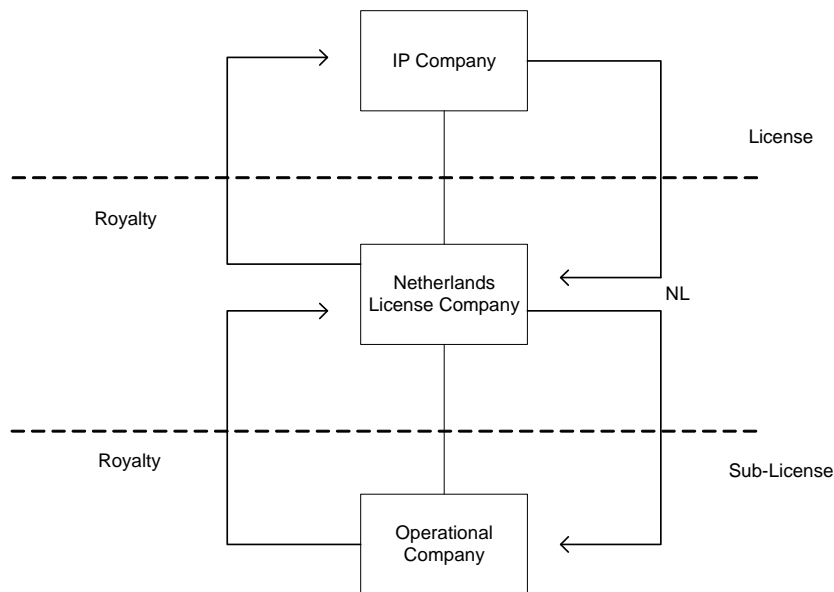


## CLIENT MEMORANDUM - NETHERLANDS LICENSE COMPANIES

License companies are treated favourably in the Netherlands. In fact, it can be argued that the Netherlands is the world's best jurisdiction to establish license companies. By virtue of the Netherlands' extensive network of over 90 tax treaties, it is possible to channel royalty payments through a Netherlands license company from one country to another at reduced or even abolished withholding tax rates. At the same time, when properly structured any income of the Netherlands license company will not effectively be subject to Netherlands corporate income tax. Add to these features the possibility to obtain certainty in advance from the Netherlands tax authorities and the benefits of a Netherlands license company become fully apparent. Below is a graphic outline of a typical royalty structure including a Netherlands license company.



The most significant benefits of the royalty structure depicted above are the following:

- The royalties payable by the Operational Company to the Netherlands License Company are not subject to withholding tax by virtue of the tax treaty between the country where the Operational Company is established and the Netherlands and/or the EU Interest & Royalty Directive. Alternatively, the withholding tax rate is substantially reduced.
- The Netherlands License Company is in principle fully subject to Netherlands corporate income tax over the royalties received from the Operational Company. However, the Netherlands License Company must on pay these royalties to the IP Company. In effect, the Netherlands License Company is only liable to

Netherlands corporate income tax on the at arm's length difference between the royalties received and the royalties payable. In case the source country has withheld royalty withholding tax, the Netherlands License Company should be entitled to a credit for the underlying foreign withholding tax.

- The Netherlands does not levy royalty withholding tax. Hence, the royalties on paid by the Netherlands License Company to the IP Company are not subject to withholding tax.
- At the level of the IP Company, the royalties received are taxable at the domestic corporate income tax rate.

Pursuant to the above example, the use of a Netherlands license company appears extremely tax efficient. Following international developments however, source countries have become increasingly reluctant to give up their withholding tax rights. This is notably the case when royalty payments are made to license companies not being considered the beneficial owners of the royalties and when general anti-avoidance rules apply. In reaction, the Netherlands has adopted certain substance and risk requirements which Netherlands license companies should meet to ensure full entitlement to all the tax benefits described in the above example. These requirements have been laid down in Netherlands corporate income tax legislation as well as policy decrees issued by the Netherlands State Secretary of Finance. Below we will elaborate on the requirements in more detail.

### **Substance requirements**

In order to be eligible for the benefits of the tax treaties concluded by the Netherlands, license companies must meet certain requirements with regard to their actual presence in the Netherlands. One of these requirements is that at least half of the directors with decision-making power must be Netherlands residents. Other notable requirements are that the board meetings must be held in the Netherlands, the major board decisions must be taken in the Netherlands and the legal and tax books as well as the bank account should be held in the Netherlands. Furthermore, the license company should bear sufficient risk as discussed below.

### **Risk requirements**

For Netherlands corporate income tax purposes, a license company is deemed to bear *sufficient risk* in case the following cumulative conditions are met: the equity of the license company is at least equal to the lower of (i) 50% of the annual royalty flow and (ii) EUR 2 million; and this equity (i) is available to cover the risk (notably debtors' and market risk) borne by the company and (ii) will actually be affected in case this risk materialises. Obviously, the proper drafting of the royalty agreements is of paramount interest in order to meet these requirements.

Royalties payable to, and royalties receivable from, group companies in connection with back-to-back agreements are disregarded for Netherlands corporate income tax purposes to the extent that the license company effectively does not bear sufficient risk in respect of these royalties. In case the license company is not considered to bear sufficient risk, it is only subject to corporate income tax in respect of the (arm's length) remuneration that should be attributed to the license company for its services. The absence of sufficient risk is generally disadvantageous for a license company however; notably because the license company then cannot credit foreign withholding tax or obtain certainty in advance (as discussed below).

### **Transfer prices and arm's length remuneration**

Any Netherlands license company must receive an at arm's length remuneration that is commensurate with its functions performed and risks assumed. In this framework, the Netherlands State Secretary of Finance has provided guidance on how to establish correct transfer prices for Netherlands license companies. For license companies, a transfer pricing model is in use which consists of two components:

- A remuneration for the equity of the license company which is at risk. This remuneration must be determined by benchmarking an at arm's length rate of return on the equity at risk.
- A tailor-made remuneration for the functions performed by the license company; the so-called handling fee.

In addition, the tax authorities have provided further guidance with regard to "smaller" license companies. When the total aggregate annual royalty flow of the license company is less than EUR 8 million, the tailor-made "handling fee" described above may be replaced by a cost-plus analysis, resulting in a mark-up on the company's operating expenses. Just as for "bigger" license companies with total aggregate annual royalty flow exceeding EUR 8 million, the remuneration for the equity at risk of smaller license companies consists of a benchmarked rate of return on same equity.

### **Credit for foreign withholding tax**

When the license company bears sufficient risk according to the criteria set out above, the license company may credit foreign withholding tax on the royalty payments received against the Netherlands corporate income tax due on the at arm's length profit calculated pursuant to the transfer pricing rules outlined above. As a consequence of this credit, in most cases effectively no Netherlands corporate income tax will be due at all by the Netherlands license company.

### **Advance Pricing Agreements and related benefits**

Through an Advance Pricing Agreement (“**APA**”), the license company has the opportunity to obtain advance certainty from the Netherlands tax authorities with regard to the arm’s lengthness of notably the return on equity and the handling fee as described above. In addition, a license company which has obtained an APA is assured that upon its request it will be able to obtain a tax residency certificate. Such residency certificate may be requested by the tax authorities in the source country, in order to grant the reduced treaty withholding tax rate.

### **In-house royalty companies**

As an alternative for client-owned license companies, many corporate service providers offer in-house license companies. When an in-house license company is used, the licensing and sub-licensing is structured through this in-house license company, where the in-house license company operates as the conduit entity. The use of an in-house license company may have several advantages. Notably, there are no expenses for the set up and maintenance of the client’s own license company. In addition, an in-house license company may provide increased substance while the “spread” between the royalties received and (on) paid by definition meets the at arm’s length requirement. On the other hand, because of the compensation requested by the corporate service provider for the use of the in-house license company, in case of larger royalty flows using an in-house license company may be less cost-efficient than a client-owned company.

### **How we can assist you**

We have extensive experience with Netherlands license companies. Pursuant to this experience, we can assist you with all aspects relating to Netherlands license companies, including the incorporation of the license company, the determination of the at arm’s length profit, the drafting of tax-efficient license agreements and the filing of the APA request and tax compliance. In addition, if desired we are also able to refer you to a corporate service provider offering an in-house license company.

For more information or advice please contact Cees-Frans Greeven (greeven@bvvg.nl) or Peter Wurzer (wurzer@bvvg.nl)

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without further advice*