DOUBLE DUTCH: DIVIDEND TAX REFORM EXTENDS EXEMPTION, YET TACKLES ABUSE

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INTRODUCTION

In the Netherlands, the third Tuesday of September is known as Princes' Day (*Prinsjesdag*). This event clearly has two sides: Traditionally, it is the annual occasion for the Dutch to show their loyalty to the monarchy (and for the ruling family of Orange to show its royalty to the people in return). Politically, it marks the opening of the new parliamentary year, with the presentation of the budget proposals for the next year. In this regard, it is the Dutch equivalent of the U.K.'s Budget Day.

In line with this double-sided character, this year's budget contains a proposed dividend tax reform that has two sides as well. First, the legislative proposal provides for a significant extension of the existing exemption from withholding tax by introducing a unilateral exemption applicable to corporate shareholders based in treaty countries, such as the U.S. At the same time, it tightens the current system by bringing cooperatives used as holding vehicles within the scope of the dividend withholding tax rules and making the new exemption subject to stringent anti-abuse rules.

These new rules are scheduled to enter into force as per January 1, 2018. When effective, the Dutch government aims to reinforce the position of the Netherlands as the jurisdiction of choice for setting up holding companies that function within business structures with genuine economic activities. In taking these steps, the Dutch government must heed the calls coming from Paris, where the O.E.C.D. is rolling out its B.E.P.S. Action Plan, and Brussels, where the European Commission continues to pursue E.U. Member States that grant illegal State Aid. Together, they bode ill for structures set up primarily for tax reasons. As will be discussed in this article, the proposed legislation attempts to forge an attractive holding company tax system without creating harmful tax regimes. Finding the right balance will require a deft touch by the Dutch government.

EXTENSION OF DIVIDEND AND GAIN EXEMPTIONS

Historically, the Dutch dividend withholding tax regime provides for exemptions in certain domestic situations. Where one Dutch company owns at least 5% of the nominal share capital of another Dutch company, the shareholder is eligible, in principle, for benefits granted under the Dutch participation exemption. The exemption applies to dividends received from a 5% or greater subsidiary. Where the exemption is applicable to the shareholder, a subsidiary distributing a dividend is not required to withhold tax.

Upon implementation of the Parent Subsidiary Directive ("P.S.D.") back in the early 1990's, a similar exemption was introduced for corporate shareholders based in E.U. Member States. Even though the P.S.D. contains a higher threshold for exemption, based on case law from the European Court of Justice, the qualifying ownership percentage for exemption in intra-E.U./E.E.A. situations may not exceed the domestic threshold.

The proposed legislation extends the scope of the existing exemption for corporate shareholders based within the E.U./E.E.A. to any jurisdiction that has concluded a tax treaty with the Netherlands containing a clause governing taxation of dividends. Consequently, a tax information exchange agreement ("T.I.E.A.") that merely provides for exchange of tax information is not covered by the proposed legislation. The contents of the applicable dividend clause are not relevant. The new unilateral exemption will apply where the treaty provides for a reduction of the statutory domestic withholding rate.

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As an example, the unilateral exemption will apply to qualifying Canadian-resident companies under the Netherlands-Canada Income Tax Treaty even though the treaty provides only for a reduced withholding tax rate of 5%. Similarly, the unilateral exemption will apply to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty that reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It will apply also to qualifying U.S.-resident companies under the Netherlands-U.S. Income Tax Treaty when those companies do not qualify for the exemption provided under the treaty.

Because the proposed legislation contains its own test for qualification and is a unilateral provision requiring no concurrence by a treaty partner, the exemption can apply even though the recipient of the dividend fails to meet any of the tests under the limitation on benefits ("L.O.B.") clause of the treaty between the Netherlands and the shareholder's country of residence. This may make the Netherlands an attractive location for a European holding company owned by a group based in the U.S. or Japan, where the relevant income tax treaties contain detailed L.O.B. clauses that are not always easy to meet. Clearly, a unilateral exemption that applies irrespective of reduced treaty rates and specific treaty requirements significantly improves the position of the Netherlands as a European "hub" for multinational enterprises headquartered in the world's largest economies – and important trading partners – such as Canada, China, Japan, and the U.S.

With a view on the simultaneous introduction of a withholding obligation for "holding" cooperatives (see below), going forward the exemption will also be applicable to distributions to "qualifying members" of such cooperatives. In other words, while the new rules may bring holding cooperatives within the scope of the dividend tax, in principle these cooperatives should not be affected if and to the extent their members are corporations established in a treaty country. That said, in these situations normally there would be no Dutch tax benefit in using a cooperative anymore, meaning that existing holding cooperatives might just as well be converted into companies.

Lastly, the new unilateral exemption will apply subject to domestic anti-abuse rules. These rules are discussed in greater detail below. Essentially, they codify the principle purpose test ("P.P.T.") as laid down in the new multilateral instrument ("M.L.I."), which has been developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan. As the M.L.I. is adopted worldwide, it may be expected that the P.P.T. will gradually become part of bilateral tax treaties, meaning that more and more tax treaties will contain similar anti-abuse rules. While dividend clauses in tax treaties currently may overrule anti-abuse rules as codified in domestic legislation, over time anti-abuse rules laid down in domestic law and relevant tax treaty provisions will merge in scope for countries that have signed the M.L.I. and revised treaties with other countries.

The key likely will not be in the standard that is adopted but in the application of that standard. It may turn out that the Dutch application of the P.P.T. may not be sufficiently rigid to satisfy the European Commission. As further discussed below, Dutch anti-abuse rules are not just meant to codify the P.P.T. as laid down in the M.L.I. but also to implement the G.A.A.R. as included in the recently amended P.S.D. Any perceived failure to implement the P.S.D. in a correct manner may lead the European Commission to take legal action against the Netherlands.

INCLUSION OF HOLDING COOPERATIVES

Under current law, as a rule, cooperatives are not within scope of Dutch dividend tax. This has been a deliberate choice; in fact, today's government policy in the Netherlands still maintains that "real" cooperatives must not be bothered with an obligation to withhold dividend tax when distributing profits to their members. As a result, the Dutch legislator has created a clear distinction between a cooperative and other business entities or arrangements such as a public company ("N.V."), a private company ("B.V."), the contractual form of an "open" limited partnership that is not transparent ("C.V."), and a mutual fund ("F.G.R."). In principle, the latter group of business entities or arrangements are obliged to withhold dividend tax on their profit distributions.

The background to this distinction is that the cooperative is traditionally used for certain collective activities (*e.g.*, purchases or sales) that are closely connected with – and supportive to – the individual businesses of its members. For this reason, it is felt that no fiscal obstacles should hinder the distribution of profits to members of cooperatives.

Pursuant to the Dutch Civil Code, the legal purpose of a cooperative is "to serve the economic interests of its members." This definition is generally accepted as being rather broad and is not restricted to any specific activities or industries. Even though cooperatives are traditionally used for collective activities within the agricultural and banking sectors, nothing on the face of the law prevents investors or companies from using cooperatives for other purposes, as long as the relevant activities serve the economic interest of a member. Consequently, holding and finance activities qualify just as well from a legal point of view.

In the course of the past decade, the use of Dutch cooperatives became quite popular within the domain of international tax planning. Although it goes without saying that such popularity was mainly caused by the absence of an obligation to withhold tax on distributions at source, it follows from the above that this was not caused by any change of law. The law always provided for that treatment. Rather, the sudden rise of the Dutch cooperative as an international holding vehicle resulted when tax advisers "discovered" the cooperative as an appropriate vehicle for structuring international investments. Particularly in relation to private equity, using a cooperative did not just create a tax benefit. It offered a nice "add-on" by reason of the flexibility it provides from a legal point of view in structuring the arrangement. This is because a cooperative is much less governed by mandatory provisions of law than a company.

Inevitably, systems in nature tend to revert to stasis, and the rise of the cooperative lead to its partial downfall once its popularity attracted the attention of the tax authorities, both in the Netherlands and abroad. It became clear that Dutch cooperatives could be used as an exit route from the E.U. to tax haven jurisdictions. This is generally considered undesirable, particularly where membership interests are held as a passive investment and members are not actively involved in the management of the cooperative and its investments, as is normally the case with private equity funds.

Under some pressure from the international community, the Netherlands introduced a withholding obligation for cooperatives in 2012 that was designed to be applicable in specific circumstances. This provision however was formulated as an exception to the rule. Hence, it was aimed at certain abusive structures only. With a view to implementing the general anti-avoidance rule ("G.A.A.R."), as laid down in the amended P.S.D., into Dutch law, the wording of the relevant legislation was amended with effect from 2016, but nothing of substance changed.

Then, in July 2016, the European Commission published a notice on illegal State Aid that set the stage for the present change in law. In its notice, the European Commission reasoned that where cooperatives are used for similar purposes and activities as companies, there would be no justification for a difference in tax treatment and any deviation from the general legal framework as it applies to companies might be construed as offering a selective advantage, which in turn may result in illegal State Aid. Considering the broad definition of their statutory purpose, Dutch cooperatives can be used for similar purposes and activities as companies, from a legal point of view. Apparently, the European Commission expressed the view that, from an illegal State Aid perspective, cooperatives should be subject to the same type of taxation as companies.

Essentially, this is what the proposed legislation aims to achieve. By introducing the concept of a holding cooperative that differs from other types of cooperatives, a cooperative that is predominantly engaged in holding and group finance activities will be brought within scope of collecting dividend withholding tax and therefore become – more or less – subject to the same type of taxation as other entities and arrangements that are customarily required to withhold tax on dividend distributions. This treatment will apply when holding and group finance activities comprise at least 70% of all activities engaged in by a cooperative. Where a cooperative is significantly engaged in activities other than holding and group finance, it remains outside the scope of the dividend tax. This will occur when other activities comprise more than 30% of the total activities of a cooperative. Consequently, cooperatives with real economic activities should not be affected by the new rules, except in unusual circumstances. Accordingly, for dividend withholding tax purposes, a cooperative will be afforded comparable treatment to a company if it is predominantly engaged in holding and finance activities.

Whether a cooperative qualifies as a holding cooperative depends on its activities over the financial year preceding a profit distribution. While in principle the composition of its balance sheet should be decisive, other factors may also be taken into account – such as allocation of turnover and the type of activities carried on by its employees. Even though the aggregate book value of participations in group companies and group loans may comprise over 70% of the asset side of a balance sheet, a cooperative may still not be regarded as a holding cooperative if it performs a headquarter function with active involvement in the management of its participations, provided that a sufficient number of employees perform management tasks of substance.

Where a cooperative has a significant number of members based in non-treaty jurisdictions such as the British Virgin Islands or the Cayman Islands, it cannot rely on the new domestic exemption from dividend withholding tax in relation to profit distributions to those members. Particularly in those situations, it seems worthwhile to consider a restructuring (*e.g.*, by making the cooperative sufficiently active through hiring employees, renting office space, and the like. Also, private equity structures with sufficient employees at the level of the cooperative and active involvement at the level of its portfolio companies may be out of the scope of withholding tax obligations. Again, the substance of the employee activities will likely be determinative, not titles and activities that occur sporadically.

Pursuant to the legislative proposal, the dividend withholding tax treatment of cooperatives remains different from companies where profit distributions are made to a member owning an interest of less than 5% in the cooperative. The withholding tax obligation on dividend distributions applies solely to qualifying members that are entitled to at least 5% of either annual profits or liquidation proceeds. For this purpose, membership interests that are directly or indirectly held by related parties or by a "cooperating group" must be aggregated. Since "real" cooperatives often have many members, this provision effectively functions as an "escape clause" since it ensures that even though they may qualify as holding cooperatives, these cooperatives are not affected – and thus bothered – by the new rules.

INTRODUCTION OF ANTI-ABUSE RULES

As already mentioned above, application of the new domestic exemption is subject to anti-abuse rules. These rules are basically a combination of the P.P.T. as advocated by the O.E.C.D. in B.E.P.S. Action 6 and the G.A.A.R. as recently inserted in the P.S.D.

The wording of the new anti-abuse rules is essentially based on existing Dutch domestic corporate income tax rules. Under specific circumstances, dividends distributed to members and capital gains from the sale or other disposition of a membership interest may be taxed in the hands of a foreign shareholder or member. Under the legislative proposal, this provision will be aligned with the new dividend tax provisions. Consequently, the exemption is denied if the following conditions are met:

- The shareholder or member (the "direct owner") holds its participation in the company or holding cooperative (the "Dutch entity") and one of the main purposes of that holding is the avoidance of Dutch dividend tax (the "subjective test").
- The shares or membership rights (the "participation") are part of an artificial structure or the profit is distributed through an artificial transaction or a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality (the "objective test").

Thus, the new legislation establishes the following obligations:

- Under the subjective test, management of the company or the cooperative must determine whether the direct shareholder or member has a main purpose of avoiding Dutch dividend tax. This is generally the case if the Dutch entity would be required to withhold more dividend tax on its distributions had the direct owner not been inserted into the structure, meaning that one must be able to rely on the objective test, as discussed below, in the event the subjective test produces negative results. Note that Dutch dividend tax avoidance need not be the main purpose for the investment under the subjective test.

- Under the objective test, one must assess whether the structure is artificial by itself or in conjunction with a series of artificial arrangements or transactions that lack valid business reasons reflecting economic reality. Essentially, this the mantra formulated by the European Court of Justice in its ruling in the *Cadbury Schweppes* case.

Where the direct owner conducts an active business to which its participation in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally present. In comparison, if the direct owner is considered to hold its participation as a passive portfolio investment rather than an active business asset, profit distributions by the Dutch entity would be subject to withholding tax.

Where the direct owner is merely an intermediary holding company, the assessment is more complicated. In any event, its shareholder (*i.e.*, the indirect owner of the Dutch entity) must conduct an active business enterprise, whilst the intermediary holding company must function as a link (*schakelfunctie*) between its shareholder and the Dutch entity. In that case, "valid business reasons reflecting economic reality" are still considered to be present if the intermediary holding company meets a number of the new relevant substance requirements in its own jurisdiction. Most of these criteria resemble existing minimum substance requirements applicable to certain Dutch-based entities and are rather straight forward. However, with the new anti-abuse rules, two additional substance requirements are introduced for intermediary holding companies:

- The intermediary holding company must incur salary costs equal to at least €100,000 for employees performing the activities that function as a link between the indirect owner and the Dutch entity. These employees may be hired from group companies through a salary-split arrangement. However, the part-time employees must perform their activities for the intermediary holding company in the jurisdiction where that company is established.

- The intermediary holding company must also have its own office space at its disposal and that space must be equipped and actually used for the performance of such activities for at least 24 months.

Since it is recognized that time will be required to meet the two additional requirements, a three-month window is provided for identifying employees and arranging facilities. Everything must be in place by April 1, 2018.

OTHER MATTERS

Existing structures with intermediary holding companies may run afoul of the new domestic anti-abuse rules if the relevant substance requirements are not met, notably the requirements to (i) pay at least €100,000 annually in salaries and (ii) rent and equip office space for at least 24 months. This would also apply to intermediary holding companies established within the E.U./E.E.A. or in a treaty jurisdiction such as Luxembourg. Even though, in these situations, Dutch dividend tax may currently still be mitigated under an applicable tax treaty, this might change once the P.P.T. is inserted in the treaty at the time of implementation of the M.L.I.

Tax rulings will terminate as from January 1, 2018, if the intermediary holding company does not meet the relevant substance requirements in a timely manner. In certain situations, having an intermediary holding company in place may no longer be necessary, as a result of the introduction of the domestic exemption.

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CONCLUSION

In recent years, the Netherlands has relinquished its historic role as the premier location for a European holding company for a multinational group based in Canada, China, Japan, and the U.S. With the adoption of an exemption from withholding tax for Dutch entities, business arrangements, and cooperatives, the "bloom" may be returning to the "tulip."

P.S. – NEW COALITION GOVERNMENT INTENDS TO ABOLISH DIVIDEND TAX

On Tuesday October 10, 2017, following a negotiation period of almost seven months (a new record) from the date of the last general elections, it was announced that a coalition of four political parties will form a new Dutch government. That same day, the new coalition presented their political agreement to the Dutch Parliament. Amongst other (tax) topics, the agreement addresses the coalition's intention to completely abolish the Dutch dividend withholding tax, effective January 1, 2019, or ultimately by January 1, 2020.

In light of this outcome, the recent legislative proposal that is the subject of this article may not pass after all. This would imply that current dividend tax provisions would remain in force until the date of abolition, albeit the contemplated withholding tax exemption for distributions to treaty country residents may still be implemented, effective January 1, 2018. More clarity on this topic is expected in the coming weeks.