DUTCH CORPORATE TAX REFORM: DIVIDEND TAX REMAINS, A.T.A.D. ARRIVES, AND TAX RATES DROP

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TAX REFORM REVISIONS

Traditionally, the Dutch budget for the new year – which includes proposed tax legislation – is presented to parliament on the third Tuesday of September, known as Princes' Day (*Prinsjesdag*) in the Netherlands. However, this year, the relevant legislative proposals will be significantly revised before they are even discussed in parliament, pursuant to the revised tax reform announced on the eve of the third Tuesday of October.

This year's budget includes certain tax proposals that were announced last autumn, when the new Dutch coalition government took office and presented its main policy goals. At the time, the new government expressed its intention to completely eliminate withholding tax on dividends distributed by Dutch companies.

One of the main purposes of abolishing this tax was to cater to the needs of large Dutch multinationals – notably Shell and Unilever. Shell and Unilever have roots in the U.K. as well as in the Netherlands, and historically they have maintained headquarters in both countries. More recently, the two multinationals have been exploring ways to reduce the level of complexity that comes with maintaining such a structure. Certain factors, such as the impending Brexit, have increased the appeal of becoming solely headquartered in the Netherlands. In particular, Unilever recently expressed a desire to rationalize its structure by centralizing all headquarters functions in Rotterdam. However, the absence of a withholding tax on outgoing dividends from the U.K. – when dividends are taxed in the Netherlands – was perceived as an obstacle to restructuring.

This led the Dutch prime minister – a Unilever alumnus – to seek elimination of the dividend tax levy as an enticement for choosing the Netherlands as a holding jurisdiction for listed companies, particularly for companies that might consider the U.K. as an alternative and would need to be persuaded to cross the North Sea when choosing a holding company location. However, a period of heavy public criticism followed, characterizing the removal of withholding tax on dividends as a "gift" to foreign shareholders. As a result, Unilever froze its corporate restructuring plans, fearing lack of support from its British shareholders. Given the political climate, the Dutch government had no choice but to reconsider its earlier proposals, which eventually led to the revised tax reform released on the eve of the third Tuesday of October.

As this article goes to press, the revisions must be tailored into amendments to the package of legislation submitted to parliament. Nonetheless, the contours at this time are quite clear:

- Corporate income tax rates will gradually be reduced even further than previously announced.

- The Netherlands will implement the E.U. Anti-Tax Avoidance Directive ("A.T.A.D.").
- Dividend tax will remain in existence for the time being.

The normal corporate income tax will be gradually reduced from 25% to 20.5% by 2021, with the first reduction occurring in 2020. At the same time, the reduced rate corporate tax for profits up to €200,000 will be gradually reduced from 20% to 15% by 2021, also with the first reduction occurring in 2020.

In addition, the legislative package released on Princes' Day contains a variety of measures that change the basis of corporation tax in the Netherlands. Inevitably, a large part of this legislative package stems from the A.T.A.D. – as its first tranche (A.T.A.D. 1) must be implemented with effect from January 1, 2019. Simultaneously, certain favorable measures are included in order to soften the impact of A.T.A.D. 1.

Even though the Dutch government has emphasized that eliminating the dividend tax is not completely off the table, and it will again be considered in due course, it now seems clear that the dividend tax, in its current form, will remain in existence for some time.

Currently, Dutch intermediate holding companies that are part of corporate structures are exempt from the obligation to withhold dividend tax when profits are repatriated to shareholders. The exemption is effective January 1, 2018, and reflects a unilateral decision to exempt dividends from withholding tax for corporate shareholders based in all treaty countries, including Canada, China, Japan, and the U.S. Once Brexit is a fact, this exemption will continue to cover U.K. multinationals structuring their E.U. operations via the Netherlands. While this extension of the exemption for E.U. or E.E.A.[1] corporate shareholders was perceived initially as a "quick fix" until the dividend tax was eliminated, it now seems that this broad unilateral exemption may remain a permanent solution.

Since this Dutch unilateral withholding tax exemption appears to be more than just a passing fad, this article will consider its main features, as well as the impact of Dutch anti-abuse rules resulting from the implementation of international and supranational law. Broadly speaking, these rules aim to combat "abusive" structures, as only business structures with genuine economic activities can benefit from the exemption for group holding companies.

IMPLEMENTATION OF A.T.A.D.

As mentioned above, on Princes' Day, the legislative proposal to implement A.T.A.D. 1 was submitted to the Dutch parliament. This package provides for the introduction of controlled foreign corporation ("C.F.C.") legislation, as well as an entirely new limitation on the deduction of interest expense.

While A.T.A.D. 1 also requires the presence of an exit tax and a general anti-abuse rule, in the Netherlands these are already in place. Therefore, these elements require no further legislation, except for some minor modifications.

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1 *I.e.*, the European Economic Area, or all the E.U. countries plus Liechtenstein, Norway, and Iceland.

A.T.A.D. 1 also contains certain measures to combat arrangements that make use of differences in qualification between tax systems. Well before the implementation date of A.T.A.D. 1, the scope of these "hybrid mismatch" rules was already extended through an amendment known as A.T.A.D. 2, although in fact there is just one directive. A.T.A.D. 2 will likely end the attractiveness of a Dutch C.V. or B.V. structure, as it forces the Dutch tax authorities to tax the income of the C.V. even though the C.V. may be transparent for Dutch tax purposes.

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In any case, most of the hybrid mismatch rules that form the second tranche of A.T.A.D. implementation must be implemented into domestic law effective January 1, 2020. Before the relevant legislative proposal is submitted to parliament (expected early 2019), the government launched a consultation round on its draft proposal on October 29.

General Anti-Abuse Provision

The general anti-abuse provision ("G.A.A.R.") laid down in A.T.A.D. 1 provides that a series of arrangements must be disregarded for corporate income tax purposes if they (i) are set up with a main purpose to obtain tax benefits, (ii) undermine the purpose or application of tax legislation, and (iii) are wholly artificial.

The Dutch government takes the view that this rule is part of existing Dutch tax law through the *fraus legis*, an abuse of law doctrine developed in the case law. Consequently, the Dutch government does not consider it necessary to further implement or codify this rule.

Exit Tax

Under current Dutch law, an exit tax is due upon the relocation of a company's seat to a place outside the Netherlands as if capital gains are realized from the move. The exit tax triggers the realization of pregnant gains and the triggering of all reserves when assets are transferred abroad. Therefore, the A.T.A.D. provision requiring E.U. Member States to levy an exit tax does not require new legislation.

However, implementation of A.T.A.D. 1 will require some minor changes to existing regulations. Under A.T.A.D. 1, exit tax must be paid within five years for transfers of assets within the E.E.A. The period is substantially shorter than the current 10-year period provided in Dutch law. Furthermore, A.T.A.D. provides that, while interest may be charged for deferred payment of the exit tax, the posting of security for the tax payment is required only if the tax collector can clearly demonstrate that a risk of nonpayment exists.

As a final point, current Dutch law taxes gains when a Dutch enterprise transfers assets to a foreign permanent establishment. In this case, A.T.A.D. 1 does not require taxation upon transfer, meaning that no legislative change is required in this respect.

C.F.C.'s

One of the cornerstones of the A.T.A.D. is a measure to combat tax avoidance through the establishment of a low-taxed C.F.C.'s or permanent establishments and the transfer of mobile assets to the C.F.C. or permanent establishment. Income derived by the transferee from the mobile assets is taxable in the Netherlands at the level of the Dutch shareholder. This measure follows B.E.P.S. Action 3.

In brief, a foreign corporation is a C.F.C. where (i) a taxpayer holds, independently or together with affiliated entities or persons, a direct or indirect interest of more than 50% in an entity or (ii) the Dutch entity maintains a permanent establishment abroad that is taxed as if it were a foreign corporation. This means that it will also be relevant for Dutch companies to know whether lower-tier C.F.C.'s derive profits from mobile assets.

Under A.T.A.D. 1, broadly, a choice is made between two taxation models:

- **Model A:** Passive income derived by the C.F.C. (*e.g.*, dividends, royalties, and interest) is included in the tax base of its parent company if this income is not distributed by the C.F.C. promptly.
- **Model B:** The profits reported by the C.F.C. are allocated to functions performed in the Netherlands on the basis of the arm's length principle (*i.e.*, a transfer pricing approach).

The Dutch government currently takes the position that the Netherlands already applies Model B because the arm's length principle is codified in article 8b of the 1969 Corporate Income Tax Act ("C.I.T.A."). Nonetheless, it would like to do more than strictly necessary with respect to C.F.C.'s. For this reason, the government has opted for Model A treatment for C.F.C.'s established in a state appearing on the E.U. list of non-cooperative countries (the "E.U. blacklist") or with a low statutory tax rate, which is defined to be less than 7%. However, if the C.F.C. performs an economic activity of substance, its income will remain exempt.

The government has chosen this measure to deter tax avoidance arrangements from occurring in the Netherlands. To emphasize that the Netherlands no longer wants to be a participant in such arrangements, the fact that double taxation arises is explicitly accepted. For example, in situations where a C.F.C. is held indirectly and C.F.C. rules also apply on the level of a share-linked intermediary, the Netherlands does not take into account the tax payable by that share-linked intermediary.

An exhaustive list of states identified on the basis of the above criteria will be drawn up annually and published in a ministerial regulation. It will be based on the E.U. blacklist for the preceding calendar year or on the statutory tax rate as of October of that year.

A C.F.C. performs an economic activity of substance if it meets the substance requirements that apply as of April 1, 2018, for the purposes of the dividend withholding tax exemption. This includes payroll costs of at least €100,000 and office space available for at least 24 months.

Several additional exceptions apply. Under one, the additional C.F.C. measure will not apply if the C.F.C. mainly receives benefits other than the tainted benefits. Under a second exception, the C.F.C. measure will not apply where (i) the C.F.C. is an entity (not a permanent establishment), (ii) a financial business is carried on by the C.F.C., and (iii) the C.F.C. regularly receives tainted benefits in transactions with third parties.

The income of the C.F.C. will be determined according to Dutch standards. For example, an arm's length fee will be taken into account for an interest-free receivable.

Interest Deduction Limitations

The A.T.A.D. provides for a generic interest deduction limitation, known as the earnings stripping measure, which will be introduced for financial years commencing on or after January 1, 2019. Under this provision, the deduction for net interest expense is capped at 30% of the taxpayer's earnings before interest, tax, depreciation, and amortization ("E.B.I.T.D.A.") or €1 million, whichever is higher. Because the cap is placed on net interest expense, gross interest income of the taxpayer is fully deductible by gross interest expense. Note that interest income or expense relates to the cost of borrowing, whether the arrangement is structured as a loan, a financial lease, or a comparable agreement. The earnings stripping limitation applies only to the extent the interest expense exceeds the interest income. Note that the term "interest" includes currency exchange results on the principal and the interest installments. To the extent that currency risk on loan principal and interest payments is protected by an offsetting hedge, the effect of the hedge must be taken into account. In addition, the cost of the hedge is to be treated as interest expense or an offset to interest income, as the case may be.

E.B.I.T.D.A. is determined under a five-step process:

1. Determine profits under applicable Dutch tax standards.
2. Adjust the profits for certain tax-exempt items – notably, exempt participation benefits, as well as the deduction allowed with regard to gifts.
3. Increase the profits determined under the first two steps by the total depreciation and write-downs of assets taken into account during the year.
4. Decrease the profits determined under the first three steps by any write-downs of an asset that has been recaptured during the year.
5. Increase the profits determined under the first three steps by the net interest expense incurred during the year.

Interest to be capitalized in a year will be taken into account for the purposes of the 30% rule as well, meaning that the profits will not be adjusted for any such capitalization. However, the limitation of the deduction of other (*i.e.*, noncapitalized) interest expense will take precedence where the 30% criterion is exceeded. In that case, the interest to be capitalized may indeed be capitalized if, and to the extent that, the interest is less than 30% of the E.B.I.T.D.A. and carried forward to a subsequent year if, and to the extent that, it exceeds 30% of the E.B.I.T.D.A.

All net interest expense in excess of the cap can be carried forward to subsequent years in which net interest expense is below the cap and can be deducted to the extent of the unused cap in the carryover year. There is no limitation on the length of the carryover period. However, certain anti-abuse provisions will be adopted to prevent taxpayers from acquiring companies with excess deduction capacity or excess interest expense that may be absorbed by the acquiring group. Under one measure, if the ultimate beneficial ownership in the taxpayer changes substantially, the carried-forward interest arising before the change in ownership can no longer be taken into account. A change in ownership is substantial if more than 30% of the shares of the company changes hands. Another rule covers the overlap between carried-forward net interest and the consolidated group regime.

An earnings stripping measure applies to a consolidated tax group. Where a group does not compute income on a consolidated basis, but instead computes income on a standalone basis for each company, a threshold of €1 million per company can be used. In certain fact patterns, multiple caps may exceed 30% of E.B.I.T.D.A. computed on a consolidated basis. Should this rule result in large numbers of de-consolidations, corrective legislation may be considered.

As was previously announced, for the purposes of the earnings stripping measure, the government has opted for the following enforcement rules in regard to A.T.A.D. 1:

- There will be no group exemption.
- Stand-alone entities will not be exempt.
- Financial institutions will not be exempt.
- The option to delay implementation until 2024 is rejected.
- There will be no grandfathering of existing loans.

Finally, certain interest deduction limitations in the C.I.T.A. will be abolished when the earnings stripping measure comes into effect. The abolished provisions will include the following:

- The deduction limitation for excessive participation interest (article 13l C.I.T.A.)
- The deduction limitation for excessive acquisition interest (the acquisition holding company provision in article 15ad C.I.T.A.)
- The limitation of the holding company loss set-off (article 20[4] through [6] C.I.T.A.)

Nonetheless, two specific interest deduction limitations will be maintained:

- Article 10a C.I.T.A. (targeting base erosion)
- Article 10b C.I.T.A. (targeting international mismatches)

DIVIDEND TAX EXEMPTION

Where a Dutch parent company owns at least 5% of the nominal share capital of another Dutch company, the shareholding is eligible in principle for the participation exemption. Therefore, dividends distributed by the relevant subsidiary are exempt from corporate income tax in the hands of the parent company. In domestic situations, because the dividend is exempt at the shareholder level, the subsidiary is not required to collect withholding tax.

When the Parent Subsidiary Directive ("P.S.D.") was implemented 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 than the Dutch participation exemption, case law from the European Court of Justice has established that the qualifying ownership percentage for exemption in intra-E.U./E.E.A. situations may not exceed the domestic threshold.

Following last year's tax reform, the scope of the existing exemption for E.U. or E.E.A. corporate shareholders was extended to corporations resident in any jurisdiction that has an income tax treaty with the Netherlands in effect where there is a clause governing the taxation of dividends. The content of the dividends article is not material. As an example, the unilateral exemption applies 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 applies to qualifying Chinese-resident companies under the Netherlands-China Income Tax Treaty, which reduces withholding rates on dividends to 5% in some circumstances and 10% in others. It also applies 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 in the treaty. This makes 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, such as Canada, China, Japan, and the U.S. – all of which are important trading partners for the Netherlands.

The unilateral exemption is subject to an anti-abuse rule. This rule stems from supranational E.U. law, which the Netherlands must implement, and international rules suggested by the O.E.C.D., which the Netherlands may codify.

Within the E.U., a special G.A.A.R. provision was inserted into the P.S.D., and the G.A.A.R. is now part of A.T.A.D. 1, as discussed above. Also, the multilateral instrument ("M.L.I.") developed by the O.E.C.D. within the context of the B.E.P.S. Action Plan provides for a principle purpose test ("P.P.T."). Even though the P.P.T. is conceptually different than the G.A.A.R. it has a similar effect. While, at present, an applicable dividend clause in a tax treaty may override a domestic anti-abuse rule, the P.P.T. will gradually become an integral part of bilateral tax treaties as the M.L.I. is adopted worldwide.

"The exemption can apply even though the recipient of the dividend fails to meet any of the tests under the L.O.B. clause in the treaty."

The Dutch anti-abuse rule starts with a subjective test, which essentially requires an analysis of whether avoidance of Dutch dividend tax was a main purpose for setting up the structure. This is considered to be the case if the Dutch entity making the distribution would be required to withhold more dividend tax on its distributions had the direct shareholder not been inserted into the structure.

What follows then is an objective test, which entails an assessment of whether the structure is artificial, either 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.

If the direct shareholder conducts an active business to which its shareholding in the Dutch entity is attributable, valid business reasons reflecting economic reality are generally deemed present. However, where the direct owner is merely an intermediary holding company, the assessment becomes more complicated. In that set of circumstances, the indirect shareholder of the Dutch entity must conduct an active business enterprise. In addition, the intermediary holding company must have a linking function (*schakelfunctie*) between that active company and the Dutch entity. Under the Dutch anti-abuse rule, that linking function must be substantiated. Most of the relevant substance criteria are of a general nature and would apply to any company. However, two additional substance requirements apply specifically to an intermediary holding company:

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 have its own office space at its disposal, and that space must be equipped and actually used for the performance of its activities for a period of at least 24 months.
- If the intermediary holding company meets all of these relevant substance requirements in its jurisdiction, then "valid business reasons reflecting economic reality" are considered to be present.

Pursuant to E.U. case law on which the Dutch rule is based, the taxpayer must be allowed to provide evidence demonstrating economic reality where the two-pronged test is met.[2] This would imply that even if its foreign shareholder does not meet all of the relevant substance requirements, the Dutch company making the profit distribution should still be allowed to demonstrate that the intermediary holding company was put in place for "valid business reasons reflecting economic reality." This may be particularly relevant for joint venture vehicles and private equity structures.

CONCLUSION

Across the globe, the landscape for international tax is in a constant state of change. Recently, the Netherlands accelerated the change by revising an elimination of withholding tax on dividends paid to foreign shareholders after it was announced with great fanfare, but before the provision was actually enacted. This change was accompanied by adoption of several rules embodied in A.T.A.D. 1, including a G.A.A.R. rule, an exit tax for corporations, a C.F.C. anti-abuse rule, a cap on the deductibility of interest expense, and a limited exemption from withholding tax on cross-border dividend payments in the context of an income tax treaty and the presence of economic substance for the direct or indirect shareholder. In this context, certainty is obtainable for an international tax plan only if it reflects the law that was, the law that is, and the law that may be.

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2 See "German Anti-Treaty Shopping Rule Infringes on E.U. Law," *Insights* no. 8 (2018), p. 4.