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Partitioning Doctrine Inapplicable in Case of Law Change, Court Says

by Anton Louwinger

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COUNTRY DIGEST

Partitioning Doctrine Inapplicable in Case of Law Change, Court Says

The Netherlands Supreme Court held on June 14 (Case 11/04538) that the partitioning doctrine for splitting benefits under the participation exemption into taxable and nontaxable periods doesn't apply if the conditions for the participation exemption weren't met because of a change in law.

Under the Dutch participation exemption, corporate taxpayers are exempted from Dutch corporate income tax on benefits (such as dividends, capital gains, and liquidation profits) derived from qualifying shareholdings. Capital losses are nondeductible unless they result from a subsidiary's liquidation, and even then, strict conditions must be met.

Several conditions must also be met for shares to fall within the scope of the participation exemption. That raises the question of how benefits are to be taxed if they can be allocated to periods during which the conditions were met as well as periods during which the conditions weren't met.

In its July 2, 1986, decision (Case 23,444), the Supreme Court held that if the conditions are not met without interruption, a benefit must be split into an exempt part that can be allocated to the period during which the conditions were met and a taxable part attributable to the period during which the conditions weren't all met. This apportionment process is referred to as the partitioning doctrine.

Up to now, the partitioning doctrine has been applied only to capital gains and liquidation profits, but not to regular dividends. Given the principle underlying the doctrine, it would be fair if it also applied to regular dividends, although that would raise the question of how to determine whether a dividend is paid out of qualifying or nonqualifying profit reserves (last-in, first out and first-in, first-out, and so on). The issue of whether and how the partitioning doctrine will be applied to regular dividends will remain unclear until it is litigated before the tax courts.

Court's Decision

The Court's June 14 decision addressed cases in which the partitioning doctrine applied and the conditions for the participation exemption weren't met without interruption because of a change in facts at either the level of the shareholder or that of the subsidiary.

The Court decided that the doctrine doesn't apply if the conditions are not met because of a change in law. If the conditions for the participation exemption are changed and there are no transitional rules, the change has immediate effect like any other change in law, the Court said. That means that if a benefit is derived from shares that, before the change of law, didn't qualify, the entire benefit is exempt if, at the time of realization, it meets all of the changed conditions.

The Supreme Court found it irrelevant that during the parliamentary discussions about the new participation exemption rules at stake in the case at issue, the parliament had deemed it unnecessary to introduce transitional rules in view of the presumed application of the partitioning doctrine — a presumption that turned out to be wrong.

In response to the Supreme Court decision, the Ministry of Finance on June 14 issued a press release in which it announced that State Secretary of Finance Frans Weekers would soon present a draft law to the Council of Ministers containing a general set of transitional rules that would apply in case of law changes that affect the participation exemption. Those rules would have retroactive effect from June 14.

Possible Transitional Rules

If there is a change in the eligibility of certain shares for the purpose of the participation exemption (qualifying or nonqualifying), those shares would have to be revalued to the fair market value effective at the time of the change in eligibility. For example, if shares that previously didn't qualify start qualifying as a result of a change in law, they would have to be stated at the then-prevailing FMV in the shareholder's Dutch tax accounts. However, the taxation of this fixed deemed gain would be postponed until the shares are alienated. According to the press release, this new system would also apply to dividends. The details of the new rules will not be clear until the proposal is sent to the parliament. ◆

♦ *Anton Louwinger, tax lawyer, Hogan Lovells International LLP, Amsterdam*