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INSIGHT

Implementation of Changes to the Parent-Subsidiary Directive in Dutch Law

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The EU Parent Subsidiary Directive has been amended, leading to corresponding changes in domestic laws. The following article explores how these changes apply to the laws of the Netherlands.

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I. Introduction

In September 2015, the Dutch government published tax bills containing legislative amendments to the Dutch tax laws as part of the budget for the year 2016. This article will focus on the changes relating to amendments in the EU Parent-Subsidiary Directive ("EU PSD").[1] Other relevant measures that are expected to become effective as per January 1, 2016 relate to (inter alia) transfer pricing (country-by-country reporting and other increased documentation obligations) and exit taxation of Dutch private individuals.

II. Background

The main purpose of the EU PSD is to create equality between domestically and internationally operating

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groups. Pursuant to the EU PSD, EU Member States are obliged (i) to exempt distributions by a subsidiary to its parent company from withholding taxes and (ii) to eliminate double taxation of such income at the level of the parent company.

On July 8, 2014, the Council of the European Union formally adopted an amendment to the EU PSD to prevent double-non taxation within multinational groups by making use of hybrid loan arrangements ("Hybrid Rule"). The main characteristic of such hybrid loan arrangement is differing tax treatment in the creditor state and debtor state. The amendment to the EU PSD will force EU Member States to disallow an exemption of the remuneration recognized on a hybrid loan arrangement if and to the extent the remuneration is tax deductible in the country where the debtor is a tax resident. The application of the Hybrid Rule will be limited to hybrid loan arrangements and will not apply to hybrid entities. Subsequently, on January 27, 2015, the Council formally adopted another amendment to the EU PSD. A general anti-abuse rule ("GAAR") has been introduced to avoid the application of the EU PSD tax exemption on dividends paid from a qualifying EU company to another qualifying EU company, in abusive situations. Both the Hybrid Rule and the GAAR will be included in the EU PSD and become effective as per January 1, 2016. Hence, EU Member States are required to amend their domestic legislation, if and to the extent it conflicts with the amended EU PSD.

III. Amendments proposed in Dutch Law

In this section, the current Dutch legislation will be briefly discussed, to the extent that it is relevant for the Hybrid Rule and the GAAR, followed by a description of the proposed new legislation.[2]

A. Hybrid Rule

1. Current Legislation

One of the elements of the Dutch tax regime which has made it so attractive, has always been the broad application of the participation exemption. In short, dividends and capital gains are exempt (and capital losses are non-deductible, except in the case of liquidation of the subsidiary, but still only if stringent conditions are met), provided that the parent company owns at least five percent of the share capital of its subsidiary and one out of three tests (relating to the purpose, assets and effective tax rate of the subsidiary) is met. Certain tag-along rules apply in situations where the parent company owns less than five percent of the subsidiary, but the group as a whole does have a qualifying interest.[3] These rules also provide that income on a loan that factually functions as equity for Dutch tax purposes (based on characteristics formulated in case law[4]), can benefit from the participation exemption (if the other relevant conditions are met). The tax treatment of the remuneration on such loan in the jurisdiction where the debtor is a tax resident is irrelevant for the Dutch tax treatment. Hence, the participation exemption as it is currently drafted, allows for a 'mismatch scenario'; income derived from a hybrid loan arrangement can be tax exempt under the participation exemption (provided the other relevant conditions are met) whereas a tax deductible expense is recognized in the debtor jurisdiction.

2. Proposed Legislative Amendment

Based on the proposed legislative amendments, the Dutch participation exemption (as well as the participation credit rules that are applicable to low-taxed passive subsidiaries) shall no longer apply to remunerations and payments from qualifying participations insofar these remunerations and payments can directly or indirectly, legally or in fact, be deducted from the participations' profit tax base.[5] This means that even in situations where the remuneration or payment is non-deductible at the level of the participation (e.g. because of the application of an interest deduction restriction rule), the remuneration or payment can be taxable in the Netherlands. In addition to the main rule stating that income on hybrid loan arrangements should be treated as taxable in the Netherlands, the same provision states that any remuneration or payment received in exchange for (hybrid) income referred to in the main rule, will be taxable as well. This rule serves as a 'catch-all' mechanism to prevent taxpayers from retaining an exemption in the Netherlands in a situation where this would not be in line with the purpose of the provision, but by structuring the remuneration on the hybrid loan in a different (but economically similar) way. Finally, the provision states that so-called 'purchased dividends' are taxable if and to the extent the remuneration on a hybrid loan is booked at the expense of the cost price of the participation. Without this rule, taxpayers could still generate (part of) the income on a hybrid loan arrangement tax free, because a future sale of the participation would be within the scope of the participation exemption (provided the other relevant conditions would be met).

The Dutch implementation of the Hybrid Rule has a broader scope than required under the amendments in the EU PSD. The Dutch rule applies to any hybrid loan arrangements (i.e. worldwide and not limited to EU situations) and it applies as from a 5% shareholding (instead of the 10% threshold provided in the EU PSD). Capital gains realized on hybrid loan arrangements, are not taxable under the Dutch implementation of the Hybrid Rule (the EU PSD does not cover this situation either). The same applies to currency exchange results.

The Dutch implementation of the Hybrid Rule will be effective as per January 1, 2016 (as required). The remuneration on a hybrid loan arrangement which is related to profits of the year 2015, but recognized in 2016, will be taxable based on the new provision. Hence, the rule applies to a certain extent with retroactive effect.

B. GAAR

1. Anti-Abuse Rule in the Dutch Corporate Income Tax Act 1969

(a). Current Legislation

Dividends (including repayment of share premium if there are profit reserves or profit reserves are anticipated) are subject to a 15% Dutch withholding tax. Based on the implementation of the EU PSD in Dutch domestic law, an exemption is available if certain conditions are met. As mentioned above, a relevant difference from the EU PSD is that the domestic exemption is already available for shareholdings of at least 5%, as opposed to 10% provided in the EU PSD. The Dutch Dividend Tax Act 1965 does not contain a general anti-abuse rule (some specific anti-abuse rules can apply). However, the Dutch Corporate Income Tax Act 1969 contains a provision based on which a foreign company that directly or indirectly holds a substantial interest (in brief, at least five percent) in a Dutch company, is subject to Dutch corporate income tax on income (including dividends, capital gains and interest on loans) realized from the Dutch company. This is only the case if such substantial interest (i) is held with the main purpose or one of the main purposes being to avoid Dutch personal income tax or Dutch dividend withholding tax levied from another person and (ii) cannot be attributed to an active business enterprise at the level of the foreign company. The Dutch corporate income tax rate applicable in this context is 25%, or 15% if only Dutch dividend withholding tax is avoided. A tax treaty may further reduce the Dutch taxing right.

(b). Proposed Legislative Amendment

In order to bring the Dutch rules in line with the language used for the GAAR in the EU PSD, condition (ii), above, is rephrased in the legislative proposal as follows:

> "It concerns an artificial construction or series of constructions, (1) whereby a construction can consist of various steps or parts and(2) a construction or series of constructions will be considered artificial when it is not established based on valid business reasons reflecting economic reality".

From the explanatory notes, it can be understood that no material changes in the interpretation of this provision are intended. The only material change of the proposed amendment relates to the situation of an active group which holds a substantial interest in a Dutch company via a passive intermediate holding company. In order to avoid application of the amended anti-abuse rule for non-Dutch corporate shareholders, the passive intermediate holding company should meet certain minimum substance requirements, which are the same as the minimum substance requirements necessary for a Dutch company requesting an advance tax ruling with the Dutch tax authorities. These substance requirements include having at least 50% Dutch tax resident board members, board meetings to be held in the Netherlands, operating the bank account from the Netherlands, bookkeeping done in the Netherlands etc.

2. Anti-Abuse rule in the Dutch Dividend Tax Act 1965

(a). Current Legislation

As mentioned above, the Dutch Dividend Tax Act 1965 provides that dividends are subject to a 15% withholding tax. This only applies to dividends that are distributed by entities that are listed in the Act. A Dutch co-operative is not a listed entity and is not an 'other company with a capital divided into shares' (it is an association, with legal personality and membership rights). Hence, distributions made by a co-operative are in principle not subject to Dutch dividend withholding tax. However, the Dutch Dividend Tax Act 1965 contains a specific anti-abuse rule which provides that a co-operative is deemed to have capital divided into shares (and as a result, needs to withhold the 15% tax) if (i) the main purpose or one of the main purposes of the co-operative is the avoidance of Dutch dividend tax or foreign tax from another person, and (ii) the relevant member cannot allocate its membership right in the co-operative to its active business enterprise. Depending on the circumstances, even if the relevant member can allocate the membership right to its active business enterprise, Dutch withholding tax is still due. In brief, this is the case where it concerns Dutch profit reserves with an existing dividend tax claim. A co-operative does not need to withhold dividend tax if it has a 'real function'. A real function is deemed present if the co-operative runs an active business enterprise, i.e. has its own office space and people on the payroll.

(b). Proposed Legislative Amendment

As part of the amendments in Dutch law to properly incorporate the GAAR provided in the EU PSD, the second condition of the anti-abuse rule concerning co-operatives is reworded similarly to the amendment of condition (ii) of the anti-abuse rule in the Dutch Corporate Income Tax Act 1969 (as set out in III.B.1., above).

IV. Practical Impact of the Proposed Amendments

The proposed changes in Dutch legislation will take effect as per January 1, 2016. Material changes to the proposals are not expected, so Dutch taxpayers will need to analyze whether the proposed changes have an impact on their Dutch (and broader international) tax position. Below, the practical impact of the implementation of the Hybrid Rule and the GAAR in Dutch law, is addressed.

A. Hybrid Rule

Because the Dutch implementation of the Hybrid Rule will become effective as per January 1, 2016, and in particular because income recognized as from January 1, 2016 will fall within the scope of the new rules, Dutch taxpayers currently benefiting from the participation exemption on hybrid loan arrangements, should consider restructuring their existing hybrid loan arrangements as soon as possible. This is in particular relevant for situations where no (full) tax deduction is available in the jurisdiction where the debtor is a tax resident (for example as a result of the application of an interest deduction restriction rule or because the debtor is in a lossmaking position without having the possibility to use these losses in the (near) future). Without restructuring, internationally operating groups face the risk of double taxation.

An important question in practice, relates to the treatment of so-called 'non-businesslike loans'. The concept of non-businesslike loans has been developed entirely in Dutch case law.[6] In brief, a non-businesslike loan is a related party loan that has been entered into under such circumstances that it can be assumed that the creditor accepted a debtor's risk that a third party would not have accepted in a similar situation. The non-businesslike loan remains treated as a loan for Dutch tax purposes, but as a result of the recognition of a non-businesslike debtor's risk by the creditor, an impairment on the non-businesslike loan is not tax deductible. Moreover, instead of the interest rate agreed between the parties, an interest rate is recognized which would have been agreed if the debtor would have attracted the loan under a full guarantee of the creditor (and under otherwise similar conditions).[7] This interest rate is, typically, substantially lower than the agreed interest rate. The difference is treated as a deemed dividend or informal capital contribution (as the case may be). On such deemed dividend, the participation exemption can be applicable (provided the other relevant conditions are met). The question raised in connection with the Dutch implementation of the Hybrid Rule, is whether this difference between the agreed interest rate and the fictitious 'guarantee interest rate' falls within the scope of the new rule and would consequently be taxable after all. The State Secretary of Finance commented in the parliamentary proceedings that the Dutch implementation of the Hybrid Rule does not extend to transfer pricing corrections. In other words, if the interest rate on a loan were to be corrected for Dutch tax purposes because it was deemed too high, the difference remains within the scope of the participation exemption and should not be treated as taxable. Under the same argument, the difference between the agreed interest rate and the guarantee interest rate on a non-businesslike loan, should remain tax exempt. In certain circumstances, it may thus be beneficial to take the position that a loan should be considered a non-businesslike loan, as it allows for exemption of part of the income recognized on such loan whereas the remuneration may still be tax deductible abroad. Questions on this topic are still pending. More clarity may be provided in the further parliamentary proceedings.

B. GAAR

In general, the introduction of the GAAR in the EU PSD is expected to give rise to increased uncertainty for internationally operating groups. In the absence of (clear) explanatory notes to the introduction of the GAAR in the EU PSD, and lacking clear case law in relation to the EU PSD GAAR, there is not much guidance as to what is considered abusive in an EU context. Pending further clarification, this will in any case lead to diverse interpretations of the GAAR by the various Member States. Taxpayers will increasingly face uncertain positions and should be prepared for more litigation to protect their rights.

The Dutch interpretation of the GAAR is not clear either. The State Secretary of Finance has confirmed in parliamentary proceedings that the Netherlands will follow the EU interpretation of abuse. Lacking explanatory notes, this interpretation will be further developed in case law. Currently, some guiding principles can be derived from EU case law, like the Cadbury Schweppes case.[8] In this case, the European Court of Justice states (in short) that there is abuse in the case of a tax-driven wholly artificial arrangement, lacking genuine economic substance.

> "No material changes are expected to the currently pending law proposals and taxpayers should consider the impact of these rules on their Dutch tax position sooner rather than later"

Examples of situations that will not be within the scope of the Dutch anti-abuse rules because valid business reasons are considered present include:

- a parent company running an active business enterprise that can allocate its substantial interest in the Dutch company to that business enterprise;
- a top holding company fulfilling a crucial role within its group as a result of its activities with respect to decision making, policy making and group financing for the benefit of the group;
- an intermediate holding company functioning as the linking pin between a parent company running an active business enterprise or performing qualifying top holding activities on the one hand, and subsidiaries running an active business enterprise on the other hand—provided the intermediate holding company complies with the Dutch minimum substance requirements (reference is made to the last sentence of III.B.1., above).

A potential point of discussion concerns the situation where a Dutch company is owned by a foreign parent company that does not fall within the examples listed above, but with a level of substance that is considered sufficient to have 'real presence' in the Netherlands where it concerns Dutch companies.[9] In my view, this substance level should be considered sufficient to avoid application of the Dutch anti-abuse rules. Since it is unclear whether this position is in line with the interpretation of the GAAR in the EU PSD, a higher substance level is generally recommended. Typical points increasing the substance level of the foreign parent company (and consequently reducing the risk of a discussion with the Dutch tax authorities with regard to application of the anti-abuse rule) include (i) operating own office space, (ii) having people on the payroll, (iii) have the group's top management present in the board of the parent company and (iv) having involvement of the parent company's senior management, through the Dutch company, in the affairs of operational subsidiaries. In the end, however, it is up to the European Court of Justice to clarify when a situation is abuse in the context of the EU PSD.

The amendments relating to co-operatives in the Dutch Dividend Tax Act 1965, should be interpreted similarly to the amendments in the Dutch Corporate Income Tax Act 1969, as discussed above.

V. Concluding Remarks

The implementation of the Hybrid Rule and the GAAR in Dutch domestic law will take effect as of January 1, 2016. No material changes are expected to the currently pending law proposals and taxpayers should consider the impact of these rules on their Dutch tax position sooner rather than later.

Tax rulings relating to hybrid loan arrangements or situations to which the GAAR applies but to which the GAAR was not applicable before the change of law, are no longer valid. The Dutch State Secretary of Finance confirmed in a decree that taxpayers with a ruling confirming nonapplication of the Dutch anti-abuse rule but after the change becoming subject to tax as a result of the amendments in the GAAR, will, under certain conditions, get the opportunity to make their structure compliant, and consequently will be able to continue to rely on the ruling until April 1, 2016.[10] This will basically apply to situations where an intermediate holding company in an active group does not meet the Dutch minimum substance requirements in its country of residence. In such situation, (i) the taxpayer notifies the tax authorities (specifically the tax ruling team) before January 1, 2016, (ii) the taxpayer confirms the intention to comply with the substance requirements as per April 1, 2016, (iii) the taxpayer accepts that the ruling becomes invalid as per January 1, 2016 if the substance requirements are not met as per April 1, 2016, and (iv) the taxpayer informs the tax authorities before May 1, 2016 whether it meets the substance requirements. Benefits realized, (e.g. dividends or capital gains) between January 1, 2016 and April 1, 2016 would be taxable under the new rules (unless the structure is made compliant before the realization moment).

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NOTES

1 Amendment of the Corporate Income Tax Act 1969 and the Dividend Tax Act 1965 in relation to the implementation of the changes to the EU Parent-Subsidiary Directive (*Wet implementatie wijzigingen Moeder-dochterrichtlijn 2015)*, no. 34.306.

2 Please note that the proposed new legislation may be amended during the course of the legislative process. This article reflects the proposed wording and the discussions in the legislative process as per November 13, 2015. Material changes to the proposals are not expected.

3 It goes beyond the scope of this article to discuss the conditions to apply the participation exemption in detail.

4 In brief, the remuneration on the loan should be profit contingent, the loan should have no term or a term exceeding 50 years, (and is only claimable by the creditor before maturity in case of liquidation, moratorium etc. of the debtor) and the loan should be subordinated to other debts of the debtor.

5 This will be incorporated in the participation exemption provision (article 13, paragraph 17 of the Dutch Corporate Income Tax Act 1969). Corresponding rules will be implemented in article 13aa, paragraph 7 of the Dutch Corporate Income Tax Act 1969, concerning the participation credit system. Because the main relevance lies in (non)application of the participation exemption, the impact on the participation credit rules is not further addressed in this article.

6 The first landmark case was rendered by the Dutch Supreme Court on May 9, 2008, no. 43849, and many cases followed over the past years.

7 Qualification as a non-businesslike loan can have various other consequences. This will not be further discussed, as it goes beyond the scope of this article.

8 European Court of Justice, September 12, 2006, C-196/04.

9 These are the typical substance requirements also referred to in section III.B.1. The requirements are more or less similar for intragroup financing and licensing companies and companies requesting an advance tax ruling.

10 State Secretary of Finance, 3 November 2015, nr. DGB 2015/5071M.

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