



KPN Mobile's tax position – further explanation



This paper is meant to provide clarification on the tax position of KPN, more in particular the tax position of KPN Mobile for Dutch tax purposes in respect to the past and future results of E-Plus in Germany.

For Dutch tax purposes, Royal KPN (owner of the majority of KPN's fixed activities) and KPN Mobile are separate fiscal entities and therefore different taxpayers. In this paper reference is made to these different taxpayers using the terms 'Royal KPN' and 'KPN Mobile' respectively. The term 'KPN' is used for the KPN group as a whole.

1. Historical overview

In February 2001, KPN finalized the legal restructuring of its activities in Germany, which resulted in a German partnership structure that constitutes a permanent establishment of KPN Mobile for Dutch and German tax purposes.

In 2001 and 2002 KPN recorded losses from its German activities for Dutch tax purposes.

In December 2002, KPN financially restructured its Mobile activities in order to arrive at a more transparent financial structure and in order to strengthen KPN Mobile's financial position. This restructuring consisted of various steps under which Royal KPN converted EUR 14 bn of outstanding shareholder loans into 7 bn newly issued ordinary KPN Mobile shares with a nominal value of EUR 2 per share.

2. Agreement with Dutch tax authorities

A. Tax consequences

The tax consequences of the legal and financial restructuring were discussed with the Dutch tax authorities. As per April 26, 2004, KPN and the Dutch tax authorities reached an agreement on these tax consequences. The key elements of the agreement can be summarized as follows:

- Upon conversion in 2002 of the EUR 14 bn of shareholder loans, Royal KPN realized a loss for tax purposes of EUR 6 bn, which can be used to offset profits of 2002 and 2003. The remaining fiscal loss can be carried forward indefinitely to shelter future taxable profits of Royal KPN. KPN Mobile recognized a corresponding taxable gain of EUR 6 bn.
- The German partnership structure of E-Plus is transparent for Dutch tax purposes and, as a consequence, KPN Mobile is deemed to carry on business in Germany through a permanent establishment. This fact allows KPN Mobile to include E-Plus' results in the basis for its calculation of Dutch corporate tax.

- The interest accruals on the shareholder loans provided directly or indirectly by KPN Royal or KPN Mobile to E-Plus are ignored for Dutch tax purposes as the vast majority of these loans are considered to be equity. For KPN Mobile EUR 500 mn of related accumulated interest expense on a loan from Royal KPN is not tax deductible in the Netherlands.
- The losses incurred by the German permanent establishment are set at EUR 11.5 bn. For Dutch tax purposes, these losses can be used to offset the Dutch operating profits of KPN Mobile. Future profits of the permanent establishment will however be taxable in the Netherlands until the entire loss of the German permanent establishment has been recaptured. Thereafter profits of the German permanent establishment are exempt from Dutch taxation. For this purpose, the reversal of the loss of the permanent establishment is computed on the basis of the reported EBITDA of E-Plus.

B. Tax accounting consequences

The key tax accounting effects are the following

- Royal KPN recognizes a deferred tax asset of EUR 2.1 bn because of the loss of EUR 6.0 bn.
- KPN Mobile records a tax charge of the same amount, as a result of which its deferred tax liability is increased.
- A tax charge of EUR 173 mn is recorded in respect of the EUR 500 mn interest expense that is not tax deductible for KPN Mobile but that is taxable for Royal KPN.
- Since KPN Mobile recorded the interest income on its loans to E-Plus as taxable income in the past a EUR 1.2 bn release of the deferred tax liability is recorded.

3. Three periods

In respect of the future tax position of KPN Mobile three periods can be identified. In the first two periods the Dutch recapture mechanism applies. Recapture means that profit of a foreign permanent establishment is not exempt from tax in the Netherlands until the accumulated profit is equal to the accumulated loss of the permanent establishment that has earlier been off set against Dutch profit.

3.1 Period 1 – zero cash tax

In the first years of the application of the recapture mechanism, the fact that the E-Plus profit is not exempt from tax in The Netherlands nevertheless does not result in a cash payment of tax. This relates to the fact that the tax loss carry forward has not yet been fully used. This has been illustrated by a numerical example, which is attached as an appendix to this paper. As clearly stipulated in this appendix the numerical example is purely for explanatory purposes, it does not represent actual KPN numbers or forecasts of profitability and shall not be relied upon by any person in any way. Based on the example, the losses of KPN Mobile (see line 4) of originally EUR 5.5 bn (EUR 11.5 bn loss minus EUR 6 bn conversion gain) have been fully off set against Dutch profits and non-exempt profits of E-Plus in the course of the year 2007. Tax will then be payable (see line 6). The numerical example also shows that in period 1 a tax charge will be booked (increasing the deferred tax liability) in respect of the Dutch result of KPN Mobile.

3.2 Period 2 – cash tax higher than tax charge

Period 2 starts at the moment that the tax loss carry forward has been fully used and ends when the cumulative E-Plus profits as from 2003 equal EUR 11.5 bn. Period 2 is the period of the recapture of the remaining E-Plus loss, i.e., the original loss of EUR 11.5 bn reduced by the E-Plus profits in period 1. This remaining loss needs to be recaptured by way of taxation of E-Plus profits until the level of this remaining E-Plus loss.

During period 2 the cash tax payment will be higher than the tax charge because the cash tax payment is based on:

- a. the taxation of E-Plus profits (recapture);
- b. the taxation of Dutch results,

Whereas, equal to period 1, a tax charge will only be booked in respect of the taxation of the Dutch results (item b). The cash tax payment arising from the recapture (item a) will be funded by the deferred tax liability, which was created and charged against P&L in the course of the realization of Dutch results in period 1.

In lines 6 and 7 in the numerical example the above-mentioned effects are made visible.

3.3 Period 3 – cash tax equals tax charge

After the recapture has taken place the profits of E-Plus will be tax exempt in the Netherlands. Then period 3 starts in which the Dutch tax charge of KPN Mobile equals its cash tax payment. Lines 6 and 7 of the numerical example show this effect.

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