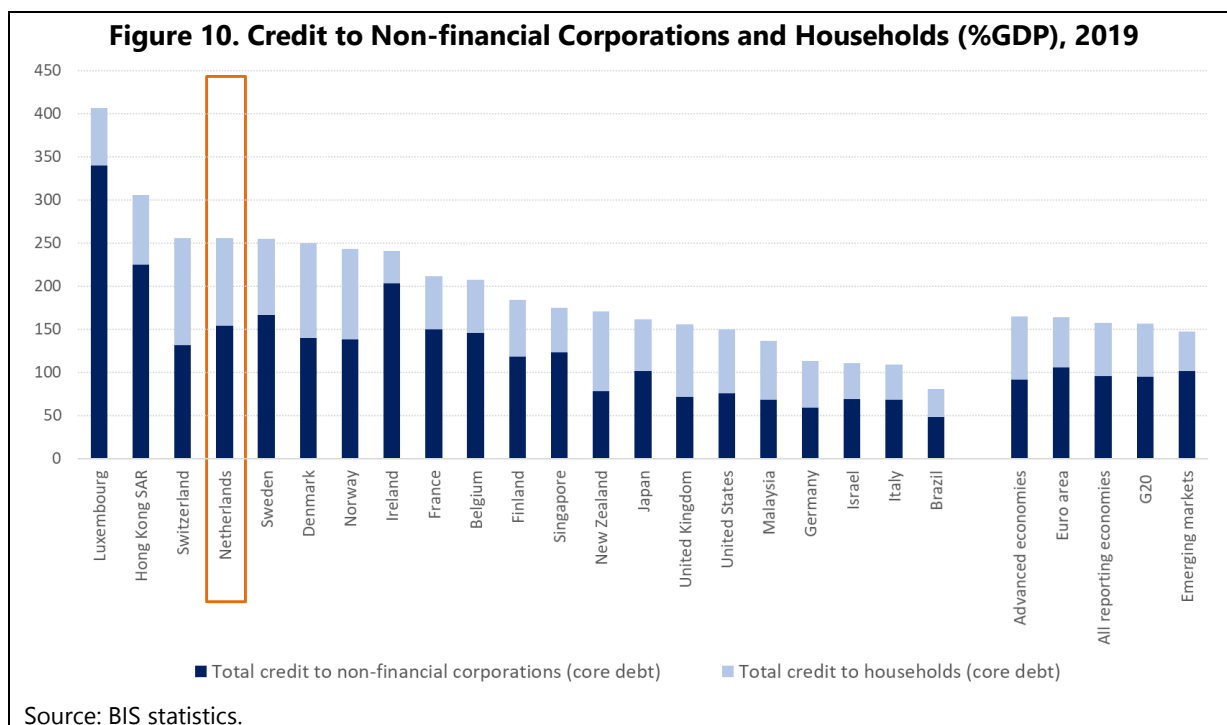
⁴⁴ Calculation of effective tax rates in that case is not straightforward: in the Devereux and Griffith (2003) framework, personal taxes affect the investor's discount rate, because the alternative investment option is assumed to pay interest. The difficulty in the Netherlands is that the alternative investment for the owner could be in Box 3, in which case the tax rate on interest is unknown, as the asset, not the return is taxed, and the rate depends on the total Box 3 wealth of the investor. For simplicity, the calculations present here use a tax rate of 26.9 percent (as in Box 2), but the alternative investment could face very different rates.

Table 6. Effective Tax Rates			
		EMTR	EATR
Tax-exempt marginal shareholder	Retained earnings	30.3	26.1
	New equity	30.3	26.1
	Debt	-11.1	20.1
Box 2, 25% CIT rate	Retained earnings	-38.5	24.3
	New equity	62.9	44.4
	Debt	-5.4	26.6
Box 2, 15% CIT rate	Retained earnings	-15.0	32.8
	New equity	67.5	52.6
	Debt	-9.8	33.1

Note: The marginal effective tax rate (EMTR) measures the extent to which taxation increases the pre-tax rate of return required by investors to break even. The average effective tax rate (EATR) is the ratio of the pre-tax NPV of the investment minus its post-tax NPV divided by the NPV of income net of variable costs and economic depreciation. See Devereux and Griffith (2003) for details.

Assumptions: Inflation: 2%, real interest: 3%, true and tax depreciation: 12.25%, profit (EATR): 20%.

Source: IMF staff calculation.



72. Various personal income tax level reforms could be implemented to reduce the debt bias. A very simple reform would be the reduction of income tax on dividends compared to taxes on interest. Such reform would, however, not help with firms whose shares are taxed under Box 3, unless that Box converts to taxation of actual returns (which is in any case advisable as noted above). As also noted above, reforms to the housing sector would reduce incentives for excessive mortgage taking.

73. At the corporate level, debt bias could also be reduced through an allowance for corporate equity (ACE). An ACE allows a deduction for a notional return on equity, too, thereby reducing the advantage for debt (IMF 2016b). An allowance for corporate capital (ACC) goes a step further and applies a notional return to both debt and equity, while disallowing deduction of interest, thereby achieving equal treatment. Such ACE and ACC systems have favorable properties, notably they are efficient, as investment is not discouraged, and they are robust to various bookkeeping choices, such as depreciation methods. Nevertheless, it might be best to not to rush the introduction of an ACE, because (i) other aspects of capital income taxation require more urgent reforms, (ii) some of the international reform developments might affect its impact. Notably, if minimum taxes are adopted, this could make introduction of an ACE easier or more difficult: minimum taxes would reduce pressure on lowering tax rates, thereby allowing a narrower tax base, but depending on implementation, the ACE could be treated as a tax benefit (counter to economic rationale), thereby triggering the imposition of minimum taxes by other countries, which would undo its favorable effects. Finally, if Europe adopts a CCCTB, the ACE might come in any case, as it is part of the current proposal.⁴⁵

74. Finally, interest limitations also reduce the debt bias. While implemented with a view to reducing scope for tax avoidance, a side effect of interest limitation rules is that additional debt beyond the amount at which interest can be expected to be deductible is not tax favored anymore. Such rules should not be tightened too much though, because they will have efficiency costs. The EBITDA rule, for example, will not only bite in firms with high debt levels, but also in those encountering difficult times and consequently low profits. Where it is binding, the rule increases the cost of capital, with negative consequences for investment, compared to the ACE.

E. Conclusions on Capital Income Taxation

75. Tax reform does not start from a clean slate and hence moving to an optimally designed system is difficult. Nevertheless, if the overall target of reform is known, a strategy can be developed to move in the desired direction.

76. If comprehensive income taxation is the target, then ultimately it will be necessary to abolish boxes 1-3 and aggregate income at the individual level. To be able to aggregate income correctly, this would include defining realistic imputed rents for owner-occupied housing. For dividends this would require some way of integrating corporate and personal level taxes. Tax preferences for pension funds could be retained to allow efficient choices regarding saving over the lifecycle (within reasonable limits).

77. If dual income taxation is the target, then there would still be a need for different boxes, although with fewer schedules than now. Ultimately such system would converge to one box for labor income and one for capital income. Regarding mixed income, rules would be needed to split it into the two boxes.

⁴⁵ Note that implementing an ACE requires an appropriate set of anti-tax avoidance measures (IMF 2016b).

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