

Private Equity.*

A guide to Dutch tax aspects
during the deal continuum

Edited by Oscar Kinders

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Contact persons in the Netherlands

Peter van Mierlo, Managing Partner Transactions Group

E-mail: Peter.van.Mierlo@nl.pwc.com

Telephone: +31 (0)10 407 66 60

Oscar Kinders, Partner M&A Tax

E-mail: Oscar.Kinders@nl.pwc.com

Telephone: +31 (0)10 407 53 48

Ad van Gils, Partner Transaction Services

E-mail: Ad.van.Gils@nl.pwc.com

Telephone: +31 (0)10 407 64 42

Andries Mak van Waay, Partner Corporate Finance

E-mail: Andries.Mak.van.Waay@nl.pwc.com

Telephone: +31 (0)20 568 65 09

Wim Holterman, Partner Valuation & Strategy

E-mail: Wim.Holterman@nl.pwc.com

Telephone : +31 (0)20 568 52 12

Andrew Kruseman Aretz, Partner Human Resource Services

E-mail: Andrew.Kruseman.Aretz@nl.pwc.com

Telephone: +31 (0)20 568 62 51

Alexander Spek, Partner Capital Markets Group

E-mail: Alexander.Spek@nl.pwc.com

Telephone: +31 (0)20 568 43 20



Foreword

The capital invested by private equity firms in Dutch companies is a factor of major socio-economic significance. The combined turnover of the Dutch companies wholly or partially controlled by private equity firms has increased substantially. In the last couple of years record numbers of large funds have been created, fund sizes have hit record levels and the velocity of investments in mega-funds has accelerated.

Private equity firms still have abundant capital that needs to be put to work in the coming years. They are therefore likely to continue to be major players in the global deal arena. In other words, private equity is here to stay.

The tax implications are sometimes underestimated during the various stages of a private equity deal. This book describes the tax aspects that may be encountered during the different stages of a deal in the Netherlands. Each chapter of this book covers a different stage in the deal and describes the relevant Dutch tax aspects. The book is a valuable resource for anyone who is confronted with the tax aspects of a deal in the Netherlands.

Gerrit Zalm
Former Dutch Minister of Finance



1. Introduction

1. 2007 was a special year for the (Dutch) M&A industry

Almost every industry is experiencing merger and acquisition activity at the moment. And 2007 will retain a special place when the story of how mergers and acquisitions reshaped the economy is told in years to come. By the end of the first quarter of this century, the world will have come to understand the impact of technological and political developments that are causing the global marketplace to shrink ever further. The M&A market will have become even more professional. Private equity will come to be seen as a logical alternative to the stock exchange or family-owned structures. And people will understand that it makes sense to refocus a company for a three to seven year period from time to time.

By 2025, a more professional method for diversifying risks in the financial lending market will have been developed and the credit crunch will be just a distant memory. Rating agencies will be less powerful in the lending business and their methods of rating certain assets will have improved. Corporate governance around mergers and acquisitions and around private equity will have evolved. M&A processes will have become more transparent. Management and shareholders will have a better understanding of their individual roles in a transaction and society in general will have a better understanding of what each party ought and ought not to do.

There are a number of specific factors that explain why this year might be viewed as a turning point in M&A history:

- the decision by some larger private equity houses to go public in the first half of the year;
- the credit crunch;
- the public debate about private equity;
- the large number of major private equity deals in the first half of this year (Hema, Norit, Wolter Kluwer Educatie, SDU and Philips Semiconductors);
- the number of large corporate deals in the second half of this year (ABN AMRO, Organon, Getronics, Numico, NBIC and Grolsch).

Spurred by the credit crunch, but also by the trend of globalisation and technological advances, corporates have few options but to play the game of catch or be caught. Prices for corporates are expected to come down, partly due to the decline in the debt multiples that banks are willing to offer for M&A financing. Synergies will once more become a decisive factor for success in the M&A game. Corporates are coming to understand the private equity game better and are becoming a worthier opponent in auctions and other sale processes. Slowly but surely a level playing field for corporates and private equity will emerge.

2. Drivers of M&A activity

The world is getting smaller and a lot of companies are struggling to keep up with the pace of change. Your competitor is seldom from your own country anymore. Nor are your clients. The demographics in the western world are having an impact on the strategy of companies in many industries, as are technological developments. Although markets are expanding, the room for

alternative strategies is contracting. A position in the top three in its own market seems to be essential for a company to be able to capture the market potential. Although M&A activity will always be opportunistic to some extent, one cannot deny the impact of these factors within the bigger picture.

Although private equity is the new kid on the block in terms of corporate ownership structures, it has gained enormously in significance in the last five years in the Netherlands. Private equity's game plan has often been to buy a business that is being privatised or a business unit that no longer fits into the core strategy of a larger corporate entity. Taking a positive view, one could describe private equity as the elegant knight saving these businesses from their former owners. A less positive view might see private equity as an opportunist, an investor that spots an opportunity and grabs it, making a lot of money along the way.

Either way, private equity serves its purpose in terms of reshaping our economy and bringing focus to the vision and mission statements of these businesses. At the same time, private equity creates a certain pull in the transaction world which has an impact on the push resulting from the strategic reorientation of corporates as the world changes.

3. Room for improvement within the M&A industry

As already mentioned, corporate governance around transactions should improve in the coming years since the relevance of transactions for society in general will remain high.

As far as the process is concerned, we feel that management's role during a Management Buyout needs to be clarified further and the rules relating to delistings in general could be further developed. Agency costs have become more transparent in a private equity market and accepted procedures will have to be formulated for dealing with these costs. In our opinion, there is also room for improvement in the procedures relating to market due diligence, tax due diligence and the structuring of a transaction. The monitoring of a deal could also improve with better insight into accounting and its impact on earnings and tighter control of the execution of the acquisition plan.

4. Tax aspects and private equity

As regards the tax aspects relating to private equity it should be noted that the tax environment for Dutch private equity practitioners has changed substantially in recent years. The aim of this private equity tax guide is to provide some clarity about the current situation. The guide contains an overview of the various features of private equity transactions, starting with a general overview of the entire deal process (Chapter 2). The guide then describes several key elements of a deal, including the due diligence process (Chapter 3), the typical fund models used in practice (Chapter 4), the different methods of arranging management participation (Chapter 7), the broad terms of share purchase agreements (Chapter 8) and the tax treatment of transaction costs (Chapter 9).

The success of private equity is often attributed to the leveraged financing of the transaction and the associated financial engineering – restructuring of a company’s balance sheet and the assumption of high levels of debt without transforming the underlying commercial reality of the business. Tax plays a key role in the financial engineering. An essential factor in structuring a private equity deal tax efficiently (see Chapter 5 on the tax structuring of the transaction) is to ensure that the interest costs can be set off against the operating income so that the tax shield can be utilised (see Chapter 6 on transaction financing). Chapter 10 describes the post-deal process. Finally, in Chapter 11 there is an overview of the professional services needed for each element of the deal.

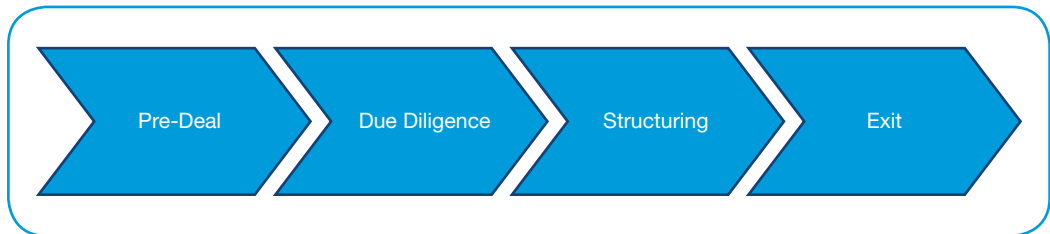




2. Deal Process

1. Introduction

The focus of a deal is, besides initiating and closing it, also on securing the envisaged return. The different stages of a deal process can generally be depicted as follows:



The most significant differences between deals in the private equity arena and the traditional strategic deal-making environment are:

- (1) by contrast with most traditional strategic deals, a foreseen and planned exit is inherent to a private equity deal; and
- (2) in a private equity deal there are a number of different stakeholders, all with different roles.

Obviously, these differences will have an impact on the deal process, for example in terms of the harvesting of deals and the dynamics between the various stakeholders (sponsor, management, banks etc.).

2. Pre-deal

The fierce competition that currently exists in the deal market means that deals have to be turned around quickly. In other words, there are time pressures throughout the deal process, from due diligence (see Chapter 3) through negotiation, financing and structuring the transaction (see Chapters 5 and 6) to the ultimate exit. The pricing of a transaction is of course a critical element, but the overall terms and conditions of a (binding) bid may perhaps be even more important.

To maximise the efficiency and transparency of a deal process and to retain control of the process – in particular the investigation of the target by the potential acquirers – the seller can, for instance, consider performing a vendor assistance or vendor due diligence to enhance the transparency of the risks and opportunities associated with the target. This benefits not only the seller, by allowing it to exercise greater control of the process and reducing the risk of disruptions during the process, but typically also the potential acquirer by addressing relevant issues that will allow the potential acquirer to limit the warranties and indemnities which are typically broadly defined in a sale and purchase agreement (see in more detail Chapter 8).

3. Due Diligence

A potential acquirer is offered the opportunity to perform a due diligence to assess and validate the assumptions underlying the proposed deal. In today's highly competitive environment most transactions are conducted by auction. An auction is initiated by issuing an offering or information memorandum to potential acquirers. The memorandum, written by the seller's corporate finance advisers to solicit interest from potential acquirers, provides an overview of the company. Potential acquirers are invited to tender a bid for the target. In Europe, including the Netherlands, it has become common practice for the offering memorandum to be supplemented with a so-called vendor due diligence report. A vendor due diligence report provides an objective and independent description of the financial, commercial and tax position of the target (see Chapter 3 for a detailed description). Especially in an auction process, a due diligence performed by the seller will facilitate a smooth, controlled and more seamless disclosure of the target's value drivers. Accordingly, it provides added value for all the parties involved in the deal and make it possible to consummate a deal sooner.

One effect of the inevitable exit strategy of a private equity fund is the emergence of a secondary buyout market, where one private equity fund sells its portfolio investment to another private equity fund. A private equity fund is not normally willing to provide extensive warranties and indemnities for a buyer or to include any post-deal pricing adjustment mechanisms ('lock box'). By addressing and settling any of the exposures and risks that were identified in an initial buyout a private equity fund can take price improvement actions. This will limit the need for lengthy negotiations over requests for extensive and broadly defined warranties and indemnities in a future secondary buyout. In other words, the deal process continues even after the closure of a transaction, not only with respect to exploiting and monetising the identified opportunities but also – and perhaps even more importantly – with a view to mitigating any of the identified exposures and risks (see Chapter 10 for a more detailed discussion of this aspect).

4. Structuring

The structure of a transaction is obviously of great importance for combining the respective interests of the various stakeholders. Most buyouts include an incentive for the management. Incentive schemes can take various forms, but generally include the possibility for management to co-invest alongside the private equity fund. This may be created by making use of different equity and equity-like instruments, e.g. common stock, preferred stock, shareholder loans (see in more detail Chapter 7).

The debt market plays an important role in private equity transactions since leveraging a transaction is one of the value drivers for private equity because private equity deals are driven by cash and free cash flow. The debt leverage capacity is typically determined by the security available to the target business and its expected cash flows (ability to pay interest and repay debt instruments). Given the debt provider's position in the 'pecking order', extensive documentation is required and agreements have to be made on issues such as covenants and pay-out policy

on dividends to equity providers. The pecking order also influences the acquisition structure. Besides the acquiring company, one typically encounters various holding and intermediate holding companies to create so-called structural subordination. This provides additional security for the debt providers (see Chapter 6 for more details).

Particularly in the last couple of years the fluid debt market has boosted the influence of private equity in the Dutch and global transactions market. However, with the shorter lifecycles of financially-engineered structures such as refinancing and leveraged recapitalisations (a leveraged recapitalisation can best be described as a partial exit strategy whereby an amount of cash is released to be withdrawn by the equity providers) more emphasis is placed on tax-efficient cash repatriation and financing strategies since cash may be transferred to the equity providers by way of either a dividend distribution or capital gain during the lifecycle of a portfolio investment. As also emphasised with the backlog in the debt market in 2007, the financing, capital and tax structure is a concern for some private equity funds. The financing, capital and tax structure aims amongst others to facilitate and enhance any cash flows within private equity fund structures. A deal process should thus take into account and focus on the effects and efficiencies of the proposed financing and capital structure to allow for full flexibility for the portfolio investment, the lender group as well as the private equity fund.

The banks and their investment committee are another important stakeholder in the deal process. They largely dictate the financing and acquisition structure with a view to safeguarding their position as debt provider. The terms and conditions of the facilities agreement and debt covenants (e.g. leverage ratio, interest cover ratio etc.) are thus an important element when designing an efficient acquisition and financing structure (see Chapter 5 for more details). The deal process should address the ability of the direct and indirect borrowers to efficiently service any financing and repayment costs out of their operating cash. In the 2007 backlog on the debt market the level of comfort required by the banks increased, not only in terms of historic risks but also – and perhaps more importantly – in terms of securing the debt servicing/cash repatriation capacity of the newly established target group. It can typically be assumed that an optimal financial structure aims to match interest costs on the debt facilities drawn down (in addition to the debt which is to be refinanced) with the territory target's profits. This aspect will surface during the deal process when discussing and analysing the debt covenants in the facilities agreement with the debt providers. A cash flow and tax model will capture and support the proposed financing, including debt covenants, and capital structure.

5. Exit

A private equity fund will eventually exit its portfolio investment. Its return will depend on various value creation factors, such as growth in operating earnings, buy and build strategy, debt leverage, etc. This value is created from day one and will continue through to exit. The exit strategy is and should be part of the entire deal process since it is the core of the private equity business. The transaction structure should retain flexibility with respect to the exit scenario (see in more detail Chapters 5 and 6). In deciding on the structure and location of the acquisition structure

one should therefore consider likely exit routes, such as a trade sale, a secondary buy-out or an IPO. Considerations include the location of the ultimate holding or IPO vehicle, the tax costs for (ultimate) investors on disposal and legal issues relating to the remittance of disposal proceeds back to the private equity fund.

A deal process – from inception through to post-deal services (see Chapter 10 for more details) – should encompass every aspect of the deal continuum to extract the full long-term value from each deal. By approaching the deal process in a transparent, consistent and controlled manner it will be possible to negotiate more smartly, create a better structure and close the deal more quickly.



3. Due Diligence

1. Introduction

Due diligence plays an important role in a wide range of transactions, from management buyouts of a division of a public company to large-scale leveraged buyouts of large listed enterprises. Due diligence is not just about uncovering and quantifying contingent liabilities, although this is obviously an important aspect. A proper tax due diligence is a key ingredient in assessing whether to proceed with a deal, and if so how to maximise the overall return achieved.

The vast majority of deals fail to achieve targeted returns by not capturing or maximising upside benefits and by not identifying hidden liabilities and downside risks. A properly conducted tax due diligence, in conjunction with legal, commercial and financial reviews, should expose these issues and opportunities and help make the investment a success.

Tax can be a major cost item, but also a rich source of cash flow savings if managed properly. This applies especially for private equity funds. The tax due diligence should therefore focus on the impact on the cash flow of the opportunities and issues identified, since cash flow is one of the most important value drivers for private equity funds.

In the Netherlands, a proper due diligence is also necessary from a legal perspective to ensure that the agreed allocation of risks (through indemnities, representations and warranties) does not preclude any claims.

2. Legal obligations of buyers and sellers

In many non-Dutch territories (Anglo-Saxon jurisdictions, for example) great emphasis is placed on representations and warranties in determining the post-deal relationship between the buyer and the seller. In the Netherlands, however, a completely different approach is taken.

Under Dutch civil law, a seller is obliged to disclose (*inlichtingenplicht*) any information it believes or ought to believe is of material interest and relevance to the potential buyer. For example, issues that may have a substantial impact on the purchase price must be revealed. The extent of the obligation depends on the circumstances. The buyer, on the other hand, is obliged to conduct a proper, active investigation and make inquiries (*onderzoeksplicht*) about the object of the sale.

Dutch case law tends to emphasise the buyer's obligation, which increases the importance of the due diligence process or a proper vendor due diligence with reliance in M&A-related transactions.

Sellers who fail to make disclosure to a purchaser cannot rely on the argument that the buyer did not adequately meet its duty to investigate. The same applies for sellers who act in bad faith or are negligent to the extent of actual misrepresentation. Consequently, buyers may successfully claim under representations and warranties that give rise to contractual liability on the part of the seller.

However, the position of the buyer seems to be weaker in the Netherlands since the buyer's obligation (*onderzoeksplicht*) appears to weigh more heavily and the scope of warranties is restricted by the knowledge that a buyer possessed or should have possessed of facts that contradicted the warranties given by the seller. The law on this point differs substantially from the principles of common law on due diligence disclosure. Under Dutch law, a buyer who did not make proper enquiries before agreeing to the sale or had or should have had knowledge of particular issues may be barred from making claims against the seller under the warranties.

When transacting business deals in the Netherlands, the best policy from a buyer's point of view is to conduct a proper due diligence investigation and require the seller to thoroughly document material issues.

For a seller, it is imperative to investigate the existence of any circumstances that may fall within the scope of the seller's general duty to disclose material issues to the buyer.

3. Tax Due Diligence

3.1 General

In general, whether or not a complete or partial due diligence is required from a tax perspective depends on whether the transaction involves assets or shares.

In asset deals in the Netherlands, tax liabilities are generally not inherited by a buyer although a review may still be required for certain specific assets, for example the VAT treatment of real estate. In share deals, however, all of the target company's tax liabilities generally remain in the target company and are thus inherited upon a purchase of the shares. Consequently, a tax due diligence is required.

From the buyer's perspective, the quality of information available about a potential acquisition determines the ultimate success of a transaction. Without ensuring that the business's financial statements are realistic a deal may deliver less than first impressions suggest. To ensure an efficient sales process, vendors need to present their financial information to potential buyers as transparently as possible. An independent assessment provides potential buyers with certainty about the business and the nature of its cash flow.

A tax due diligence helps to identify and highlight the elements of the business that are critical for its future success.

3.2 Types of tax due diligence

The following types of tax due diligence can be distinguished:

- Buy side due diligence
- Vendor due diligence
- Vendor assistance

3.2.1 Buy side due diligence

A buy side due diligence should focus not only on assessing and validating the assumptions that underlie the deal but should also identify opportunities and potential synergies. Depending on the type of sale, whether it is by auction or a bilateral deal and the phase of the deal (exclusiveness), buyers are permitted to perform a limited or a more in-depth review. The scope of the review also depends on the availability of a vendor due diligence prepared by the seller.

3.2.2 Vendor due diligence

A vendor due diligence is basically the same as a buy side due diligence, but for indeterminate buyers. The scope and approach of such a review should therefore ideally cover all the items that different types of buyers (financial or strategic) would focus on.

Vendor due diligences have recently become quite popular. One of the reasons for this is that a vendor due diligence is beneficial for the sales process. One of the biggest advantages is that sellers know up front what the issues and/or opportunities are and can therefore act upon the findings before the start of the actual sales process. A vendor due diligence also gives the seller more control over the sales process by limiting the room to manoeuvre for buyers and thus speeds up the sales process. Another advantage is that the management of the target company is only faced with a single, in-depth due diligence process as opposed to several time-consuming due diligences performed by different potential buyers.

A vendor due diligence should provide the same comfort for potential buyers as their own due diligence since the vendor due diligence report should be fully scoped and in most cases is assigned to the buyer upon a successful transaction. Consequently, buyers can save time and expense that would otherwise be spent on their own due diligences.

3.2.3 Vendor Assistance

A vendor assistance is more or less a lighter version of the vendor due diligence. An important difference is that the report will not be assigned to the buyer and may therefore provide less comfort and fewer advantages than a vendor due diligence report. Consequently, potential buyers may seek more comfort by performing their own in-depth due diligence and would want to include broader representations and warranties and/or indemnities in the sale and purchase agreement (SPA).

4. Scope of due diligence

Several factors can influence the scope and performance of a buy side tax due diligence. For instance, the business in which the target operates can affect which taxes need to be reviewed or mean that a quick and dirty scan would be sufficient. For example, if the target is a production company with relatively large number of blue-collar employees one would not expect significant payroll tax issues given that such employees do not receive remuneration elements (e.g. fringe benefits) that are likely to yield payroll tax risks. In that case, a quick scan should be sufficient to assess whether any other payroll tax risks can be expected. VAT and customs duties are, however, important areas to review when purchasing or selling a manufacturing company.

Another factor (as described in section 2) is the legal obligations of buyers and sellers. This is particularly important in terms of the scope of the due diligence given the increasing popularity of auctions in the Dutch market in recent years (see Chapter 2). Needless to say, a full-scope tax due diligence during such an auction may be undesirable in view of the costs if the deal aborts, which is why the vendor due diligence has become more popular. On the other hand, in most cases the successful bidder is not allowed to perform a confirmatory due diligence.

5. Disclosure to the tax authorities

5.1 General

As a rule, a Dutch taxpayer is obliged to provide a tax inspector on request with all data and information that could be regarded as relevant for taxation and to disclose any books, records or other data which may be relevant for establishing the facts relevant for the levying of taxes. This obligation also extends to information held by third parties, with the exception of certain categories of persons that are exempted by law from the duty to disclose information. Failure to fulfil this obligation may have adverse implications for the burden of proof in any appeal procedure, i.e. the burden of proof may shift to the taxpayer.

Under Dutch law, attorney-client privilege applies to legal advice but this statutory privilege does not extend to tax consulting services provided by tax advisers and accountants. However, according to a guideline published by the Dutch State Secretary for Finance, a so-called informal privilege of nondisclosure of information does apply to tax advisers and accountants. This privilege is intended to provide the same degree of protection for communications between taxpayers and their tax advisers with respect to tax advice as for communications between a taxpayer and its attorney under the attorney-client privilege. In other words, the taxpayer does not have to disclose tax advice it has received or information held by a third party.

5.2 Impact on due diligence reports

Whether or not a tax due diligence report (whether buy side or vendor side) should be disclosed under the general rule depends on whether such a report falls within the scope of the so-called informal privilege of nondisclosure.

A tax due diligence report is prepared as part of the process of deciding whether, and at what price, to proceed with the purchase of a company and to ensure that the valuation of the target can be fairly ascertained, i.e. that the purchaser gets what he pays for and that the value of his shares is not unexpectedly depleted by an unforeseen tax liability or cash tax outflow, for example. One can therefore argue that given its objective a tax due diligence report can be regarded as relevant for the determination of a tax liability and as such should be disclosed to the Dutch tax authorities if requested.

Dutch case law, however, stipulates that the principle of fair play limits the extent to which the Dutch tax authorities can request disclosure of documents if those documents were prepared for the purpose of providing advice on or discussing a taxpayer's tax position. It is questionable

whether this is also true for documents, including tax due diligence reports, which contain some factual information if the objective of the document is to provide advice on or to discuss the tax position of the taxpayer. Parts of documents containing factual information will have to be disclosed on request. In light of that, it may be advisable to split the report into a factual part and a part containing the advice or to omit the non-factual parts when providing the report to the tax authorities.

If, for example, a tax due diligence report forms an integral part of a financial due diligence report it cannot be argued that the purpose of the whole document is to discuss or provide advice on the taxpayer's tax position. It follows from the case law referred to above therefore that the recommended best practice is not to include a tax due diligence report in a financial or commercial due diligence report to preclude the unintended disclosure of a tax due diligence report.

6. Focus of tax due diligence for private equity funds

The number of auctions has increased significantly in recent years. In this type of sale, particularly in deals involving private equity, it is more difficult to obtain a broad spectrum of representations, warranties and/or indemnities to cover the tax exposures (see more detailed discussion in Chapter 8). Consequently, the tax due diligence should focus on the impact of the opportunities and the issues identified on the valuation and on the cash flows.

Typical cash effects that could have an impact in terms of corporate income tax are restrictions on the deductibility interest, the application of the participation exemption under which dividends or capital gains can be received tax neutral and the possibility to carry forward losses to absorb future taxable profits (see Chapter 5 and Appendix I for further discussion of these issues). One aspect which may cause future cash effects with respect to value added tax (VAT) that needs to be considered during a tax due diligence is whether VAT rates, VAT exemptions and the reverse charge mechanism have been applied correctly. Management participation schemes are another significant matter that needs to be considered in relation to payroll taxes (see Chapter 7 for more details). Yet another aspect to be considered in a tax due diligence is whether exemptions with respect to real estate transfer tax have been claimed correctly, for example for reorganisations. In relation to customs and excise duties, the correctness of the qualification of imported goods and whether import and excise duty formalities have been observed needs to be considered. Finally, it should be noted that any penalties or interest imposed by the tax authorities in relation to additional assessments imposed could also have an impact on future cash flows. For an overview of some these Dutch taxes, see Appendix I.

7. Public to Private Transactions

It should be noted that the dynamics of a public offer are different from a regular LBO. Amongst others the possibility of a true due diligence investigation is very limited due to non-disclosure provisions under insider trading rules and no warranties and indemnities can be obtained (see also

Chapter 8). In addition, the legal process is complex and time consuming and the role of minority shareholders like hedge funds may be disruptive.

The Dutch Ministry of Finance has announced new legislation concerning public takeovers (in implementation of the EU Merger Directive). One of the measures is that a shareholder that jointly or individually owns more than 30% of the shares in a listed company is required to make an unconditional public offer for the remaining 70%. Other measures include more severe deadlines and review of the funding of such public offers.

The following aspects need to be borne in mind when pursuing a public to private transaction. Although there is no minimum requirement with respect to an acceptance hurdle for a public offer, in practice a 95% threshold is aimed for as this allows the bidder to employ a forced squeeze-out of the minority shareholders. The 95% threshold also allows the Dutch bidding entity to apply the tax consolidation regime. If this 95% threshold is not met, an alternative measure is a legal merger of the Dutch target company into Bidco (or even an asset deal), subject to legal and commercial considerations. Note that these alternatives might very well be opposed by minority shareholders.

A final point to consider with respect to public to private transactions is that the price should be set clearly and objectively. In that context, a fairness opinion will generally provide an assurance of independence.



4. Typical fund models

1. Introduction

The key taxation issues faced by private equity practitioners in relation to the structuring of private equity funds are to enhance the tax position, to create an optimal financing structure and funds flow and to enhance the efficiency and flexibility of future (partial) exits. From a tax perspective, the funds should be structured with the aim of minimising tax costs on the acquisition of the target, additional funding, the fund flows and the ultimate exit.

2. Lifetime of a private equity fund

Investments in unlisted companies are generally made for a period of five years (sometimes more, sometimes less) and the principal exit routes are through trade sale, secondary buy-out, management buy-back or an IPO. The long-term nature of the investments and the difficulties in finding buyers for investment units are such that most private equity funds are of the closed-end type, which eliminates the need for funds to sell parts of their portfolios to redeem their shares, and are incorporated for a limited period of time ranging from eight to twelve years. Given the nature of the return on a private equity investment, which is largely concentrated upon exit, the cash flow of the fund is usually negative during the first few years.

3. Location for a fund vehicle

The best jurisdiction in which to locate a fund vehicle will be dictated mainly by legal and tax considerations. From a tax perspective, the absence of dividend withholding tax (see also Chapter 5) for a tax-free exit option is one of the primary factors in securing an optimal funds flow. In this context, it should be noted that the Netherlands has a worldwide network of tax treaties, embracing all EU and OECD member states, Central and Eastern Europe and the Far East, under which double taxation is avoided. In addition, in 2006 the Netherlands introduced a policy of gradually reducing the dividend withholding tax. Besides the absence of a dividend withholding tax, also the absence of an interest and royalty withholding tax and the absence of a capital tax and stamp duty on the transfer of shares may also influence the decision on the jurisdiction in which to set up a fund vehicle. Relevant non-tax factors are the legal flexibility of the regulatory regimes and the responsiveness of the regulators and the capital market.

4. Overview of potential fund jurisdictions

As already mentioned, tax considerations are important in deciding on the best jurisdiction in which to locate a fund vehicle. In this respect, it is interesting to see that over the years several countries have introduced favourable tax regimes as well as specific legal entities that can be used as a fund vehicle. The following sections highlight the key characteristics of and differences between some fund vehicles in different jurisdictions. They are:

1. a Dutch *Commanditaire Vennootschap* (CV);

2. a Dutch Cooperative Association (Coop);
3. a *Société d'investissement à capital risque* (SICAR) in Luxembourg;
4. a Limited Partnership (LP) in Guernsey;
5. a Limited Liability Company (LLC) or Limited Liability Partnership (LLP) in Dubai;
6. a *Fondo de capital-riesgo o FCR* (VCF) or *Sociedades de capital-riesgo o SCR* (VCC) in Spain.

Before looking in detail at how a fund is typically structured in section 5, the following sections outline the key characteristics of these fund vehicles.

4.1 The traditional Dutch limited partnership fund vehicle

The traditional fund vehicle in the Netherlands is a 'Commanditaire Vennootschap' (CV). This vehicle is similar to a limited partnership, the traditional venture capital/private equity fund-raising and investment vehicle known in the US and the UK. The structure of the CV can be either tax transparent or tax non-transparent depending on the mechanics of the CV agreement. The CV can be structured as transparent to avoid having a taxable entity in the Netherlands, in which case the income of the CV is allocated to the partners for the purposes of Dutch tax.

Under Dutch private law, the limited partners in a CV, i.e. the investors, may not perform any acts of management in respect of the CV. This is to avoid endangering their status as limited partners. If they perform management activities they run the risk of being qualified as a general partner and consequently incurring unlimited liability. Because of their unlimited liability, general partners normally use a limited liability company to cap the liability.

A CV is typically structured as a tax transparent fund vehicle. As such, it is not subject to corporate income tax or dividend withholding tax. Because a CV is tax transparent, it is necessary to establish an intermediate holding/acquisition structure that allows access to double taxation treaties and the EU Parent-Subsidiary directive. Furthermore, such an intermediate holding/acquisition structure should create flexibility with respect to funding and cash repatriation from a legal, accounting and tax perspective. In this context, a Dutch BV or Cooperative is a feasible option for an on-shore holding/acquisition vehicle (see Chapter 5 for more details on the use of a Cooperative in acquisition structures).

4.2 The Dutch Cooperative Association as fund vehicle

In addition to the traditional CV, the Dutch Cooperative has also emerged in recent years as a fund vehicle in the Netherlands. Generally three types of Cooperatives should be distinguished. The differences between these three relate to the liability of the members. These three types are:

1. The Cooperative of which the members are unlimited liable;
2. The Cooperative of which the member's liability is limited;
3. The Cooperative of which the member's liability is excluded.

Unless the articles of association provide otherwise, the members are fully liable. In addition, the articles may provide for limited liability or exclude liability for the members.

Since the Cooperative, like the BV, can benefit from the Dutch participation exemption, dividend income and capital gains should be tax exempt in the Netherlands. If structured properly, profits repatriated by the Cooperative to the investors should not be subject to dividend withholding tax at the level of the Cooperative.

Provided the Cooperative contains sufficient substance in the Netherlands, the Cooperative should be entitled to the benefits of the tax treaties. The Cooperative should therefore be entitled to the lower tax rates applicable under the relevant tax treaties with respect to any withholding tax due on payments of passive income to the Cooperative from another jurisdiction. In addition, the legal form of a Dutch Cooperative is mentioned in the Annex to the EU Parent-Subsidiary Directive and it is therefore entitled to the benefits of the directive.

The Cooperative can be funded in several ways. Financing through shareholder debt or equity should generally not encounter Dutch tax issues. If US investors are attracted, it may be considered to fund the Cooperative through Preferred Equity Certificates (PEC) and Convertible Preferred Equity Certificates (CPEC). In addition, since no capital tax is levied in the Netherlands capital contributions upon incorporation as well as future capital contributions to the Cooperative do not trigger an upfront tax charge.

Normally, one would expect that the interest in the Cooperative should be assigned to the business of the investors. This means that the interest in the Cooperative is not held as a free portfolio investment but as part of the core business of the investors in the fund. The fund itself should then not be considered as a foreign taxpayer in the Netherlands (see also Chapter 6).

One point to note with regard to the general legal aspects of a Cooperative is that under Dutch corporate and civil law, the Cooperative is a separate legal entity with its own rights and obligations and the capacity to legally own assets and conclude agreements. Membership is open to any type of private equity vehicle. In other words, it is not restricted to individuals and companies and partnerships may also become members.

There are some provisions of the Dutch Civil Code concerning the terms of the articles of association of a Cooperative. In general, the Cooperative's articles can be regarded as an agreement between the members and the Cooperative so there is a lot of flexibility with respect to their content (e.g. profit allocation and repatriation).

The possibility of issuing different classes of membership rights, i.e. priority rights, preference rights and alphabet rights, makes the Dutch Cooperative a flexible vehicle.

In addition, when a Dutch Coop is used as fund vehicle, certain regulatory issues may apply. Pursuant to the Dutch Investment Institutions Supervision Act (*Wet Toezicht Beleggingsinstellingen*), under certain circumstances a licence is needed from the Dutch Financial Markets Authority (*Autoriteit Financiële Markten* or AFM). The primary focus of the AFM is, however, the supervision of investment funds that are publicly marketed. Since private equity commonly targets professional investors rather than the public at large, no licence may be required provided certain conditions are met.

4.3 Luxembourg SICAR

The form of investment company generally used by venture capital and private equity firms in Luxembourg is the SICAR. The SICAR is commonly set up in corporate form, generally as a partnership limited by shares (*Société en Commandite par Actions* or SCA), to benefit from the advantages of the tax regime applicable to that type of entity. The general partner owns and operates the business and assumes liability for the partnership, while the limited partners serve solely as investors. In a SCA different classes of shares are used to differentiate the interests held by the general and limited partners and to structure their entitlement to different distribution rights.

The SICAR is subject to regulation by Luxembourg's financial sector regulator, the *Commission de Surveillance du Secteur Financier* (CSSF). Among the requirements are that it must be audited annually and certain regulatory restrictions may apply to its investments. The SICAR must appoint a custodian bank which must be a Luxembourg-based credit institution and the law provides for ongoing light supervision by the CSSF during the life of the SICAR. The subscribed share capital of the SICAR may not be less than EUR 1 million, it must be fully subscribed and a minimum of 5% must be paid up. The SICAR is subject to a *de minimis* capital duty on equity subscriptions (once-off levy of approximately EUR 1,250).

The main tax advantage of the SICAR is that, under certain conditions, the risk capital income of a SICAR is exempt from tax. The remainder of the income is taxed at approximately 30%. Additional tax advantages are the absence of dividend withholding tax and (theoretically) access to Luxembourg tax treaties with respect to income received from jurisdictions where the targets are located. However, it should be noted that in practice other jurisdictions may question whether the SICAR is entitled to tax treaty benefits (reduction of withholding tax, etc). General and limited partners resident outside Luxembourg should generally not be subject to tax on dividends and capital gains as non-residents of Luxembourg. It should also be noted that, like in other jurisdictions, substance requirements should be monitored. Very briefly, this requirement means that the SCA must be managed and controlled from Luxembourg. This involves that the directors of the general partner vehicle have to travel on a regular basis to Luxembourg and that Luxembourg-based directors have to be appointed to the board of the general partner who are genuinely able to scrutinise and potentially reject recommendations made by any advisory companies (see in more detail section 5.1).

4.4 Guernsey/Jersey LP

In Guernsey and Jersey a limited partnership is commonly used as a fund vehicle. In both jurisdictions this vehicle is similar to a UK limited partnership. An investment fund structured via a Guernsey limited partnership is transparent for Guernsey/Jersey tax purposes and from a Guernsey/Jersey tax perspective the profits of the partnership are allocated to the partners. The situation may however be different from the perspective of the jurisdictions where the investors are resident. Since the tax treatment of the investors depends, among other things, on the treatment of their interest in the Guernsey/Jersey partnership in their resident jurisdiction, this is one of the considerations for the investors concerned.

The limited partners, i.e. the investors, must not perform any acts of management in the partnership if they wish to preserve their status as limited partners. If they perform management tasks they run the risk of being qualified as a general partner and consequently assuming unlimited liability. Because of their unlimited liability, general partners commonly use a limited company to cap their liability.

If an investment fund established in Guernsey is structured with a general partner through a corporate vehicle on Guernsey, the latter vehicle may qualify for Exempt Company status and therefore be exempt from Guernsey income tax. To qualify for Exempt Company status, the beneficial owners of the company must be non-Guernsey residents. The shareholders should therefore not be resident in Guernsey. Distributions made from an Exempt Company are not subject to withholding tax.

4.5 Dubai fund LLC/LLP

In Dubai, the fund entity could take the form of a partnership vehicle, such as the Limited Liability Partnership (LLP), or a corporate vehicle, such as the Limited Liability Company (LLC). As a partnership vehicle the LLP may offer greater flexibility with respect to fund distributions than the corporate LLC. At the fund level, the interests of the investors can be separated using different classes of shares or units. Regulatory issues may require the management company to be situated in Dubai.

The fund vehicle should be established in the Dubai International Finance Centre (DIFC) in the United Arab Emirates (UAE), primarily because it will then be able to avail of the UAE's double tax treaty network. However, it should be noted that in practice it is questionable whether other jurisdictions will respect the tax-exempt fund vehicle's entitlement to tax treaty benefits (reduction of withholding tax, etc).

The DIFC is a Dubai government-sponsored free zone that was specifically established in 2004 to operate as an independent capital market. It is not subject to the ordinary commercial rules and regulations applying to entities registered in the UAE. LLCs and LLPs established in one of the designated free zones in Dubai, as well as the management company, should generally not be subject to corporate tax and dividend withholding tax. These free zones provide for tax holidays to attract business to Dubai. In the free zone, there are no rules prescribing that any of the investors must be local so all the investors may be resident outside Dubai. If the fund vehicle is established in such a free zone it should not be subject to either corporate tax or capital duty and the foreign investors, whether corporate or individual, should also not be subject to tax.

4.6 Spanish ECR

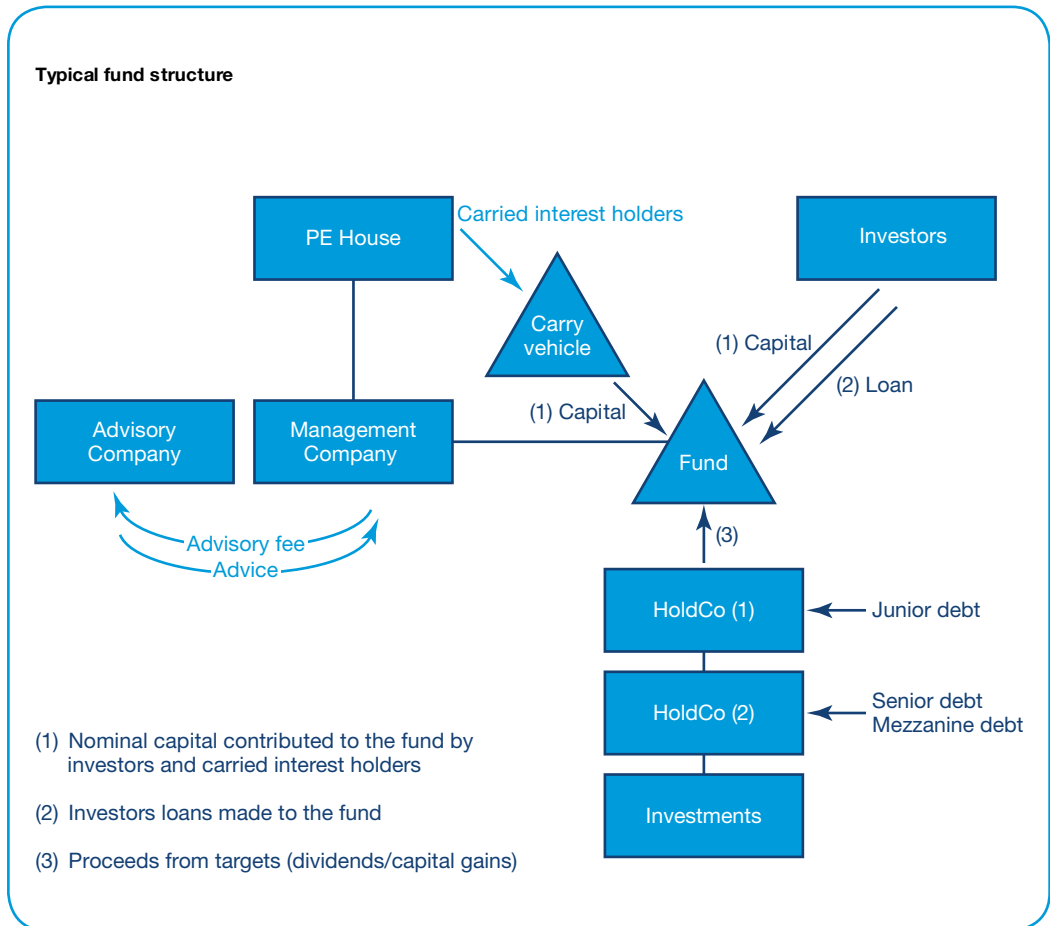
Venture capital entities in Spain are known as *Entidades de Capital Riesgo* (ECR). There are two specific types: the Venture Capital Fund (*Fondo de Capital-Riesgo o FCR*) and the Venture Capital Company (*Sociedades de Capital-Riesgo o SCR*).

The minimum share capital of a Venture Capital Fund (VCF) is EUR 1,650,000 and of a Venture Capital Company (VCC) it is EUR 1,200,000 (in 2007). There is a special tax regime that only applies to the income derived from investments by these entities within the Compulsory Investment Ratio (CIR). This CIR is 60% of the total income. In other words, 40% of the investments can be in assets that do not comply with the CIR.

Dividends received by a VCC or VCF are tax exempt and capital gains are exempt for 99%, i.e. they are effectively taxed at approximately 0.30%. Spanish VCCs and VCFs do not pay capital duty on incorporation or on subsequent capital contributions. The main tax advantages for non-resident investors are that capital gains and dividends received are not taxable in Spain and are free of withholding tax (irrespective of the percentage and period of the shareholding, unless the recipient is resident in a tax haven).

5. Typical Anglo-Saxon fund structure

A typical fund structure and the relevant inflows can be depicted as follows:



5.1 Substantive requirements and transfer pricing aspects

As general partner of the fund, the management company usually subcontracts with advisory companies. To ensure that the management company (being the general partner), which is typically located and active in a low-tax jurisdiction, does not become taxable as a non-resident in the country where the advisory companies are located, the general partner should not carry on its enterprise in those jurisdictions through a Permanent Establishment (PE). If the management company carries on its enterprise in other jurisdictions through a PE it could be liable to tax as a non-resident for the profits attributable to the PE. Generally, to avoid having a PE the general partner should pursue activities in that capacity only in the jurisdiction where it is located. Hence, fund decisions regarding investments should be taken in the low-tax jurisdiction where the management company is located.

There could be a substantive requirement in the jurisdiction where the general partner resides provided that the management company has to have genuine decision-making capacity.

Depending on the eventual structure of the fund, the advisory company may be connected to the general partner for transfer pricing purposes (e.g. through common shareholders). In such case, the arm's length nature of the remuneration paid by the general partner to the advisory company should be respected (i.e. it should be in line with the market). What arm's length remuneration is, depends on who performs the Key Entrepreneurial Risk-Taking (KERT) functions and where they are performed.

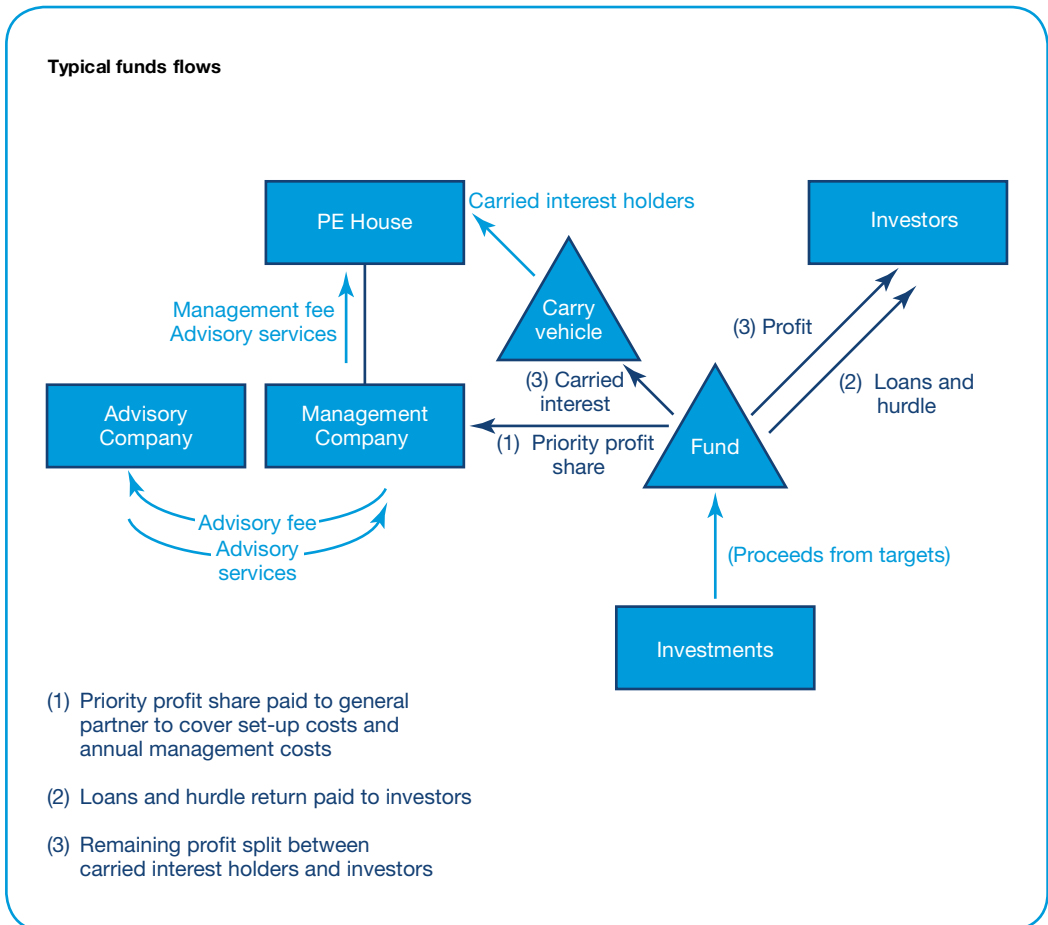
5.2 Dutch VAT considerations

As far as the implications for Dutch VAT are concerned, it should be noted that in principle an advisory fee charged by an advisory company in the Netherlands to a general partner in a low-tax jurisdiction, typically Guernsey or Jersey, may be subject to VAT in the Netherlands (depending on the exact scope of these services, see in this respect also Chapter 9). However, the reverse charge mechanism applies to advisory fees. Hence, if the fees are charged to an entity established outside the EU the place of supply is where the recipient is established. Consequently, the Dutch advisory company is not liable to account for VAT on the fees charged, but the management company should in principle make a self-assessment for VAT for the fees in accordance with local VAT law (if a VAT system is in place).

Another point to note is that management fees charged by a Dutch management company are in principle liable to Dutch VAT. If the management company is not resident in the EU, VAT can in principle be reclaimed with a VAT refund request pursuant to the 13th Directive. This is to the detriment of the cash flow but can be mitigated if the contract and activities of the Dutch company are structured properly.

6. Commitments and fund flows

With respect to the income flows within the fund it should be noted that the commitments of the participants to the fund vary depending on their role within the structure. Generally, the outflows of a fund can be depicted as follows:



The key participants in the fund, together with the related commitments/outflows, are described below.

6.1 The investors

Generally speaking, but not limited to, the commitments by and outflows to the investors (being the limited partners in the fund's limited partnership) are as follows:

- The investors contribute capital to the fund;
- The investors make commitments to provide interest-free loans to the fund once suitable investment opportunities have been identified; and

- The investors receive a preferred return on their loans to the fund (hurdle rate) and share profits in excess of that return with the carried-interest holders.

6.2 The private equity house

The commitments by and outflows to the private equity house are as follows:

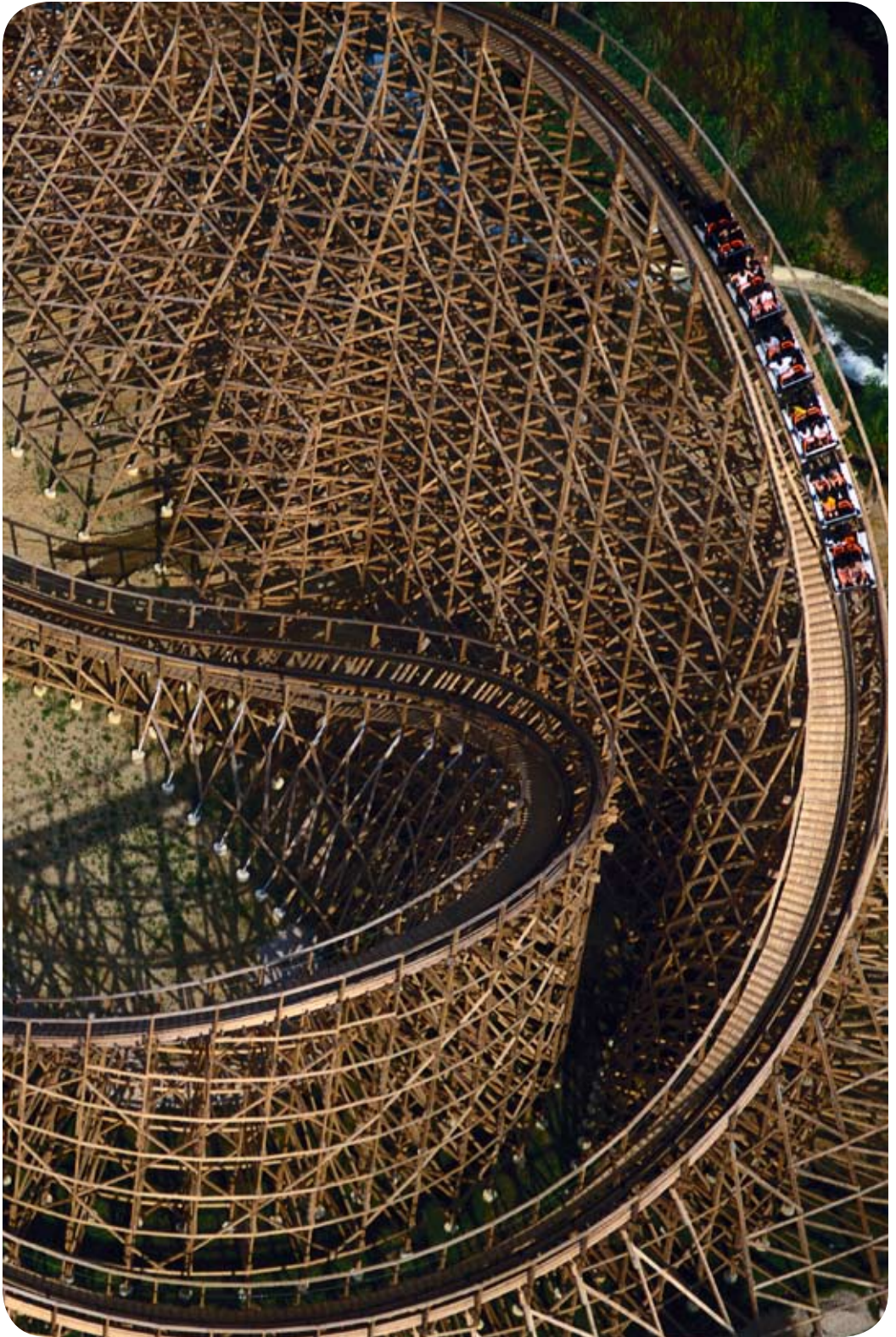
- The principal role of the private equity house is to identify investments, appraise investment opportunities, negotiate the terms of those investments, monitor the investments, create added value by an active involvement in the management of the investments and oversee the exit from them; and
- The private equity house receives a priority profit share from the fund to cover initial set-up costs and an annual management fee.

6.3 Carried-interest holders

Carried-interest holders may be individuals who are partners in the fund (either directly or through a carry vehicle) as well as employees or directors of the management company or an associated company. These individuals contribute nominal capital to the fund for their carried interest in the fund. Until the loans of the investors have been repaid and the preferred return has been made to the investors, the carried-interest holders are considered to have a profit-sharing ratio of 0%. Once the loans and the preferred return have been paid, i.e. once the hurdle has been reached, the profit-sharing ratio changes and the carried-interest holders typically receive 20% and the investors 80%. Taxation of the carried interest is one of the concerns to be addressed for Dutch resident fund managers.

6.4 Fund managers

The fund managers are entitled to contribute a limited amount of equity to the fund, which entitles them to share in the profit available after repayment of the hurdle interest on the investors' loans. The profit attaching to the equity share in the fund can produce attractive returns due to subordination of the fund manager to the other investors. Besides the acquisition and recycling process, the private equity managers will divide their time between managing the funds by assisting, advising and monitoring their portfolio companies on the one hand, and managing relations with their investors and the capital market in general on the other.



5. Tax Structuring of the Deal

1. Key drivers for private equity

Private equity firms aim to realise a high return on investment, typically by pursuing a value-added, active management strategy. In a cash-flow driven and competitive private equity market, tax is increasingly regarded as a key value driver. The tax efficiency of acquisition structures is of paramount importance for enhancing the cash-flow position of a private equity fund's portfolio companies, but perhaps even more importantly for enhancing the efficiency and flexibility of future (partial) exits.

Exotic jurisdictions and tax havens are still used as locations for private equity funds but are fading in importance as locations for investment or acquisition vehicles. The current trend is for private equity to move their investment or acquisition companies to onshore locations, such as the Netherlands and Luxembourg, for tax-related and other reasons. These companies are then used as a platform for their pan-European and, to a lesser extent, global buyouts.

Key drivers of the deal structure will be the desire to secure the maximum legal flexibility with regard to aspects such as acquisitions, decision making, the exit and minimising the tax leakage throughout the investment, and particularly upon an exit. The proceeds from the management of the portfolio companies (in the form of capital gains, dividend or interest income) should accrue to the investors in the most tax-efficient way. Consequently, the after-tax costs of each type of financing will be a key factor in the choice of acquisition structure. Deduction of interest costs can effectively reduce the cost of that finance for the group and thus ultimately the cost of the final return on the investment.

The following items will typically be relevant in the deal structuring process:

- selection of a suitable local acquisition vehicle;
- selection of the most favourable jurisdiction for an acquisition and financing company;
- assessment of the transaction costs and the tax treatment of those costs (for more detail see Chapter 9);
- assessment of tax-efficient management participation (for more detail see Chapter 7);
- selection of a tax-efficient financing structure;
- preparation of a cash-flow model ensuring efficient debt servicing;
- ensuring a tax-efficient exit for the investors.

2. Dutch holding structure

A holding company acting as the fund's acquisition vehicle is a common feature of acquisition structures.

The Netherlands' good infrastructure makes it a popular location for head offices of multinationals. In addition, many international companies have an operating subsidiary in the Netherlands to take advantage of the country's central geographical situation as a gateway to the European market. From a tax perspective, one of the requirements for setting up a holding company in

the Netherlands is that the company must have a genuine substantial presence in the country (i.e. personnel, buildings, etc.). Many international companies already meet this requirement of a substantial presence for tax purposes since they have their head offices and operational subsidiaries in the Netherlands.

The Dutch holding regime is popular due to its full participation exemption rules, the country's extensive double taxation treaty network and the fact that, with a proper structure, no (dividend) withholding taxes have to be paid on distributions or repayment of debt (see section 5 and Appendix I for more details).

For private equity funds, which often have to make deals in a short period of time, another aspect that makes the tax climate attractive for a holding company is a tax authority that is able to cooperate at short notice. A tax authority that is accessible and works quickly helps dealmakers to eliminate tax risks and avoid discussions afterwards. In this respect, it is of importance that negotiations with Dutch tax inspectors tend to be informal, by way of consultation, rather than taking place in a climate of litigation and penalties, as is commonly the case in most Anglo-Saxon countries.

There are some specific Dutch tax and legal regulations that have an impact on the Dutch acquisition finance practice.

The most important legal provisions that impact on Dutch deal structuring and financing are:

- financial assistance rules (for more details see Chapter 6);
- rules with respect to corporate interests; and
- insolvency law.

The most important Dutch corporate income tax regulations in this respect are:

- limitations on the deductibility of interest;
- taxation of dividends and capital gains for individual shareholders with a substantial interest and certain corporate shareholders in situations where no tax treaty is applicable.

The challenges posed by these legal rules can be managed by adopting the proper structure. Foreign private equity houses which actively manage their investments face less risk of potential liability as a foreign taxpayer in the Netherlands. Interest deduction restrictions can be mitigated in such a way that sometimes shareholder loans from private equity funds may be deductible for Dutch corporate income tax purposes.

The constraints mentioned above are therefore limited, assuming a suitable tax structure is also feasible from a commercial and legal perspective. This is generally the case for private equity transactions.

The Dutch tax system contains some interesting features (see Appendix I for more details). They include:

- full participation exemption on dividends and capital gains;
- interest relating to the external acquisition of shares may be tax deductible in most cases with proper structuring;
- no withholding tax on interest and royalties;
- withholding tax on dividends can be avoided by means of proper structuring;
- a wide network of tax treaties concluded with all industrialised countries worldwide.

Sections 3 to 6 describe some of the Dutch tax regulations one encounters while structuring a deal in more detail.

3. Participation exemption on dividends and capital gains

The Netherlands applies a so-called full participation exemption. When the conditions for the participation exemption are met, all dividends and capital gains of substantial shareholdings are fully tax-exempt. Ever since 1893 the Dutch tax legislators have adhered to the principle that distributions between corporations should not be taxed twice.

Two tests have to be met to qualify for the full participation exemption:

1. an ownership test, to control that the holding requirements are fulfilled; and
2. an assets test, which establishes that the participation can be regarded as 'active'.

1. Ownership test

The ownership test is passed if the taxpayer holds at least five percent of the nominal issued share capital of a company with a capital divided into shares. Furthermore, the ownership requirements are fulfilled if a taxpayer holds five percent of the participation interests in a joint account fund, is a member of a Cooperative Association or is a limited partner participating for at least five percent in the profits realised by an 'open CV' (a Dutch limited partnership that is treated as a company for Dutch tax purposes).

2. Asset test

The asset test is passed if the company in which the shareholder has an interest can be regarded as an active company. If more than 50 percent of the assets of the participation consist, directly or indirectly, of portfolio investments it is regarded as a passive participation (for more details see Appendix I).

If the assets test and the ownership test are passed, the participation is regarded as active and the participation exemption applies. Whether or not the active company's profits are subject to tax is then irrelevant for the application of the Dutch participation exemption, by contrast with other European countries where such a subject-to-tax requirement is commonly applied. In this respect, it should be noted that the absence of a subject-to-tax requirement for active companies under the Dutch participation exemption does provide for structuring opportunities with respect to companies which are not subject to tax.

It is also important to note that the Dutch tax authorities are willing to provide advance confirmation that the participation exemption will apply to a given interest held by a Dutch holding company.

3.1 Income derived from hybrid loans

If an investment qualifies for the participation exemption, income derived from hybrid loans receivable from such a subsidiary could also be covered by the participation exemption. This creates planning opportunities if the interest paid on hybrid loans is deductible in the source country.

4. Limitations on deductibility of interest

4.1 General

The Dutch Corporate Income Tax Act provides for a couple of possible restrictions on the deductibility of interest paid to related parties. The most important ones are the thin capitalisation rule and the anti-base erosion rule. Apart from these rules, interest deduction restrictions may also apply if debt is classified as equity for Dutch tax purposes, i.e. so-called hybrid loans.

Interest expenses should also meet the arm's length standard. If interest is paid to a bank or another third party (without guarantees from group companies) the arm's length standard will normally be met. The interest rate charged by a third party is often used as a benchmark to determine the interest rate on related party debt (i.e. to determine whether the interest rate on related party debt meets the arm's length standard).

For Dutch corporate income tax purposes, related parties are generally considered to be companies or individuals that have a direct or indirect interest of at least one-third in the Dutch taxpayer or in companies in which the Dutch taxpayer has an interest of at least one-third. Companies and individuals are also considered related parties if the Dutch taxpayer and another company have a direct or indirect shareholder that has an interest of at least one-third in both the taxpayer and the other company.

If a related party provides guarantees to a Dutch taxpayer in relation to third-party borrowings, the implications should be carefully reviewed. Third-party debt may be requalified as related-party debt unless, for instance, the borrower can demonstrate that it could have obtained the debt on a stand-alone basis. Typically, this would be demonstrated using cash flow models showing that the company can service its debt, including interest payments. Consequently, guarantees provided to obtain better terms, i.e. a lower interest rate, should not cause any harm.

4.2 Thin capitalisation rules

Dutch thin capitalisation legislation limits the deductibility of interest payments in the event that a company is excessively financed by means of debt. Whether a taxpayer is excessively financed by debt is determined by comparing its debt and equity. A company is considered to be excessively financed by debt to the extent that its average debt exceeds three times the average amount of its equity, the so-called fixed ratio criterion.

The thin capitalisation legislation is only applicable if the taxpayer is part of a 'group' as defined in the Dutch Civil Code (*Burgerlijk Wetboek*). A group is defined as 'an economic unity in which legal persons and companies are organisationally connected'. In practice, this means that companies constitute a group if one company is essentially in control of the other.

The non-deductibility of interest payments is maximised at the balance of interest payments owed to related parties and interest received from those parties. Hence, the thin capitalisation provisions will not limit the deductibility of interest payments if a company has exclusively arranged external loans.

Apart from the fixed ratio criterion, the Dutch taxpayer can elect to apply the 'group' debt-to-equity ratio based on the group's consolidated financial statements. Again, for Dutch tax purposes the concept of a group is based on the definition of 'group' in the Dutch Civil Code. The consolidated accounts could be used as evidence of the existence of such a group. This ratio provides companies with flexibility, for example in situations where the debt financing position of a certain industry is relatively high.

Although, according to Dutch private law standards, private equity funds generally belong to a group they are not usually obliged to consolidate their investments because they have an explicit exit strategy. Consequently, the highest level of 'group' consolidation, according to the Dutch Civil Code and therefore for the purposes of Dutch thin capitalisation rules, normally starts with the acquisition holding company directly below the fund. The group ratio therefore includes all debt provided by the fund and external sources on a consolidated basis at that holding company level. If the Dutch (intermediate) holding company's debt-to-equity ratio is similar to or better than the group's, which is the case if the Dutch holding company heads the group, interest should not be subject to Dutch thin capitalisation rules.

4.3 Base erosion rules

As in the case of the Dutch thin capitalisation rules, the base erosion rules only disallow interest paid to related parties, i.e. if the debt is used to finance certain tainted transactions (such as dividend distributions, a repayment of capital and the acquisition of or contribution of capital to a subsidiary). Interest paid on genuine third-party debt should be deductible.

In addition, even if interest is paid to related parties on loans to finance a tainted transaction, the interest should still be deductible provided that both the transaction and its financing are based on sound business principles. That might be the case, for example, when group debt is eventually financed outside the group and there is a direct relationship between the related party debt and external debt. A direct relationship is mainly determined on the basis of the terms, the repayment, the remuneration and the magnitude and duration of the loans.

5. Withholding tax on dividends

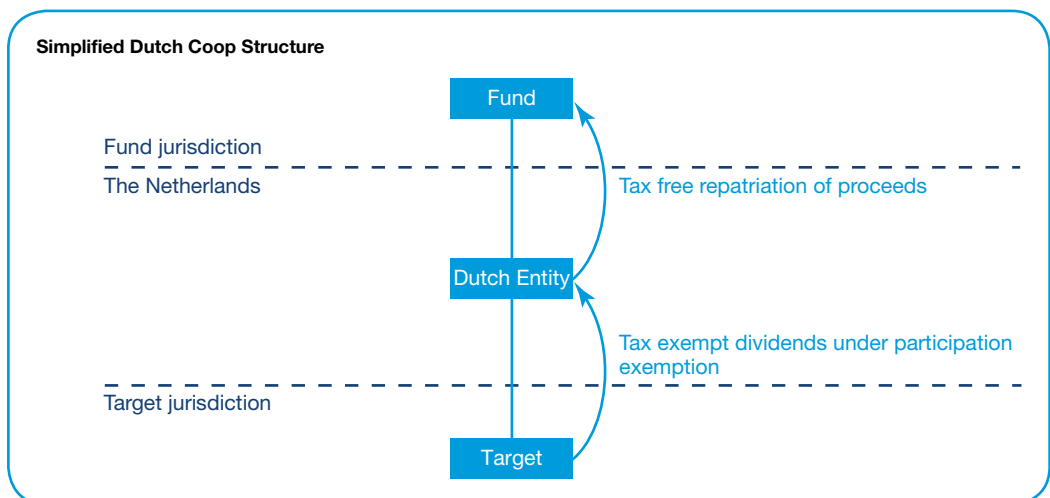
Dutch dividend withholding tax is imposed on dividends distributed by Dutch tax-resident companies. In principle, the tax rate is 15%.

No tax is withheld if a Dutch company distributes dividends to a company in another EU member state when the EC Parent-Subsidiary Directive (No. 90/435/EEC) is applicable. The Parent-Subsidiary Directive applies if the following conditions are met:

1. both companies have one of the legal forms mentioned in the annex to the directive;
2. at the time of the distribution the parent company has held at least 25 percent of the par value of the paid-up capital in its subsidiary for an uninterrupted period of one year;
3. both companies are subject to a tax on profits, without the option of an exemption or an actual exemption;
4. neither company is deemed in their respective country of residence to be resident outside the EU on the basis of a tax treaty concluded with a third State.

Generally speaking, the Dutch dividend withholding tax is reduced under tax treaties to 10, 5 or 0 percent for dividends from a participation that exceeds a certain threshold. The Netherlands has concluded tax treaties with more than 80 countries worldwide. With this extensive treaty network, the Netherlands is a preferred location to establish holding and financing companies.

In recent years, the Dutch Cooperative Association has gained in popularity. One of the reasons for this is the inclusion of the Dutch Coop in the EU Parent-Subsidiary Directive since 2003. One of the main characteristics of the Dutch Coop is that Dutch dividend withholding tax does not apply to distributions by the Coop to its participants, provided the articles of association of the Coop are properly structured. The Netherlands is a particularly interesting location for some transatlantic and pan-European private equity funds entering the European market, and to a lesser extent for structuring global investments.



The structure shown before is a simplified example in which a private equity fund uses the benefits of a Dutch Coop to ensure tax-free distributions to the fund.

6. Substantial interest taxation

The income a corporate shareholder receives from a substantial interest in a Dutch company is subject to corporate income tax unless that interest forms part of the assets of the shareholders' business enterprise. The income from a substantial interest includes not only dividends received and capital gains realised but also income and gains from loans to a company in which a substantial interest is held.

A non-resident entity has a substantial interest in a company resident in the Netherlands if, directly or indirectly, it:

- a. owns at least five percent of the issued share capital of that company;
- b. has rights to acquire shares representing at least five percent of the issued share capital of that company; or
- c. has profit-sharing certificates relating to at least five percent of the annual profits of that company or at least five percent of its liquidation proceeds.

The rights of enjoyment to shares or profit-sharing certificates as well as participations in mutual investment funds can qualify towards holding a substantial interest.

Private equity funds will generally be protected from substantial interest taxation if their investment forms part of the assets of a business enterprise of the fund. In this respect, active management of the investments is regarded as a business enterprise. In general, private equity funds do actively manage their investments and this constitutes part of their business activities. It is therefore possible, and is common practice, for private equity funds to obtain an advance ruling from the tax authorities confirming that substantial interest taxation is not applicable.

7. Tax grouping

Under certain conditions a parent company may be taxed, together with one or more of its subsidiaries, as a group (see in more detail Appendix I). For corporation tax purposes, this means that the subsidiaries are deemed to have been absorbed by the parent company.

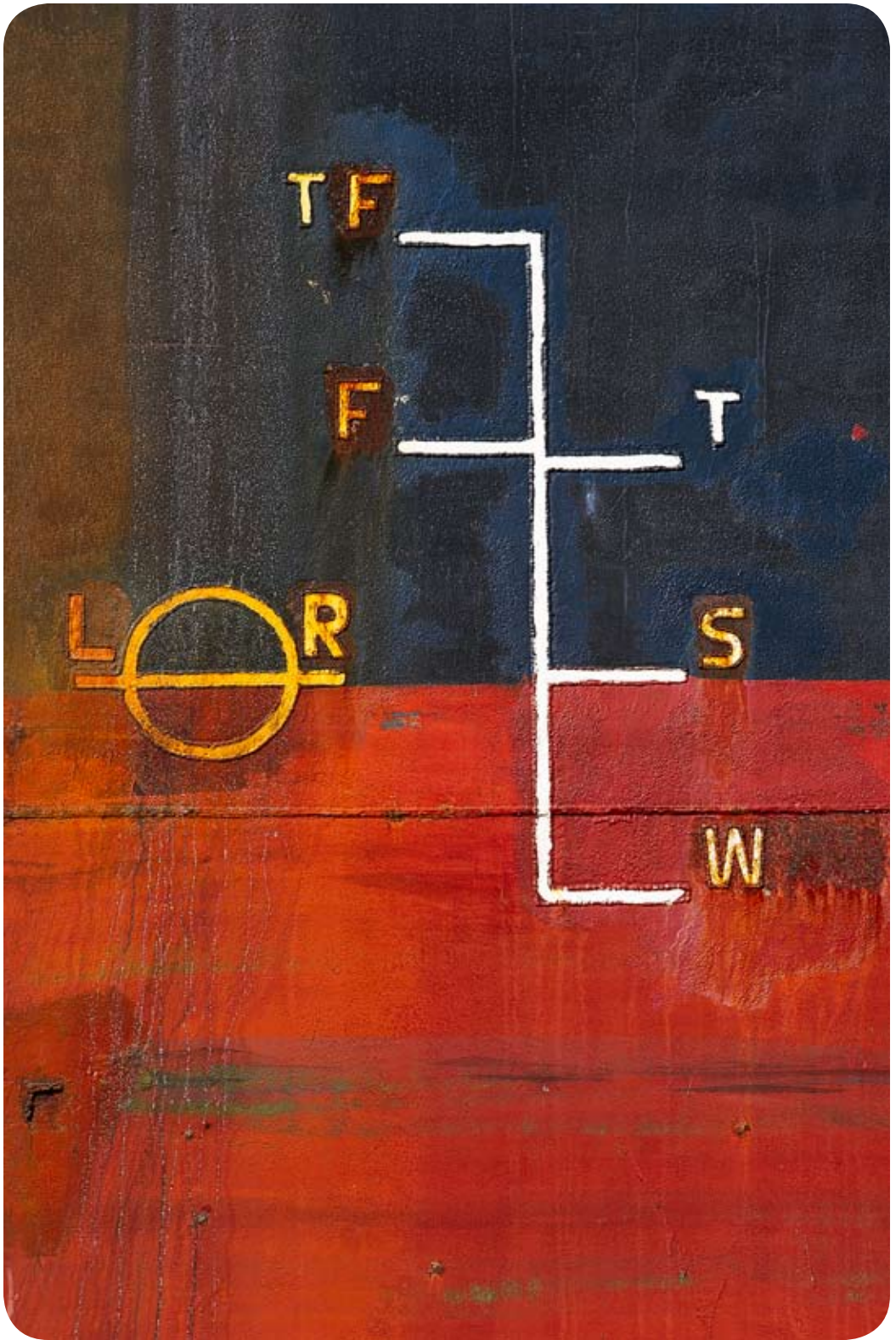
The main advantage of group taxation is the possibility to offset interest on acquisition debt against the operating profits of the target companies. Other advantages are that the losses of one company can be set off against the profits of another group company and that fixed assets may in principle be transferred tax-free from one group company to another.

8. VAT grouping

In addition to corporation tax grouping, VAT grouping is also possible in the Netherlands provided that certain criteria are met.

Dutch companies that have a financial, economic and organisational link can in principle be joined in a VAT group (at the request of the companies themselves or at the discretion of the Dutch tax authorities).

The main administrative benefit of VAT grouping is that transactions between companies in the VAT group fall outside the scope of Dutch VAT. Furthermore, the right to recover input VAT in relation to residual/general costs is determined on the basis of the external activities of the companies in the VAT group. As a result, the VAT taxable activities of the operating companies can have a positive effect on the input VAT recovery position of the holding company compared with the input VAT recovery position of the holding company on a stand-alone basis.



6. Deal Financing

1. Introduction

Financial institutions are important stakeholders in driving successful large buyout operations by private equity houses. In the typical buyout, a mix of financial institutions is brought together to raise the funds required.

Most of the larger financial institutions in the Netherlands have dedicated leveraged finance teams, which underwrite and syndicate a single transaction with various forms of debt including senior, mezzanine and high-yield debt, bridging finance and working capital facilities. These teams are highly active in local and international buyouts. Besides the Dutch financial institutions, there are UK and continental European leveraged finance teams as well as mezzanine and intermediate capital houses active in the Dutch private equity market.

This section discusses some of the instruments that can be used and how the financing can be organised between the debt and equity providers.

2. Optimising the financing structure

2.1 Introduction

In a Leveraged Buyout (LBO), the correct mix of debt and equity providers is assembled to serve the objective of minimising the cost of capital.

Every financing instrument has a rate of return according to its risk profile. The risk profile is determined by a combination of the ranking of the different financial instruments, the level of security and additional conditions. The risk profile varies from senior financing to junior financing, mezzanine instruments and equity, which for private equity investors generally consists of ordinary shares, preference shares, shareholder loans or a combination thereof.

Subordination is used to reflect the different risk profiles between and amongst the different categories of the financial instruments. In the event of a company's liquidation debt providers are in a similar position to the other creditors of the company, whereas the equity providers are subordinated to these creditors and thus face a higher risk.

Subordination can be organised either contractually amongst the creditors ('inter-creditor agreement') or by inserting multiple intermediary companies to reflect the subordination between the senior, junior and mezzanine debt providers in a multi-tier legal structure ('structural subordination') (see the illustration in Chapter 4.5).

2.2 Debt servicing capacity

In a LBO, the appropriate proportion of each type of financing greatly depends on the type of business of the target and the debt servicing capacity of its free cash flow.

A company's debt servicing capacity typically sets the limits to the amount of debt the company can attract. If the debt servicing limits of senior (and junior) financing have been reached, in combination with additional securities, a company will have to look for other sources of financing, such as high yield (junk) bonds, mezzanine financing or equity.

The limit of what financial institutions are prepared to lend is determined by a multiple of EBITDA. High multiples reflect favourable lending and market conditions and permit higher deal prices. It goes without saying that the rate of return on the financing as such (spreads over LIBOR or EURIBOR for example) also has a direct impact on the debt multiples (i.e. more debt can be serviced as the rate of return decreases).

In the period 2003-2007 the amounts raised by private equity funds reached steadily higher record levels, resulting in higher debt multiples, higher prices and a very competitive debt and private equity market, which led to lower returns for the debt providers and even a softening of the lending conditions. These factors meant that private equity investors were forced to struggle to meet their targeted return, for example by adopting a buy and build strategy or by streamlining a target's business model.

2.3 Debt push-down strategies - financial assistance rules

In the Netherlands there is the concept of tax consolidation, which solely from a Dutch tax perspective means that there is no need to push debt down to Dutch target level (see Chapter 5 for more details). In a typical LBO deal this situation is however different, as legal and banking considerations (for example the use of target's assets as security to agree on more favourable lending conditions and a lower rate of return) outweigh tax reasons. Moreover in a vast majority of the LBO deals there are also non-Dutch companies involved.

Typical debt push-down strategies involve the use of

- (i) leveraged dividends or capital repayments, and
- (ii) a local holding company in combination with tax consolidation or subsequent legal merger.

The decision to use and the feasibility of a particular debt push-down strategy depends heavily on legal (see below), financial, commercial and tax considerations.

In considering the appropriate debt push-down strategy in the Netherlands (and in most other countries), so-called financial assistance rules have to be taken into account. These financial assistance rules are laid down in the Dutch Civil Code and restrict the ability of a target company, or subsidiaries of the target company, to guarantee, underwrite or support a third-party purchase of its shares. However, to the extent that the loan does not exceed the freely available distributable reserves (*vrij uitkeerbare reserves*) and the articles of association permit such a loan it does not fall within the scope of the financial assistance rules.

Clearly, therefore, in a typical buyout situation where the financing is to be secured by the assets of the target group and where there is a commercial, legal and/or tax need to push debt down into the target structure the financial assistance rules should be closely monitored.

A commonly used structure in the Netherlands that circumvents the financial assistance rules is the use of an upstream legal merger between the target and the acquiring company as surviving entity.

2.4 VAT considerations

The provision of financing (interest-bearing loans) in principle qualifies as a VAT-exempt activity. As a result, debt push-downs via the Netherlands might have an impact on the input VAT recovery right of the Dutch companies in a structure. Input VAT in relation to interest-bearing loans provided to recipients established in the EU cannot be recovered. However, input VAT relating to interest-bearing loans granted to non-EU recipients is recoverable (for more details see Appendix I).

In view of this, the VAT consequences of financing activities should be closely monitored.

3. Modelling the cash flow

3.1 Financial modelling

The debt multiples offered and the terms of various debt instruments used in a buyout (redemption period, yield, covenants and securities) are closely related to the modelling of the expected rate of return and the related future post-tax cash-flow (debt servicing capacity). Modelling the expected return and cash flow is therefore a key step for the providers of both equity and debt in a LBO deal structure. In this context, a detailed analysis of the tax line (taking into account the new financing and capital structure) is essential.

In the larger UK-driven LBOs such tax line analysis is common practice, and there is clearly also a growing tendency among banks in the Netherlands to require a more detailed analysis of the underlying tax assumptions.

The terms sheet of the various debt instruments is negotiated by the private equity house. The terms of the bank financing are by definition negotiated at arm's length, but the terms of the shareholder instruments should be properly substantiated for tax purposes.

3.2 Assessment of optimal financing

Based on the outcome of its due diligence investigation(s) and after analysing the business plan and running a financial model on projected returns and cash flows, the private equity house intensifies the negotiations on the terms sheet of the debt package with various potential financial institutions. On that basis, and bearing in mind the anticipated bid price for the shares in the target, an assessment is made of the sources and uses needed to complete the share transaction, including the refinancing of existing debt and the payment of transaction costs including financing expenses (see Chapter 9 for more details).

The importance of the target having an optimal tax line, for example via the effective tax deductibility of interest on shareholder and bank debt, for the value of the target arises from the fact that the value of the target is the discounted value of its post-tax cash flows. Thus the benefit

of a reduced tax position is an improved cash position to service, inter alia, the bank debt and future (CAPEX) investments.

3.3 Structuring the shareholder funds

The 'equity financing' of private equity houses generally comprises loan stock, which can take the form of shareholder loans (possible tax attribute as well as flexible cash repatriation instruments) and ordinary shares and/or (occasionally) preference shares.

The ultimate return for the private equity house then comes from the (accrued) fixed rate of return on the shareholders' loans or preference shares and the gain (or loss) on the ordinary shares at the time of exit.

The return on the shareholder loans (and preference shares) has to be considered given its pre-eminently 'affiliated' nature. For tax purposes, therefore, it is advisable to substantiate the arm's length nature of the remuneration of the instruments, for example with a loan pricing benchmark study. Fundamental to the success of a LBO is the buy-in of existing management (or owners of the business) or of a newly recruited management team. Note that in the latter case, that the management investment scheme has implications not only for corporation tax but also for payroll tax (as described in the next chapter).



7. Management participation

1. Introduction

The incentivisation and motivation of either existing owners of the business, existing management or new, incoming management is a fundamental element in the vast majority of buyout deals. The underlying assumption is that the management's performance is a vital element that can either make or break the deal. Consequently, in almost every transaction management is required to invest alongside the private equity house in order to align their interests with those of the private equity house in seeking growth in the value of the business and to motivate them to achieve the goals defined in the business plan.

Since the costs involved in a management participation arrangement are generally significant for a private equity house, the financial implications of these incentive arrangements must be clearly understood and properly managed:

- *from the point of view of management* to ensure that the reward is market competitive, tax efficient, supportive of value-creating behaviours and the risks are well understood and managed;
- *from the point of view of the company* to ensure that costs are controlled (often these incentive arrangements fall under the scope of international accounting standards), dilution and cash flow effects are properly managed, financing risks are optimally managed and the incentive arrangements are sufficiently robust and challenging.

The following factors are also relevant in selecting a management incentive arrangement:

- The target group ('Tier 1 management' and/or 'Tier 2 management') and the purpose (retention / incentivisation / investment) of the participation;
- Alignment with the business strategy of the company and the reward strategy of the company/ acquisition target;
- The tax implications for both the company and the participant (corporate and income tax consequences);
- The funding of the arrangement;
- The legal framework/corporate structure (i.e. employment law, prospectus requirements, maintenance, etc.); and
- Accounting and governance consequences.

Furthermore, significant commercial and reputation advantages can be gained from proactive communication of the objectives and outcomes of the management participation with other stakeholders (i.e. Works Council, other personnel and the general meeting of shareholders).

The most commonly used types of management incentive arrangements are outlined in Section 2. In Section 3, the Dutch tax implications for management of the various incentive arrangements are described. Section 4 summarises some other considerations. Section 5 discusses the main points that private equity houses need to consider in the implementation of management incentive arrangements.

2. Type of management incentive arrangements

The management incentive arrangements in a transaction environment can generally be divided into four different types:

- Share schemes;
- Stock option schemes;
- Loan arrangements; and
- Cash-based remuneration.

Bear in mind that every transaction is different in terms of the corporate structure, financial engineering and preferred management participation. The above list is therefore not exhaustive but merely an overview of the most common management incentive arrangements.

2.1 Share schemes

Co-investment

For Tier 1 management, a co-investment or share incentive arrangement is generally implemented. In such an arrangement the manager purchases, possibly at a discount, a shareholder interest. An investment in advance is required of the participants (financing) and the financial risks ensure there is a real alignment of interests between the participant and the private equity house (retention). Furthermore, these types of schemes can generally be structured in a tax-efficient manner for the participant.

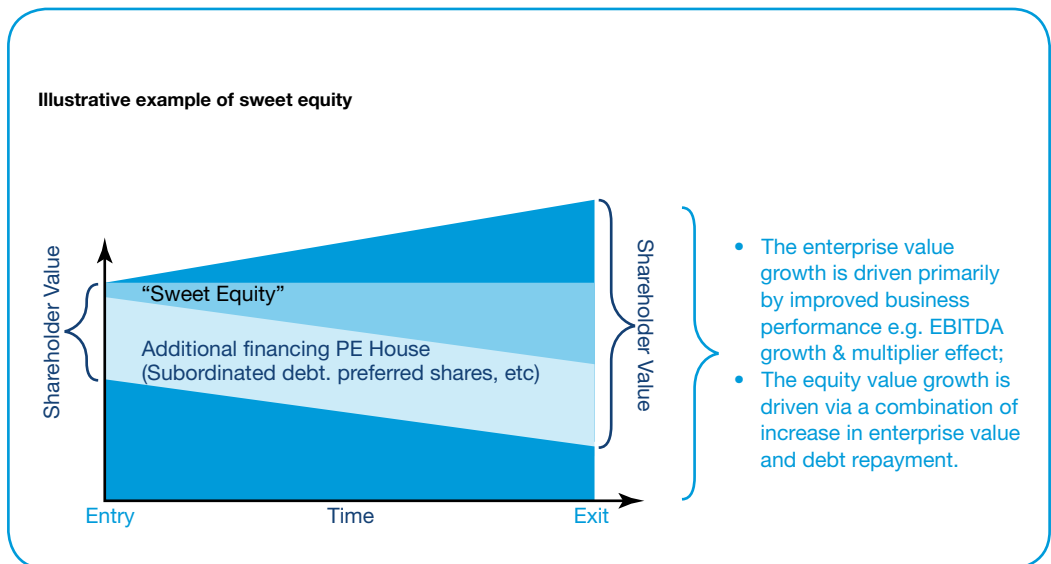
Restrictions

There are almost always conditions attached to the management participation. The most commonly employed restrictions are (i) a continued employment requirement (good and bad leaver provisions), (ii) restrictions on the transfer of shares and (iii) terms giving the management a right or obligation to sell if the other investors exit (the so-called drag and tag-along rights).

Leverage in the structure

Additional leverage is generally created for management in the financial structure of the transaction. Leverage can be created by investors partly investing in fixed-return instruments such as preference shares, loan notes or shareholder loans. Since management invests solely or primarily in common equity, leverage is created but there is also more risk.

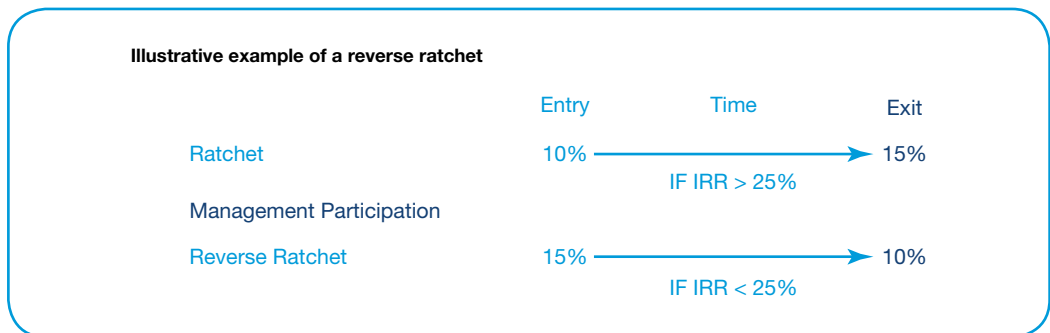
Preference shares and shareholder loans have a fixed return so any excess in value created upon an exit is allocated to the common equity, a part of which ultimately flows to management. This is why such schemes are referred to as 'sweet equity'. The figure below provides an illustrative example.



Ratchet schemes and reverse ratchets

Ratchet schemes are commonly used to motivate management in private equity deals. A ratchet scheme provides for an additional pay-out to management dependent on the company's future performance or the investment multiple achieved by the private equity house. A ratchet scheme can be implemented in many different ways. For example, it can provide not only for the automatic multiplication of certain shares but also for the option of converting shares into another class of shares or of converting convertible bonds/preference shares held by management into common shares. Payments under a ratchet scheme are generally considered to be taxable income for management.

For tax purposes, a more favourable structure in the Netherlands is to provide that the management's stake in the shareholding will decrease if the company underperforms (a so-called reverse ratchet scheme). Again there are numerous ways to structure this. See the figure below for an example of a reverse ratchet scheme.



To begin with, the private equity house holds 85% of the shares and management 15%. The reverse ratchet scheme provides that the target rate of return is 25% (i.e. on exit the private equity house should receive an IRR of 25% on its total investment in the target company). Let's say that on exit the IRR for private equity is only 20% on its total investment. Under this ratchet scheme, the number of shares of the private equity house will automatically multiply by 1.2. Since the IRR is only 20% its number of shares has to be multiplied by 1.2 in order to achieve its target return of 25%. Consequently, the overall performance causes management's participation to decline from 15% to 10% and private equity's stake to increase from 85% to 90%.

Growth shares / Hurdle shares / Flowering shares

Another way of creating leverage is by granting management the option of investing in a separate class of ordinary shares. The new class of shares only entitles its owners to profit from the future growth in the value of the company from the date the shares are issued. These are therefore called growth shares. In economic terms, these growth shares can be compared with an option right and they are therefore priced as such. Growth shares allow management to purchase a larger stake than they could have acquired if they had to invest in common shares.

Membership interests (participation in a Dutch Cooperative)

In many recent deals PE houses have used a Dutch Cooperative Association (Dutch Coop) as the acquiring entity. The Dutch Coop is a separate legal entity under Dutch law, with its own rights and obligations and with the capacity to legally own assets and conclude agreements. The Dutch Coop does not have a capital divided into shares (see in more detail Chapter 5).

It is possible to issue different classes of membership rights, i.e. priority rights or preference rights, which makes the Dutch Coop highly flexible from a legal perspective and attractive for PE houses. Management can be offered the opportunity to invest in a membership interest. Generally, the tax treatment will be the same as with an investment in shares.

Other possibilities

One can of course structure management incentive arrangements by (i) combining the aforementioned elements, (ii) creating hybrid arrangements or (iii) using alternative types of shares, such as performance shares, matching shares and/or deferred shares. Every case therefore requires detailed analysis and careful structuring.

2.2 Stock option schemes

Stock option schemes are not often implemented for Tier 1 management in Europe since they do not provide for an up-front investment and are not felt to be tax efficient. However, stock option schemes remain popular as an incentive instrument for Tier 2 managers in a deal environment. Basically, with a stock option scheme the company gives the participant a right to acquire shares in the company during a fixed period at a predetermined price. There is little or no up-front investment required from the participant (leverage) and inserting a restriction period can intensify the relationship with the company (vesting). Furthermore, performance targets can be attached to the grant and exercise of the option (aligning interests). Finally, in principle no favourable tax treatment can be achieved by implementing such a structure and stock option schemes generally trigger accounting charges for the company.

2.3 Loan arrangements

A loan arrangement can also be used for Tier 1 management in the framework of an acquisition. An example of such an arrangement is the loan note, in which the interest payment on the loan is deferred and can, for example, be made contingent on the future results of the target (earn-out arrangement). The best known loan arrangement is the convertible bond, in which a loan is provided by management to the company with a right of conversion to shares attached (option). However, there are other cash-based loan arrangements, such as profit participating loans (PPL). A PPL is provided by management to the company and provides for a return equal to a certain increase in the value or earnings of the company. The Dutch tax treatment of the PPL is still open to discussion. Following the abolition of the deductibility of share-based arrangements for corporate income tax, the popularity of cash-based exit arrangements has increased. For more information about the corporate income tax consequences of the various schemes, see section 3.5.

2.4 Cash-based incentives

With the exception of exit and completion bonuses, long-term cash-based incentives are rarely employed for Tier 1 management in a transaction environment. Retention bonuses are sometimes paid, but these generally relate to the compensation structure (settlement or replacement of existing bonus arrangements) and are not linked to the transaction.

The completion bonus is intended to reward management for their additional efforts in the deal process and to ensure their alignment with the seller's interest until the closing date or shortly after (milestones). In addition, where management is invited to invest the completion bonus can then also be used to facilitate this investment. Payment of the completion bonus is generally subject to closure of the deal, sometimes within a specified time frame.

Cash-based incentives implemented for the benefit of Tier 2 management are generally arrangements in which the payout and/or the benefit is dependent on the investment multiple realised by the investors. These are known as exit ratchet arrangements. Additional performance criteria can be attached to maximise the retention and motivation effect. Exit ratchet arrangements do not require complex legal structuring but are in principle fully liable to Dutch taxation at the time of payment. Other cash-based incentives commonly introduced for Tier 2 management are Stock Appreciation Rights (SARs), which are economically similar to option rights and can be settled in either shares or cash (for example at exit) and Restricted Stock Units (RSUs), which are instruments that are also economically similar to shares.

3. Dutch tax treatment of incentive arrangements

Assumptions

Having briefly outlined the main characteristics of the various management participation and incentive arrangements, the basic income tax and social security consequences for management that may arise (i) at acquisition, (ii) during the lifetime of the investment and (iii) at exit are outlined below. Please note that for the purposes of clarity several assumptions have been made. These are:

- the manager qualifies as a Dutch resident throughout the holding period of the investment;
- the manager is not a managing or statutory director of the company;
- the manager holds the shares as assets in a private capacity and not via a personal holding or other investment vehicle;
- the manager acquires shares in a non-listed company.

Substantial interest shareholding

Another assumption made is that the manager does not hold a so-called substantial interest (Box 2) for tax purposes. Under the Dutch Personal Income Tax Act of 2001, an individual holds a substantial interest in a company if he or she owns, directly or indirectly, at least (i) 5% of the issued and paid-up share capital and/or 5% of the voting shares in that company, or (ii) at least 5% of the issued and paid-up share capital and/or 5% of the voting shares of any class of shares or (iii) is entitled to 5% of the annual profits and/or 5% of the proceeds at liquidation. All income from a substantial interest is taxed at a maximum flat rate of 25% and is calculated as the aggregate amount of:

- the distributions (i.e. dividends) made on shares or certificates that are part of the substantial interest (regular gains), reduced by the deductible expenses; and
- the profits realised upon disposal of shares or certificates that are part of the substantial interest or upon disposal of part of the rights pertaining to these shares and certificates (capital gains), reduced by the deductible expenses.

Please note that if the manager already owned shares in the company concerned these shares will also form part of the substantial interest as of the moment a substantial interest is acquired. Should you want to avoid creating a substantial interest it is worth considering structuring the participation through a special vehicle or providing management with a combination of shares and other instruments such as options and/or profit participating loan arrangements.

3.1 Tax treatment of share schemes

At acquisition

In general, where management directly purchases equity this should in principle not trigger any Dutch tax implications at acquisition as long as the transaction is considered to be at arm's length. In this context, the Dutch tax authorities focus on whether the equity has been purchased at a discount given (i) the time that has passed between the transaction date and the participation of management, (ii) the leveraged structure of the investment (the so-called envy) and (iii) the pricing of all other instruments in which the PE house invests (preference shares, loan notes, etc.).

Furthermore, if the shares are restricted and/or good and bad leaver provisions are attached to the shares this may jeopardise their investment nature for Dutch tax purposes. It is generally accepted practice in the Netherlands to consider participation by management in shares as an investment for tax purposes (Box 3), regardless of whether good and bad leaver provisions are attached. This is based on the understanding that shares are generally independent financial instruments that are commonly traded in the market. However, on the basis of the wording of the attached good and bad leaver restrictions, the financial risks for management are minimal, the shares may be regarded as being linked to the employment. In that case, any gains realised with such shares could be regarded as income from employment, which is taxable at a maximum rate of 52% (2008). Whether that actually happens will depend on the nature and severity of the restrictions. Generally, this situation can be avoided by careful structuring of the leaver provisions attached to the investment.

Discount

The value of the management shares is affected by the nature of the rights attached to them. In practice, one has to consider each of the restrictions attached to the shares (bad leaver provisions, blocking period, illiquidity, etc.) to establish the fair value. There are some general rules of thumb that can be applied in this context. For example, if a blocking period is applicable it may be possible to reduce the value of the shares by negotiating a discount (i.e. a value depreciating factor) on the fair market value of the shares with the Dutch tax authorities.

During the holding period/at exit

If the purchase of the management participation is regarded as an investment, the average fair value of the investment is subject to an effective annual imputed net wealth tax of 1.2%. However, actual gains realised with the shares (capital gains, dividends, etc.) are not subject to tax.

Membership interests (participation in a Dutch Cooperative)

An important consideration with respect to investing through a Dutch Coop (see Section 2 for more information about the Dutch Coop) is whether the participation in the Dutch Coop qualifies as an investment. If so, it will be treated in very much the same way as described above for share scheme arrangements. It is important to carefully assess whether, based on its articles of association, the Dutch Coop should be regarded as a transparent entity for income tax purposes or whether it operates as an independent entity with its own legal personality. The management's participation should therefore be clearly linked to their membership interests rather than to contractual arrangements.

For the purposes of the rules on substantial interests, the membership interests in a Dutch Coop should be treated as similar to a profit right. This implies that as long as the different classes of membership interests together do not entitle the manager (i) to 5% of the annual profits and/or (ii) to 5% of the proceeds at liquidation and/or (iii) to 5% or more of the total voting rights in the Dutch Coop, no substantial interest holding should arise.

Ruling practice

In view of the significant differences in terms of taxation depending on whether the incentive arrangement is deemed to be investment or employment income, it is worth considering obtaining up-front certainty by requesting an advance ruling from the Dutch tax authorities. In such ruling procedures the investment nature of the participation, if properly structured, is generally accepted. The Dutch tax authorities focus mainly on the valuation of the shares. It is therefore recommended that supporting documents are provided, preferably prepared by an independent valuation expert.

Ratchets

Reverse ratchet and ratchet arrangements are likely to have different tax implications in the Netherlands. Let's say management buys 10% of the equity for a sum of EUR 1 million. Upon exit after five years, this 10% is worth EUR 3 million. Under a ratchet arrangement, management will receive an additional stake of 5% because the private equity house has achieved its IRR of 25%. Management's total stake of 15% is worth EUR 4.5 million. The gain that should be attributed to the additional 5% equity is likely to be taxed as income from employment, which means that if a ratchet scheme is used the total taxation amounts to approximately EUR 750,000 (EUR 1.5 million x 52%). The effective gain for management is therefore EUR 2.75 million (EUR 4.5 million minus EUR 1 million minus EUR 750,000).

Should the management arrangement be structured as a reverse ratchet, the initial purchase price would amount to EUR 1.5 million and the total gain of EUR 3 million is tax exempt. Therefore, this structure yields an extra EUR 250,000 in profit for management. However, the management's investment risk must be managed carefully.

3.2 Stock option schemes

Participation by means of a stock option scheme will give rise to a charge for income tax and social security contributions at the date of exercise. The taxable benefit is equal to the difference between (i) the fair market value of the underlying shares at the exercise date and (ii) the actual exercise price paid by the participant (the spread). The spread is treated as employment income, which is taxed at a maximum rate of 52% (2007).

It can be argued that options that are purchased at fair value should be regarded as an investment and that gains realised with such options are free from Dutch tax. The Dutch tax authorities are generally unwilling to accept this position unless the options can be freely transferred or sold.

3.3 Loan arrangements

Where management participates in the target company by means of a loan arrangement, the wording and valuation of such arrangement are key to determining the Dutch tax implications. If

sufficient economic substance exists and the leaver and transferability provisions attached to the arrangement are not too onerous, the loan may be regarded as an investment. However, since it is non-transferable, one could take the position that the loan arrangement should be split into two elements, with part of the return being qualified as an investment return and the return above this normalised return being regarded as employment income.

3.4 Cash-based arrangements

Cash-based arrangements are taxed as employment income at the date of payment at a maximum rate of 52% (2007).

3.5 Corporate income tax

On 24 May 2006, new draft legislation in the Netherlands proposed the abolition of the Corporate Income Tax deduction (CIT deduction) for employee stock options, comparable rights (e.g. warrants and convertible bonds) and employee shares. Under these rules, a CIT deduction is not available for new grants of employee stock options, comparable rights (e.g. warrants and convertible bonds) and share awards that vest on or after 1 January 2007. The Minister of Finance confirmed that in principle the costs of incentive arrangements settled in cash would still be deductible for CIT purposes. Therefore, to qualify for CIT deduction, the selected incentive arrangement should in principle be structured as a cash-settled arrangement.

4. Funding

Management will not always have the financial resources to make the investment in the target that the private equity house requires. A bank or the private equity house itself can provide management with funds to make the requisite investment or to pay the income tax due on the stock options in the form of either an interest-bearing loan or an interest-free loan.

Interest-bearing loan

If an interest-bearing loan is provided the manager has to pay annual interest on the loan. In determining the appropriate interest rate, the company could apply market interest rates or the 'standard' annual interest rate as set by the Dutch tax authorities (4.7% for 2007). Please note that this 'standard' interest rate is adjusted annually and parties are free to decide whether (i) the annual interest will be payable annually or (ii) will accrue to the principal of the loan. If the annual interest rate is equal to or higher than the 'standard' annual interest rate set by the Dutch tax authorities, this should not result in a taxable benefit for Dutch wage tax purposes. Therefore, under such an arrangement, the effective annual costs for the employee would be equal to the interest payable to the company.

Interest-free loan arrangement

An interest-free loan constitutes a taxable benefit. The fact that no interest is paid on the loan provided to a manager/employee is deemed to be a benefit in kind and should be reported annually in the company's local Dutch payroll administration. The taxable benefit is again based on the 'standard' interest rate as set by the Dutch tax authorities. In order to determine the taxable

benefit of the loan, a 4.7% annual interest rate (2007) will be attributed to the value of the interest-free loan and will be taxed at a maximum of 52% (2007). The participant will therefore pay tax at an effective rate of 2.44% annually.

Completion bonus

As already mentioned in section 2.4, completion bonuses are often used to fund the management's participation.

5. Overview

To sum up, the initial considerations in selecting the appropriate participation arrangement are the target group (i.e. Tier 1, Tier 2 or an even broader group) and the purpose of the incentive arrangement (i.e. alignment, retention or incentivisation). Once these basic underlying principles have been identified, the structure of the participation can be determined on the basis of the corporate structure of the transaction and the tax implications for both management and the company. In addition to careful structuring of the documentation, the valuation of the instruments is crucial for Dutch tax purposes and is determined by the transaction structure, the amount of the investment and the likely pay-out. Consideration should also be given to the tax, legal and financial (accounting) implications of the participation structure selected. Finally, communication tools may help management to fully understand and appreciate the implications of the design and structure of their participation in the investment and how their total reward package establishes a link between reward and performance.



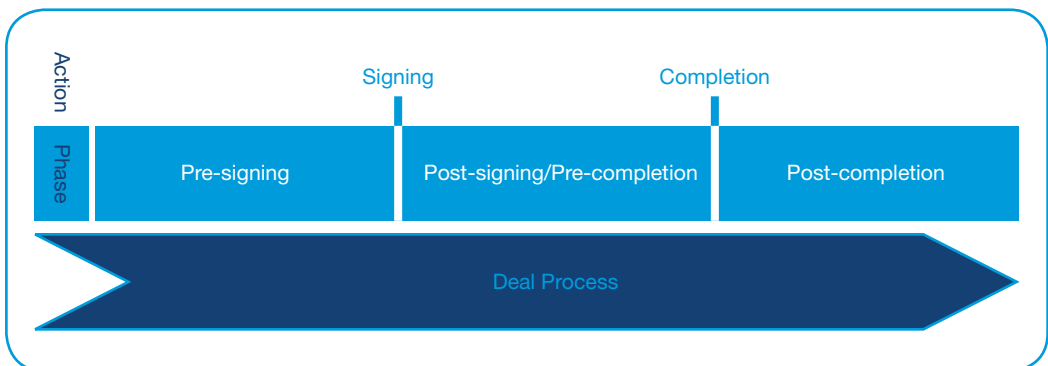
8. Share Purchase Agreements

1. Introduction

One of the most essential aspects of a share deal is the Share Purchase Agreement (SPA). The SPA documents the binding terms of the transaction, such as the parties involved in the share deal, the purchase price, the closing date, warranties and/or indemnities by the seller and/or the purchaser. Essentially, the SPA is a mechanism for allocating risks between the parties in a share deal. Therefore, all matters that are of relevance to either the seller or the purchaser should be documented in the SPA.

2. SPA and the phases of the deal process

The simplified model below shows the various phases and actions in a deal process. The remainder of this chapter discusses these phases and actions in relation to the terms of the SPA .



- Pre-signing phase: during the pre-signing phase the purchaser can decide not to proceed with the deal without penalties, for example in light of the outcome of the due diligence.
- Signing: the date on which sellers and purchasers agree on the sale and purchase of the shares in the target company in accordance with the conditions set out in the SPA.
- Post-signing/Pre-completion phase: during this phase, also known as the straddle period, the purchaser cannot walk away from the deal unless specific clauses have been inserted in the SPA, and generally a penalty is due. This phase of the deal typically involves fleshing out the conditions in the SPA and securing approval from authorities, competition bodies [in the Netherlands being the 'Nederlandse Mededingings Autoriteit'], works councils, etc.
- Completion (or closing): at the time of completion (or closing), all the transactions that have to take place to finalise the share deal are carried out (such as the signing of the deed of transfer of the shares, the payments that need to be made by the purchaser to the seller, etc.). From this moment the purchaser is the owner of the shares to which the SPA relates.
- Post-completion phase: after completion the deal cannot be cancelled; only a final pricing adjustment can be made in accordance with the pricing mechanism that was agreed in the SPA.

3. General content of SPAs

SPAs generally include the following clauses:

- Definitions: the key definitions that are used throughout the SPA;
- Sale & Purchase: this section defines what is being sold and who the sellers and the purchasers are;
- Consideration: this section defines the purchase price. The purchaser's interest at the time of the SPA is to pay what he is willing to pay based on the information available at the time of the acquisition. However, some aspects of the target company and its subsidiaries may still be uncertain at the time the SPA is signed. Deferred compensation is then negotiated to cater for these uncertainties at closing. Various methods of adjusting the purchase price that might be included in the SPA will be discussed briefly below;
- Warranties and Indemnities: this section sets out the financial exposures of the target company and its subsidiaries that are covered by warranties and/or indemnities (see below for a more extensive discussion of warranties and indemnities);
- Completion/closing: this section stipulates when the shares will actually be transferred from the seller to the purchaser and describes the actions that have to be taken at that time to complete the share purchase;
- Post-completion or straddle period restrictions: this section sets out the restrictions on the activities that the seller can carry out without the prior written consent of the purchaser.

4. Translation of the outcome of the due diligence into the SPA

The due diligence (see Chapter 3) reveals information for a purchaser regarding various legal rights and obligations and (potential) historic exposures of the target company and its subsidiaries. For example, possible future penalties imposed in relation to transactions prior to completion for which taxes had to be paid but were not reported or paid to the tax authorities may have an impact on the value of the target and should consequently affect the purchase price. The same applies for future tax liabilities that might arise from the period prior to the completion but that have not yet been accounted for by the target company and its subsidiaries. For example, if the company has not applied the correct VAT rates or the correct VAT qualification to certain costs, VAT may be due as yet together with penalties and late payment interest.

Consequently, the buyer may decide not to proceed with the share deal because the potential exposure is too great. Whether the buyer will incur a penalty depends on the phase of the deal process when this occurs. Alternatively, the parties can negotiate to cover the risks with:

- Disclosures (exceptions to the warranty) that are accepted by the purchaser without a price adjustment;
- Disclosures that are accepted by the purchaser in return for a price adjustment;
- Warranties and penalties to be included in the agreement;
- Indemnities.

5. Protection from tax liabilities

Possible exposure of the target company and its subsidiaries arising from the period prior to completion can be covered by warranties or indemnities. The following sections briefly describe the differences between the two.

5.1 Warranties and disclosures

Warranties

A warranty is a statement by the seller that the business it is selling corresponds with the information it provided to the buyer and which caused the buyer to decide to purchase the shares at the price that was agreed. In general, a warranty only covers a specific fact relating to the target company and its subsidiaries. If the statement proves to be false, the buyer can claim financial compensation for damage arising from the provision of incorrect information. Warranties are necessary because the law provides little protection for a buyer with respect to the assets and liabilities of the target company.

However, the protection from tax liabilities is limited by a number of factors. First, a warranty is subject to time constraints. In this respect, the buyer needs to make sure that the warranties only lapse several months after the expiry of the statute of limitation period in order to ensure that he will be able to recover any tax exposure during the entire period during which the exposure may arise. Second, the seller can limit liability by fixing a maximum amount for claims. Third, warranties can be limited by disclosures by the seller.

Disclosures

A buyer cannot sufficiently rely on warranties without disclosure of the documents and other relevant information pertaining to the specific SPA warranty. Such disclosure is usually provided through a Disclosure Letter.

Inadequate disclosure may expose a seller to a claim under a warranty in the SPA. Furthermore, the negotiation of the Disclosure Letter can serve as a mechanism to eliminate nasty surprises for the buyer before he commits to the purchase.

Depending on the wording of the SPA, the seller may not be liable for any fact or circumstance that:

- was mentioned in the Disclosure Letter;
- was identified by the purchaser during the due diligence process;
- was included in information in the data room.

The buyer must therefore conduct very thorough research since he will not be able to recover financial damages at any time.

Furthermore, the seller cannot be held liable for damages if the claim arises from any action or omission of the purchaser after completion (for example, contacting the tax authorities).

5.2 Indemnities

By contrast with a warranty, an indemnity requires the seller to make payments to the buyer if, after completion, the target company and/or its subsidiaries become liable for specific unforeseen tax liabilities in connection with matters that arose prior to completion. In that case the amount of tax that has to be paid by the target company or one of its subsidiaries will exceed the amount that was provided for and the shares in the target company will prove to be worth less than the buyer originally thought. The amount that the buyer can recover is on a “euro for euro” basis.

In certain respects, however, an indemnity is inadequate. An indemnity covers a buyer for unexpected tax liabilities that may arise during an agreed period. However, it is also possible that a seller has claimed an exemption, relief or performed a transaction in the past that may result in a future tax liability (i.e. a post-completion tax liability). Such a tax charge does not relate to the period covered under a tax indemnity so those items should be covered under a tax warranty. A tax indemnity may be inadequate with regard to the following items:

- Exemptions claimed in the past if they may be reversed in future years;
- So-called tainted transactions within a fiscal unity that may limit the flexibility of a buyer;
- Disputes with the tax authorities;
- Compliance aspects in general (i.e. items that have an impact on the company’s future tax position).

5.3 Protection from tax liabilities in relation to private equity funds

Indemnities and the sale of shares by private equity funds

Unexpected tax liabilities that arose prior to completion and which are covered by tax indemnities in the SPA can have a significant impact on the purchase price after completion. As private equity funds are typically driven from a return on investment/cash-flow perspective, in principle they cannot pay for any historical tax liabilities that arise from a target whose shares have been sold by a private equity fund, as the return on investment is settled on the exit and claims cannot be recovered from the private equity fund afterwards. Private equity funds are therefore usually unwilling to provide the purchaser with any indemnities in the SPA but instead aim to negotiate to transfer all historical tax with the shares that are sold. In this respect, they may rather grant the purchaser a discount on the purchase price than maintaining uncertainty about whether any future payments of tax liabilities may impact their return on the investment which has normally already been distributed to the investors.

Indemnities and the purchase of shares by private equity funds

Nevertheless, when private equity funds purchase shares in a target company they usually negotiate to have tax indemnities included in the SPA, since private equity funds are - again from a return on investment/cash-flow perspective - unwilling to account for any tax liabilities that arise from the period prior to completion (i.e. the private equity funds do not want the return on their investment to be affected by tax liabilities that arise from the period during which the target company was controlled by other parties). Again, if the seller is a private equity fund (i.e. a secondary buy-out) it will be difficult for a buyer to negotiate any indemnity.

6. Purchase price adjustments

6.1 Earn out

As already mentioned, the SPA can also include mechanisms to determine adjustments to the purchase price after completion. An earn-out clause refers to deferred compensation (in cash or in stock) based on the future results of the target when the seller continues to operate for a certain period after the sale. Such clauses are particularly effective in motivating the vendor after the sale. They may also be tax-efficient for the seller, since a price adjustment after the sale still qualifies as a capital gain on shares which may be tax-exempt for the seller (and non-deductible for the vendor).

The share purchase agreement can also provide for adjustments to the purchase price depending on a number of contingencies, such as the result of a post-closing audit of the accounts, the outcome of a material piece of litigation or the receipt of a tax assessment.

In this context, a deferred payment can offer protection for the purchaser when it is linked to contingencies that might affect the value of the acquired company.





9. Transaction Costs

1. Introduction

The acquisition of a business generally involves substantial transaction costs, ranging from legal fees for the purchase agreement to the charges invoiced by banks for providing debt financing. Different transaction costs are treated differently for tax purposes. Some costs are tax deductible, others are not. The extent to which the VAT on these costs can be recovered is also important.

2. Purchase costs and corporate income tax

2.1 Restriction on deduction of purchase costs

Current legislation on the participation exemption states that costs relating to the purchase of a participating interest are not deductible for corporate income tax. Selling costs associated with the disposal of a participating interest are excluded from deduction as well. The legislature has stated that purchase costs are “all costs that a taxpayer has to incur to achieve its intended holding in a participating interest”.

However, this does not mean that all costs incurred in relation to an acquisition are covered by the restriction on deduction, since a distinction can be made between purchase costs and financing costs and corporate expenses. The latter cost categories are typically tax deductible, even if they are related to a transaction.

Purchase costs

Purchase costs are not deductible and have to be capitalised, which increases the cost of the participating interest. Any subsequent downward revaluation or disposal of the participating interest is covered by the participation exemption, which excludes the costs from the taxable profit. Capitalised acquisition costs will effectively only lead to a deduction if the purchased participating interest is dissolved (by application of the liquidation loss rules). Examples of purchase costs include fees charged by external advisers to draw up the purchase agreement and the fee paid at the end of the transaction to an intermediary in connection with a successful acquisition.

Financing costs

Financing costs are generally tax deductible. They relate mainly to debt drawn to finance the acquisition. Examples of financing costs are interest payments (see also Chapter 5) and handling and arrangement fees paid to the entity which has successfully arranged the financing.

Corporate expenses

Corporate expenses are generally tax deductible. Corporate expenses can be defined as the normal costs of running a company. They are costs that would be incurred even if no participating interest were to be acquired in a given year. Examples of corporate expenses are incorporation costs, Chamber of Commerce fees and the costs of preparing the consolidated balance sheet.

Some costs are not easy to classify. They include the costs of a due diligence review (see Chapter 3) or advice on the tax structure (see Chapter 5). Since banks use such reports when assessing the

creditworthiness of the future debtor some or all of these costs can be attributed to the financing of the transaction and can be deducted. A formula that could be used for the allocation of the costs is the proportion of the acquisition that is financed with debt. Note that the allocation of costs that do not clearly fall into one or other of the above categories ultimately depends on the circumstances of the actual case. According to the circumstances of a particular case it will be possible to allocate more or less of the costs to the deductible financing costs.

In view of the different tax treatment of the various types of cost, it is always important to distinguish in the costs and invoices between expenses and activities associated with financing the transaction (financing costs), costs which would be incurred irrespective of the transaction (corporate expenses) and purchasing costs. It could be useful to break down the invoices according to these categories.

2.2 Capitalised from what point

Apart from being able to identify the different types of transaction cost (purchase costs, corporate expenses and financing costs), it is also important to know from what point in the transaction process certain costs are no longer deductible. It is conceivable that costs which would be classified as generally non-deductible purchase costs according to the above guidelines are nevertheless deductible because of the period when they were incurred. An example is costs connected with due diligence reports prepared during a bidding process for a possible acquisition.

Current case law on the treatment of costs states that the question of whether costs should be capitalised or may be deducted has to be answered in light of the information available at the time they were incurred. It is important in this context to establish the precise status of the acquisition process at every moment that costs are incurred. A substantial portion of the costs may still be deductible if there is a sound analysis.

2.3 Transaction costs for inclusion in a fiscal unity

According to Dutch tax literature, the non-deductible category of purchase costs could still be deductible if the acquired company joins a fiscal unity with the acquiring holding company from the acquisition date.

Deductibility depends on whether, from a tax perspective, a participating interest relationship continues to exist with the target after it has been included in the fiscal unity. The wording and history of the law shows that no such participating interest relationship exists after the companies are joined. From a tax viewpoint, with the inclusion of the target in the fiscal unity it is not the interest in the subsidiary but the subsidiary's assets and liabilities that are included in the parent's balance sheet. For tax purposes, the transaction is similar to an assets-liabilities transaction and so it could be argued that if the companies are immediately joined there is no identifiable participating interest. One could argue that the purchase costs would then be deductible. This subject has not been tested in the tax courts so there is no certainty on this point.

3. Costs related to the issuance of shares

The main criteria for judging the deductibility of costs relating to the issuance of shares relate to the nature of the costs. Should the commission ultimately paid to the banks (underwriter) be associated with financial services commission (i.e. intermediary services and insurance of placement with the public) then these costs would be accounted for in the issuing company. The fees will in that case be paid out of the proceeds of the issuance. It is therefore arguable that these costs should be tax deductible.

Alternatively, the commission may be associated with the right of the banks to issue/sell the shares of the issuing company. This situation would be comparable to the bank having a put option. In such a scenario, the issuing company renounces part of the proceeds from the issuance, effectively reducing the proceeds for the issuing company. Accordingly, the costs relating to the issuance are treated as a non-deductible discount on the gross proceeds and thus the costs should not affect the entity's taxable result.

The underwriting agreement is a very important source of information for the Dutch tax authorities in determining the tax treatment of the costs. To safeguard the deductibility of the costs it is therefore important to consider the tax consequences when drafting the underwriting agreement.

4. Acquisition costs and VAT

The treatment of acquisition costs for VAT depends very much on the specific circumstances of the individual case. There are, however, some basic principles with regard to the recoverability and possible recharge of transaction costs and the VAT due on them.

4.1 Recipient of the services

From a Dutch VAT perspective it is very important to determine which company is the recipient of the service. In that context, it is strongly recommended that during the structuring process, when the optimisation of the structure takes place, it is determined which company is/should be regarded as the recipient of the services and to ensure that engagement letters reflect this position or are assigned/novated to the recipient accordingly.

4.2 Recoverability of VAT on transaction costs

The principal rule is that there is “no deduction of VAT without VAT entrepreneurship and VAT taxable activities”. Furthermore, in the Netherlands there is a “use and enjoyment” rule which provides that non-entrepreneurs are liable for self-assessment for Dutch VAT on services from non-EU service suppliers if the services are deemed to have been used and enjoyed in the Netherlands.

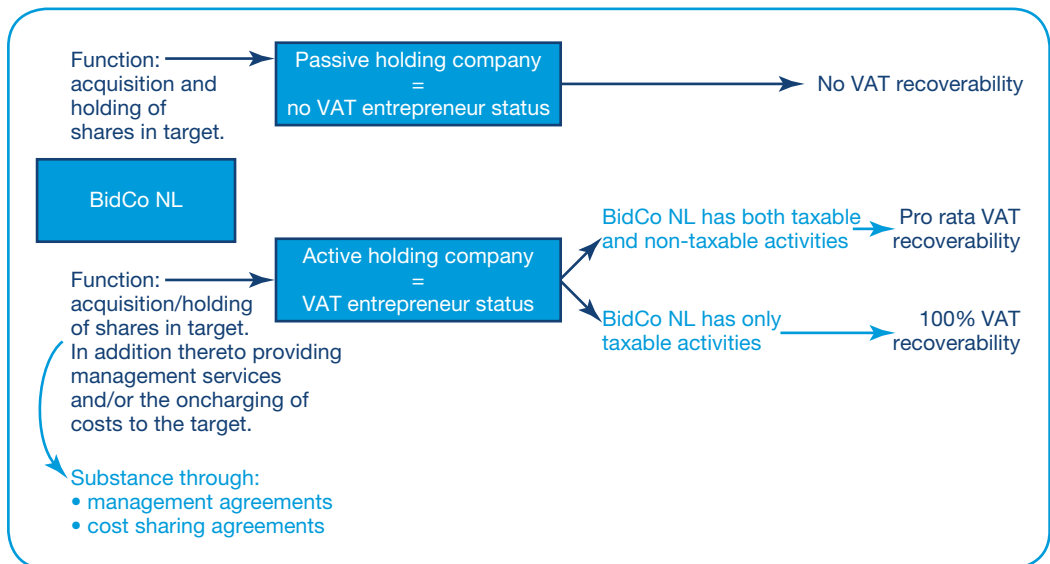
It is therefore important in cases where an acquisition holding company, which is generally newly incorporated, is used to consider the details of the VAT entrepreneurship and the VAT treatment of the different types of costs that will be incurred well before the actual acquisition takes place. A

holding company is only regarded as an entrepreneur for VAT purposes if it has economic activities in addition to merely holding the participating interest. Economic activities would for instance be the provision of management services by the acquisition holding company for the target.

It is generally also possible to obtain the status of VAT entrepreneur by recharging costs through a cost-sharing agreement. Consideration could also be given to forming a VAT group between the acquisition holding company and the target companies.

If the holding company qualifies as a VAT entrepreneur, self-assessed input VAT on invoices issued to the holding company can generally be recovered. As a general rule, transaction costs (purchasing and selling) form part of the residual/general costs of the holding company with respect to determining the recoverability of the VAT on those costs. General costs are normally recoverable for VAT purposes on a pro rata basis, the percentage being calculated over the turnover on taxable supplies in relation to the total turnover of the holding company.

The figure below illustrates the VAT recoverability in different holding company situations.



While general costs in principle lead to a proportional entitlement to recovery, this is often not the case for costs connected with the financing of the acquisition.

These financing costs and financing activities are generally VAT exempt and do not create an entitlement to deduction (see Chapter 6 on this point). The fact that providing financing is VAT exempt may also be relevant in the situation where the holding company not only provides management services but will also grant interest-bearing loans to the target. As indicated above, the percentage of the holding company's turnover that arises from VAT-exempt services (the supply of group financing) can increase and might have an adverse effect on the company's

position in terms of recovering input VAT since in principle the part of the VAT on the transaction costs directly attributable to the VAT-exempt financing activities cannot be recovered unless the financial activities are performed for non-EU established recipients. The VAT-exempt activities might also impact on the input VAT recovery in relation to general costs which cannot be attributed to either VAT-exempt or VAT-taxable activities.

4.3 Recharging transaction costs

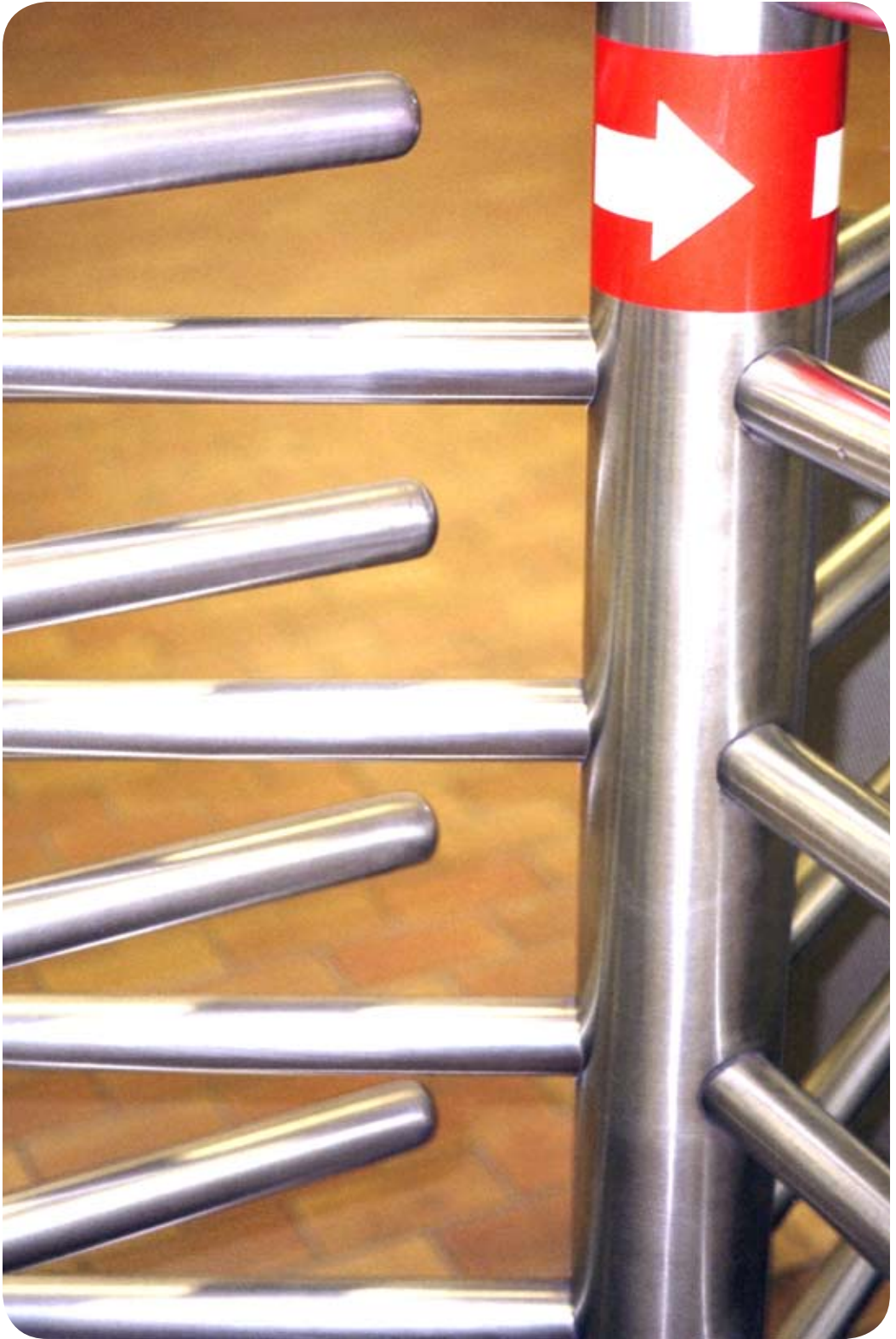
The invoices of the various service providers are usually sent to the company that concluded the agreement with them. Depending on which company ultimately benefits from the service and qualifies as the recipient of the service (see our comments above), part of the transaction costs may be passed on to different group companies (see our comments about the use and enjoyment rule). The costs that can be passed on include financing costs and legal fees for setting up the holding company structure.

Since the passing on of different types of costs can have different VAT consequences, it is important to consider aspects such as whether the various costs should be passed on separately instead of as a bulk of costs. Furthermore, to avoid VAT leakage it is also important that the company the costs are passed on to is also entitled to recover input VAT it incurs when recharging transaction costs.

As already mentioned, the supply of VAT-exempt activities can have an adverse impact on the supplier's input VAT recovery position. Hence, when recharging costs associated with VAT-exempt (banking) services the impact on the input VAT recovery position of the recharging entity should be closely monitored. An alternative might be for the bank to send its invoice directly to the relevant group company. This would mean, however, that the bank's original agreement with one company has to be replaced by an agreement with the group company that is invoiced or alternatively that the original contract should contain a novation clause or be assigned to the relevant group company.

Acquisitions generally involve substantial transaction costs. The CIT and VAT implications of the costs should therefore be considered carefully since proper treatment of acquisition costs may lead to a fair result on which part is or is not tax deductible. It is important to consider the acquisition costs at an early stage of the structuring process. To reduce risks and prevent VAT leakage it is advisable to keep proper records of the costs associated with the transaction and to address the topic of VAT entrepreneurship and VAT recoverability in good time.





10. Post-deal services

1. Introduction

Following completion of the deal, the envisaged tax efficiencies of the acquisition structure have to be realised and sustained and unforeseen tax leakage has to be avoided. This means that tax formalities must be observed in good time and management must have a clear understanding of the legal and tax structure that was employed. With a view to the future exit, it is also important to address any issues that were identified during the tax due diligence in a timely fashion and to optimise the tax compliance position of the target companies.

2. Formalities

2.1 Tax registration of newly incorporated companies

When new companies are incorporated they have to be registered with the tax authorities in their respective jurisdictions. It is important to arrange their registration soon after completion of the deal to ensure that the companies are recognised by the tax authorities and become part of the regular compliance process (e.g., issuance of assessments and tax returns, extension of filing dates, etc). Early registration will also facilitate the processing of a request for an advance tax ruling or a tax grouping.

In the Netherlands, registration for corporate income tax and wage tax purposes is generally a formality. However, attention must be paid to the information provided in relation to the VAT registration. As discussed in chapter 10, VAT on acquisition costs can only be reclaimed if the claimant qualifies as an entrepreneur for VAT purposes at the moment of tax registration.

2.2 Tax grouping

If the intention is that the acquisition and target companies will form a tax grouping for corporate income tax purposes in their respective jurisdictions of tax residence, a request must generally be submitted to the tax authorities within a certain timeframe.

In the Netherlands, such a request must be submitted to the tax authorities within three months of the acquisition of the legal and beneficial ownership of the target companies. If the request is not submitted in time it will not be possible to use part of the profits of the target companies to offset the transaction and financing costs to the extent that such costs are deductible.

Furthermore, a tax grouping can generally only be established if certain requirements are met on a permanent basis. It is therefore important to closely monitor compliance with the requirements following completion of the deal. See Chapter 5, Section 7 for an overview of the requirements that must be complied with to establish a tax grouping for Dutch corporate income tax purposes (e.g. effective management and control of the companies must be situated in the Netherlands, 95% legal and beneficial shareholding threshold, concurrent financial years, etc).

If the acquisition and target companies would also like to form a tax grouping for VAT purposes a separate request must be submitted to the relevant tax authorities. In addition, if the target

companies were part of a Dutch or foreign tax grouping with the seller, another request must be submitted to cancel such tax grouping with respect to the acquired target companies.

2.3 Transaction costs

Following completion of the deal, the transaction costs must be charged to the appropriate acquiring companies and may then be charged on within the group. We refer to our comments in Chapter 9. This process must be monitored closely to mitigate the risk of any unnecessary tax leakage.

2.4 Compliance with advance tax rulings

If the tax treatment of the acquisition structure has been agreed in advance with the tax authorities and an advance tax ruling has been issued, it is essential that the facts and circumstances on which the ruling was based do not materially change following the completion of the deal. For example, if the ruling request describes the fund's decision-making process it is essential that the actual decision-making process corresponds with the facts and circumstances presented in the request. If the actual situation differs from the facts and circumstances as presented the advance tax ruling may be void, in which case there is no agreement on the tax treatment of the acquisition structure. Therefore, the tax authorities must be informed as soon as possible if it becomes apparent that the facts and circumstances will change following the conclusion of the advance tax ruling.

Furthermore, advance tax rulings generally apply for a fixed period of time. If the rulings expire prior to exit it is important to renegotiate the rulings in good time.

2.5 Compliance with Sale and Purchase Agreement

The sale and purchase agreement generally contains provisions regarding the allocation of tax compliance responsibilities between the seller and purchaser prior to and after completion of the deal. The sale and purchase agreement may also prescribe other obligations for the seller and purchaser. It is therefore important to carefully review the sale and purchase agreement and determine internal responsibilities following the completion of the deal to ensure that the sale and purchase agreement is executed correctly.

2.6 Changes in existing legislation

In principle, the tax treatment of the acquisition structure is based on the laws that are effective at the time of the transaction. However, tax legislation changes regularly, in most jurisdictions even annually, and it is therefore essential to monitor such changes closely following deal completion.

3. Follow-up tax due diligence issues

Tax warranties and indemnities are generally limited in their duration and can only be relied upon if the seller is informed of an alleged breach of a warranty or indemnity within a certain timeframe. To avoid losing its entitlement to invoke a tax warranty or indemnity, it is important for the purchaser to address tax issues that were identified during the tax due diligence in a timely fashion. Some

tax issues may require further analysis in order to get a better understanding of the actual risks involved, while for others agreements may have to be reached with the tax authorities. See Chapter 3 for a discussion of the issues that are typically investigated during a tax due diligence.

Besides ensuring that tax warranties and indemnities can be invoked, addressing the tax issues identified in the due diligence issues also helps clear away any tax obstacles to a smooth and efficient exit.

4. Refinancing

As described in chapter 7, banking or legal requirements may make it necessary to refinance existing debt or effectuate debt push-downs in the acquisition structure after completion of the deal. These refinancing processes need to be implemented in accordance with the transaction documentation whilst maintaining the envisaged tax benefits of the acquisition structure.

5. Reporting and accounting – tax position

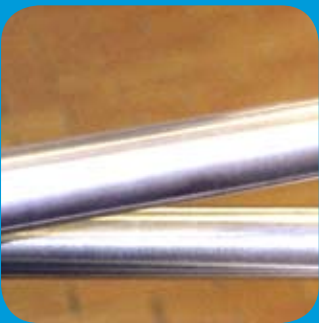
Following completion of the deal, the acquisition and target companies must adopt new reporting and accounting policies. This involves, inter alia, establishing appropriate reporting lines and assessing existing IT systems in order to determine their compatibility with the shareholder's IT systems to ensure efficient reporting of financial and management information.

In today's business environment, companies also need to remain in control of their tax position and have a clear understanding of their tax weaknesses. Establishing new reporting lines may present a good opportunity to establish and implement a so-called Tax Control Framework.

A Tax Control Framework basically entails establishing clear tax reporting lines, which is particularly important because the tax position is based on input from several departments within the organisation. Implementing a Tax Control Framework may therefore significantly mitigate the risk of weaknesses in the tax position, which is obviously also important from the point of view of a future exit.

A Tax Control Framework also enables companies to improve the effectiveness of their tax function and strategy since potential tax issues can be addressed at an earlier stage and the tax position can be managed proactively.

In relation to the Tax Control Framework and the tax position of companies in general, special attention should also be paid to compliance with the transfer pricing regulations in the various jurisdictions involved. Transfer pricing is high on the agenda of the tax authorities in the Netherlands and other countries and is generally identified as a risk during tax due diligences. Describing and documenting the transfer pricing processes should therefore be a high priority following deal completion.





11. Transactions Group

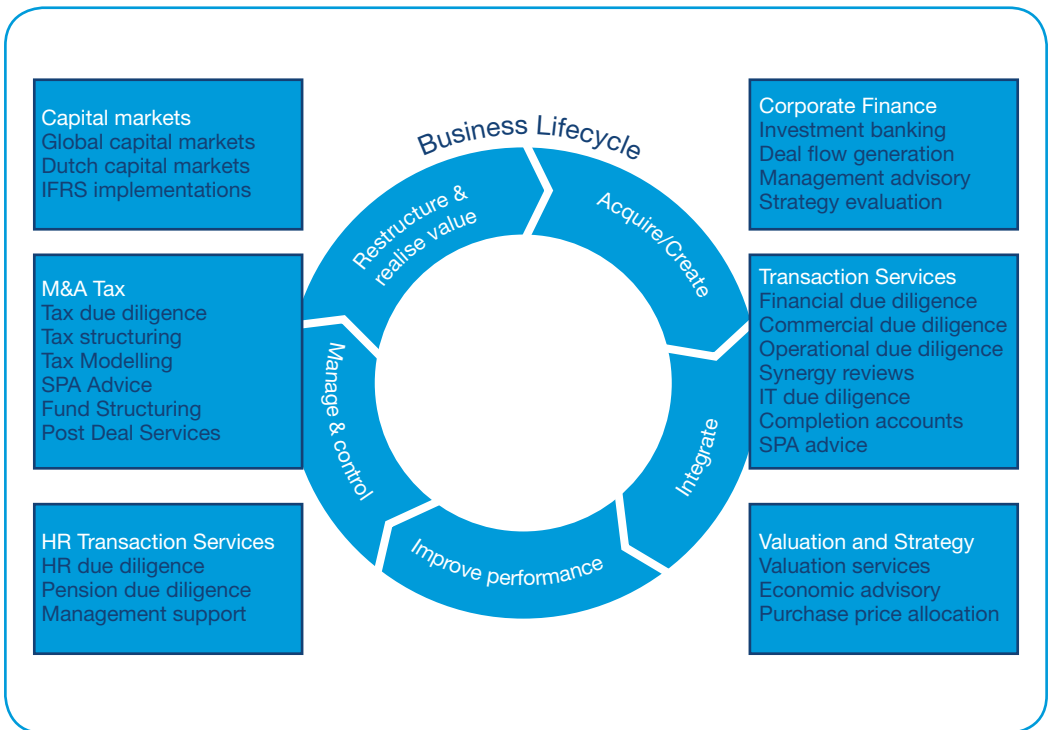
PwC

1. Introduction

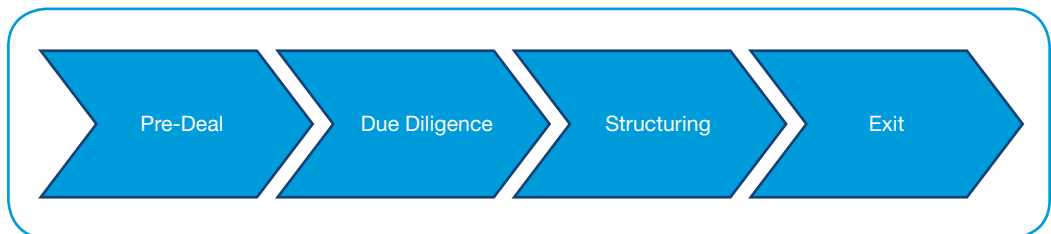
Technological changes, globalisation, deregulation and the ageing of the population. These trends are forcing corporations into a strategic reorientation. This results in acquisitions, disposals, alliances and capital market transactions. The focus of these transactions is on value maximisation and risk minimisation. PricewaterhouseCoopers (PwC) aligns its transaction-related services with the private equity deal continuum: from development and implementation of strategy to the implementation of change; from corporate finance and valuation to accounting and structuring.

2. Integrated, multidisciplinary approach

Transactions are looked at from various angles: from financial and commercial to fiscal and HR aspects to ICT and operational aspects. An integrated, coherent approach is the solution to the ultimate goal of risk minimisation and value maximisation. PwC’s Transactions Group offers various integrated services to optimise value for PE houses.



PwC's Transactions Group (TG) pursues a multidisciplinary approach and employs more than 250 professionals from our Assurance, Tax and Advisory service lines. The TG supports private equity from multiple angles throughout the deal continuum:



3. Sourcing deals

Corporate finance and investment banking

Private equity houses are always searching for new opportunities. PwC's specialist private equity team assists private equity houses in this process. Our Corporate Finance specialists have a detailed insight and broad knowledge of the markets and work closely with the firm's industry experts. Our Corporate Finance services include initiation of the transaction, valuations as well as structuring and arranging financing of the transaction and management participations.

4. Executing deals

Due diligence

Our Transaction Services specialists help private equity houses to assess a prospective acquisition with financial, commercial and operational due diligence advice. Prospective purchasers want an independent opinion on the target, including the identification of opportunities and risks, upsides and downsides and the value drivers of the target. Private equity houses use financial, commercial, operational and strategic information in their assessment of the target. Our due diligence specialists assist private equity houses in this analysis and are highly experienced in private equity transactions, resulting in a greater likelihood of a successful transaction.

Our commercial due diligence specialists extend the due diligence procedures to the market and commercial environment in which the target operates. What is the industry and what position does the company hold in this market? What is the target's potential in the light of market developments? A thorough assessment of the potential of a target is almost impossible without a detailed understanding of the market environment.

PwC's M&A tax specialists assist private equity houses in the taxation due diligence process during the acquisition process (see in more detail Chapter 3). The taxation due diligence focuses on identifying risks and opportunities in the areas of corporation tax, dividend withholding tax, VAT, wage tax and local taxes. Our tax specialists also assess the taxation structure and form initial views of potential taxation structures going forward.

Our HR Transaction Services team assesses the human resource risks and opportunities of the target, including remuneration and retention strategies and pension due diligence. Our IT due diligence specialists assess the information technology platform as well as the scalability of the IT organisation.

SPA advice and completion accounts

The outcome of due diligence procedures will often be reflected in a Sale and Purchase Agreement (SPA, see also Chapter 8). Our transaction specialists assist buyers in the financial and fiscal aspects of the SPA, such as fiscal warranties and closing mechanisms. Our transaction services specialists assist PE houses with the review of completion accounts with a view to minimising post-deal cash flow exposures.

Management advice and participations

In many PE transactions management will participate in the company going forward (a so-called MBO). For most managers this is a significant and important step in their relationship with the company. This requires careful planning from fiscal (see in more detail Chapter 7), legal and financial perspectives. Our management advisory role encompasses independent advice for management in complex buy-out situations as well as fiscal structuring of the management participation.

Deal translation

The closing of the transaction is followed by the accounting treatment of the transaction in the financial statements of the target or Newco. PE houses should at this stage consider what the optimal treatment of the acquisition is and which GAAP to use. If an exit through an IPO is being considered, companies may wish to move to IFRS or US GAAP at an early stage. Our deal translation specialists identify the potential accounting issues and treatments prior to the closing of the deal and assist PE houses in the implementation following the closing, including purchase price allocation. PwC's valuation and strategy specialists assist companies in the valuation of the tangibles and intangibles required for purchase price allocation under the various GAAP.

Economics

The specialists in PwC's Economics group focus on analysing economic, political and strategic issues. Particularly important are competition aspects, such as approval by the Netherlands Competition Authority (NMA). Our specialists build a case with analysis underpinning and supporting NMA approval requests.

5. Creating value

Fiscal structuring

During the third period of the investment life cycle of a PE investment the focus will be on the implementation of the transaction, integration and performance improvement (creating value). The fiscal due diligence has laid the basis for identifying the optimal fiscal structure. Our fiscal structuring specialists assist PE houses in setting up an optimised fiscal structure (see in more

detail Chapter 4), including maximising interest deductibility, minimising effective tax rates and tax efficient cash and dividend streaming (see in more detail Chapter 5 and 6).

Operational due diligence and post-deal services

An acquisition calls for a serious investment from key stakeholders in the company. Attention is often devoted mainly to the closing of the transaction. However, a thorough post-transaction operational plan is equally important. Our operational due diligence experts analyse the operational (and synergy) assumptions and improvement potential underpinning the deal. Our specialists are experts in the translation of operational assumptions to cash flow and ultimately the deal value and exit opportunities.

More and more PE transactions involve carve-outs from global organisations. Our carve-out specialists assist PE houses with the identification of carve-out issues and the implementation and the effectuation of the carve-out.

6. Exiting and realising value

Corporate finance and investment banking

PE houses have various exit opportunities such as IPOs, trade sale and secondary or tertiary buy-outs. PwC offers various services to assist PE houses in pursuing the best exit opportunities.

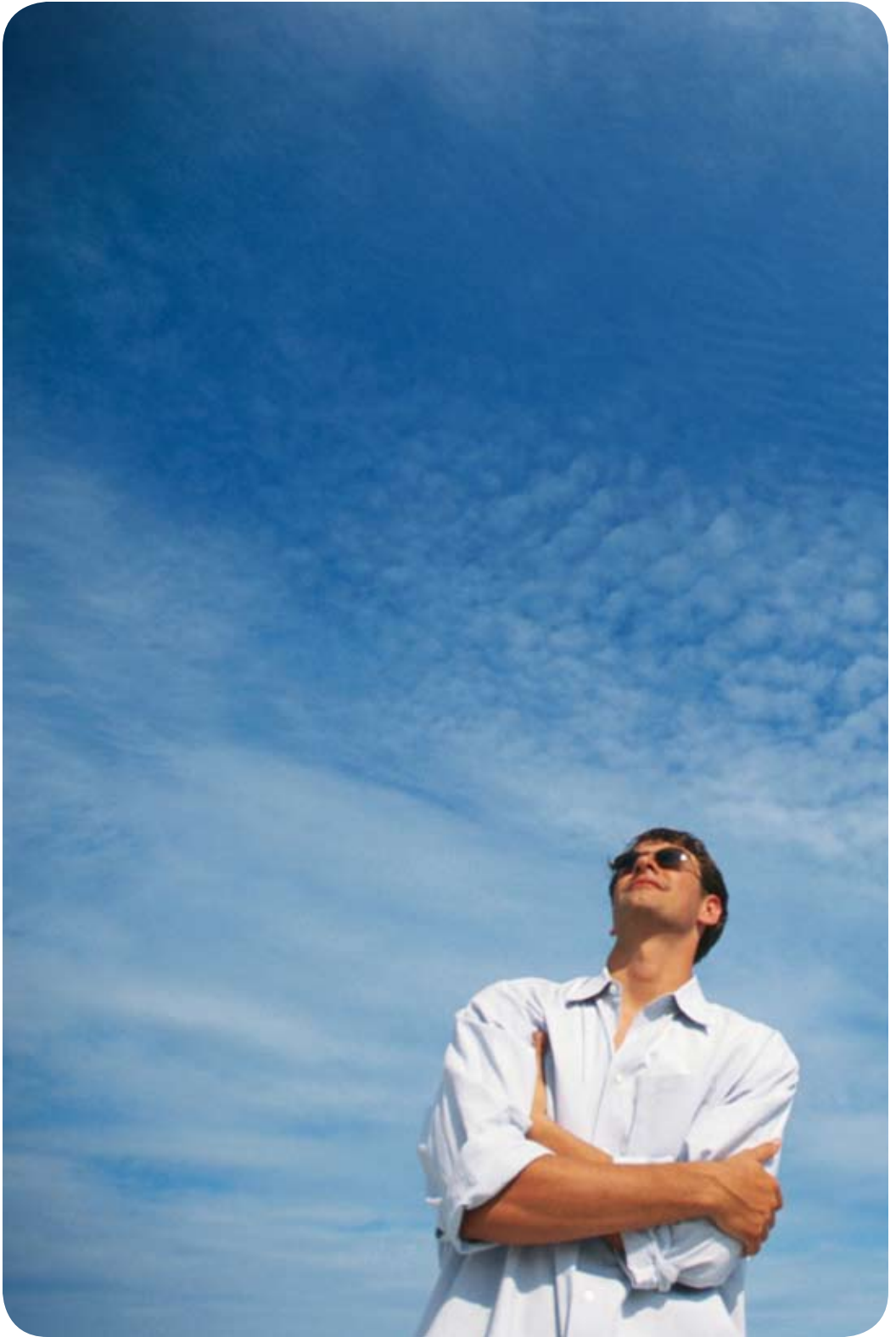
Our corporate finance specialists assist PE houses throughout the process of identifying the optimal exit strategy and identifying prospective purchasers.

Capital market transactions

IPOs are laborious and time-consuming projects with processes that are becoming more and more complex. Shareholders, investment bankers and regulators place increasing demands on the transparency and on the quality of the communication in general, and of the offering memorandum in particular. Our capital market specialists provide pre-IPO assistance including restatements into IFRS or US GAAP as well sponsoring due diligence services.

Vendor due diligence

More and more transactions with deal values higher than EUR 50 million are accompanied by a vendor due diligence report. The Vendor Due Diligence (VDD) is an independent full-scope due diligence that focuses on financial, commercial, operational, taxation, IT and HR matters. It provides vendors and prospective purchasers with a detailed impression of the risks and opportunities of the target. Detailed analyses will highlight potential blind spots at an early stage and support vendors and prospective purchasers in their decision-making process.



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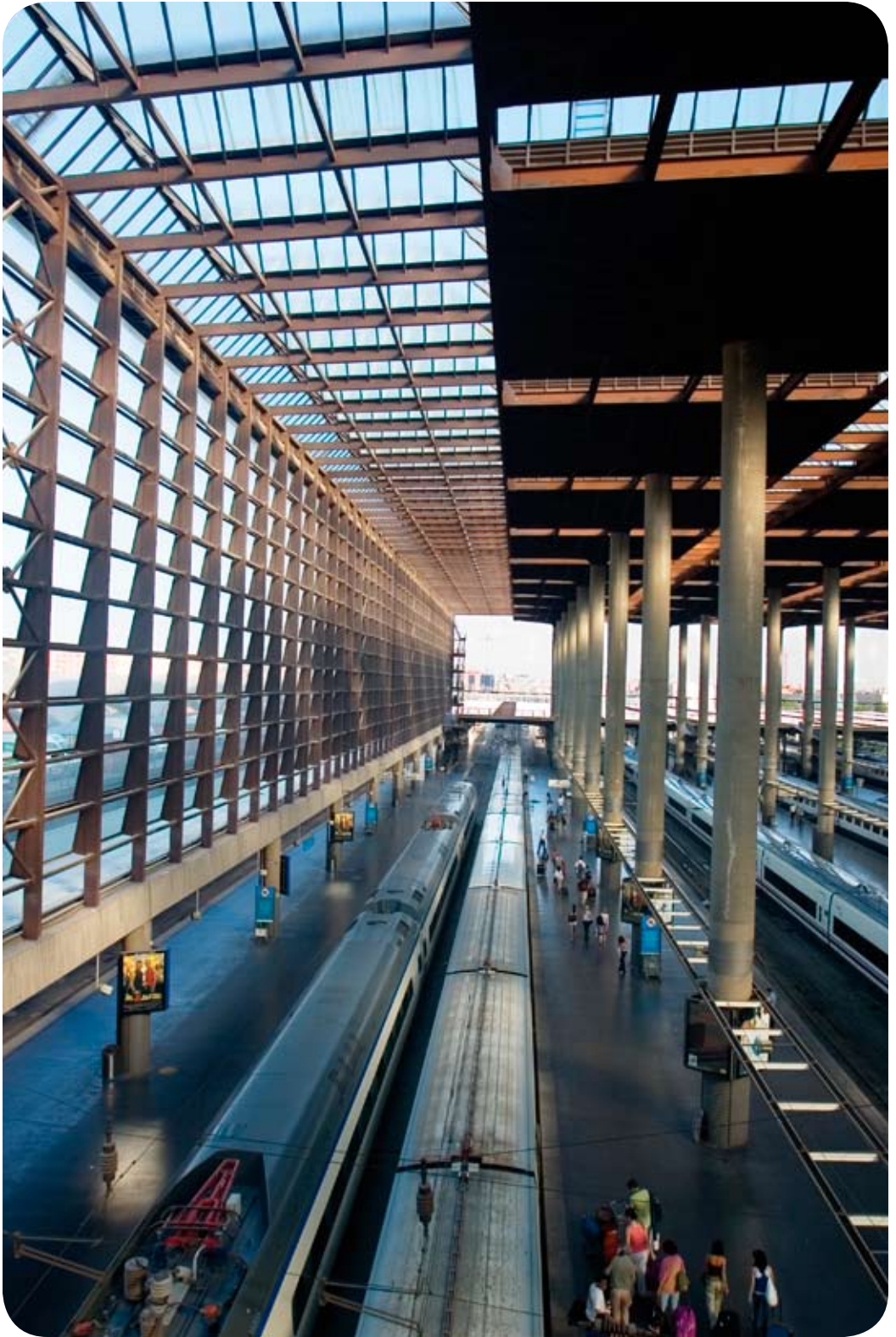
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Appendix I: High-level Dutch tax features

1. Introduction

Historically, the Netherlands has owed its reputation as a location for finance, holding and distribution companies not only to its geographical position and infrastructure but above all to its beneficial tax system. Appealing aspects for foreign investors include the Dutch participation exemption, under which both dividends and capital gains are fully tax exempt. Other traditional features were and still are the absence of withholding tax on interest and royalties and a worldwide network of tax treaties encompassing all EU and OECD member states and most countries in Central and Eastern Europe and the Far East, under which double taxation is avoided.

For private equity funds, where deals are often made in a short period of time, an attractive tax climate also depends on a tax administration that is able to cooperate at short notice. A tax authority that is accessible and works promptly helps dealmakers to eliminate tax risks and avoids discussions afterwards. In this respect, it is of importance for Dutch private equity practitioners that negotiations with Dutch tax inspectors tend to take the form of informal consultation.

As of 1 January 2007 significant changes were made in the Dutch corporate income tax regime and to several other taxes. The amending legislation was initiated because of the Dutch government's desire to create a competitive tax regime in a pan-European perspective. The Netherlands also extended the existing treaty network with newly concluded treaties in 2007.

The following sections describe these developments and a number of the business taxes which can be of relevance to private equity funds.

2. Reduction of the corporate income tax rate

The standard rate of corporate income tax, which had already been reduced from 31.5% to 29.6% in 2006, was further reduced to 25.5% with effect from 1 January 2007. The aim of the reduction is to attract more investment from foreign multinationals and also deter those multinationals that currently reside in the Netherlands from migrating to a better tax environment.

3. Reduction of the dividend withholding tax rate

The dividend withholding tax rate was reduced from 25% to 15% with effect from 1 January 2007. This should reduce the administrative burden for companies and shareholders as many shareholders will no longer be required to apply for a reduction from the general rate of 25% to the more common 15% treaty rate. With careful structuring, the dividend withholding tax can even be reduced to zero.

However, under most of the Netherlands' eighty tax treaties, dividend withholding tax is reduced even further or even mitigated altogether (see section 9). In addition, it should be noted that the Netherlands does not levy an interest and royalty withholding tax.

4. The participation exemption regime

Since 1 January 2007 the participation exemption applies consistently to shareholdings of 5% or more unless the shareholder's interest is a portfolio investment in a company that is subject to a tax rate that is not considered adequate (adequate being an effective tax rate on profits equal to at least 10% over a taxable base according to Dutch tax standards). This is measured at the level of the company itself, unless the company heads a tax consolidation group, in which case the consolidated effective tax rate applies. For Dutch portfolio investment subsidiaries that do not meet the 10% test, a tax credit method applies rather than a tax exemption.

It is very important to bear in mind that whether or not a shareholder's interest in a company constitutes a portfolio investment is determined solely by the assets of that company, including its own goodwill and other intangibles. For example, if the company's consolidated assets are predominantly 'free' portfolio investments or consist predominantly of assets used for passive group financing activities (e.g. group loans), the shareholder's interest will in principle be regarded as a portfolio investment. A distinction is made in this respect between portfolio investments held by a company in the course of its business and 'free' portfolio investments. Only the presence of 'free' portfolio investments can lead to qualification as a portfolio investment subsidiary. Portfolio investments held by a company in the course of its business (for example, as security for insurance obligations) are qualified as 'good' assets. In determining a company's consolidated assets the company's liabilities are not taken into account. In other words, loans from and advances to subsidiaries and lower-tier subsidiaries cannot cancel each other out.

The participation exemption will however apply to a participation in a subsidiary whose consolidated assets consist for at least 90% of real estate.

For a portfolio investment shareholding that does not fall under the scope of the participation exemption, double taxation will be avoided by applying the tax credit method, unless the portfolio investment shareholding is effectively not subject to tax at all. For EU shareholdings there is the option of crediting the actual underlying tax.

5. Fiscal Unity regime

A parent company and its Dutch-resident subsidiaries (of which the parent owns at least 95% of the shares) may, under certain conditions, file a tax return as a single entity ("fiscal unity"), which means not only that all intra-group transactions are ignored but also that intra-group reorganisations can take place without tax consequences. However, if the group breaks up a recapture may take place. Group taxation is available for companies whose place of effective management is in the Netherlands, both for Dutch tax and treaty purposes.

6. Net operating losses

From 1 January 2007 tax loss carry-back is available for one year. Tax loss carry-forward is limited to nine years. This also applies for start-up losses.

Complex rules may prohibit the utilisation of net operating losses after a change of 30% or more of the ultimate control in a company. Furthermore, there are limits to the possibilities of loss utilisation for holding/finance companies. Companies carrying out significant other activities (with 25 or more employees) are in principle unaffected by these loss relief restrictions.

7. Interest deductibility rules

A number of interest deductibility rules exist in the Netherlands which change regularly. Careful structuring is needed to secure the optimal effective tax rate in accordance with these rules.

8. Tax Exempt Investment Fund Regime

A new investment fund regime was introduced in the Netherlands in 2007. New legislation created an exempt investment fund regime that entered into force on 1 August 2007. The main characteristics of the new regime are that investment funds that are subject to it are exempt from corporate income tax and are not subject to dividend withholding tax. The bill was prompted by the Dutch government's desire to create a competitive tax regime for investment funds and to attract more investment funds to the Netherlands.

9. Tax treaty network

The Netherlands has a worldwide network of approximately 80 tax treaties, including treaties with all EU and OECD member states and most countries in Central and Eastern Europe and the Far East, under which double taxation is avoided. This network is steadily expanding. In 2007 the Netherlands concluded new treaties with Jersey (on the exchange of information relating to tax matters), the United Arab Emirates (to avoid double taxation on income) and Bahrain (to exempt tax on income and profits derived from international air transport). These treaties have not yet entered into force. The tax treaty with Barbados to avoid double taxation on income concluded in 2006 will be applicable as of 1 January 2008.

10. Value-added tax

Known in Dutch as BTW ('Belasting over de Toegevoegde Waarde'), VAT is payable on sales of goods and on services rendered in the Netherlands, as well as on the importation of goods and on the "intra-European" acquisition of goods. There are three tax rates.

| | |
|---|-----|
| Main tariff | 19% |
| Reduced tariff on certain prime necessities | 6% |
| Special tariff, applicable mainly to intra-European Union supplies, exports, imports stored in bonded warehouses, services rendered in connection with the above and certain other services | 0% |

The following are exempt from tax:

1. The supply of immovable property two years after putting it into use and lease. However, if the lessee uses the immovable property for 90% or more for input VAT-deductible purposes, the lessor and lessee may opt for VAT to be charged on the rent, in which case the lessor may deduct the VAT charged in respect of the property.
2. Medical, cultural, social, and educational services.
3. Services provided by banks and other financial institutions in connection with payment transactions and the granting of credit facilities.
4. Insurance transactions.
5. Transactions in shares.

11. Transfer tax on immovable property

Acquisition of economic or legal ownership of immovable property in the Netherlands is subject to a transfer tax of 6% of the market value; some exemptions are available.

12. Capital tax

In order to attract more foreign investment, capital tax was abolished as of 1 January 2006.

13. Other indirect taxes

Insurance tax of 7% is payable on insurance premiums if the party taking out the policy is a resident of the Netherlands or if the insured object is in the Netherlands. Several exemptions are available.

Municipalities impose immovable property tax on the owners of the immovable property. The rates vary from one municipality to another. The taxable basis is the market value of the immovable property. Please note that the (assessment of the) value as of 1 January 2007 is also of importance for corporate taxation since that value may limit the amount of depreciation.

Excise duties are levied on certain consumer goods (e.g., cigarettes, cigars, mineral oils, alcoholic products, etc.). No excise duties are levied if the goods are used solely as raw materials and duties are refundable if an article is exported.

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