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Dutch government proposes implementation of the amended EU parent subsidiary directive

On 15 September 2015, The Dutch Government published its proposal for the implementation of the amendments to the EU parent subsidiary directive (EU Directive 2014/86 on hybrid mismatches, and EU Directive 2015/121 on general anti-abuse rules). It is anticipated that the proposed legislation will become effective as per 1 January 2016.

Hybrid mismatches

Introduction

In 2014, article 4 of the EU Parent Subsidiary Directive (EU PSD) was amended with the aim to combat hybrid mismatches (EU Directive 2014/86 of 8 July 2014). Pursuant to this amendment, a parent company will be required to exempt profits paid by an EU subsidiary only to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary. The current Dutch legislative proposal (hereinafter: the legislative proposal) implements these measures into the Dutch tax legislation.

Proposed legislation in the Netherlands

According to the legislative proposal and in line with article 4 EU PSD, the participation exemption (PE) shall not be applicable to payments received from a subsidiary to the extent that these payments are *essentially* deductible for CIT purposes in the other country. By adding the term 'essentially' the Dutch Government accepts the possibility of double taxation: If the payments are deductible by their nature (essentially) at the level of the subsidiary, the payments will be taxed in the Netherlands only. But if the payments under the hybrid instrument are legally deductible – but ultimately non-deductible

under local restrictions of interest deductibility like thin capitalisation rules – the PE does not apply, resulting in double taxation. Such double taxation would infringe the right of free establishment and/or capital movement, and it is highly questionable whether such infringement could be justified.

The scope of the legislative proposal is not limited to payments received from subsidiaries based in the EU/EER. Following the BEPS discussions, the Dutch Government is of the opinion that anti-abuse rules should apply on a worldwide basis, in order to effectively combat treaty shopping and treaty abuse.

The legislative proposal does not apply to benefits received upon the alienation of shares in a subsidiary nor on currency exchange results. This makes sense, because these benefits will not result in a deduction at the level of the subsidiary.

According to the Parliamentary notes, payments received which the Dutch parent company deducts from the acquisition price of a subsidiary – as they were in fact an element of the purchase price - will be qualified as (non-exempt) taxable income as well to the extent the payments were deducted at subsidiary level.

General anti-abuse rules

Introduction

Under current Dutch tax law, anti-abuse rules are included both in the Dividend Withholding Tax Act (DWT Act) and article 17 of the Corporate Income Tax Act (CIT Act). The DWT Act includes a beneficial ownership test, so-called earnings stripping rules and – regarding dividends payable to EU/EEA parent companies - an alignment with anti-abuse provisions of existing tax treaties. Article 17 CIT Act permits the Netherlands to tax the foreign parent company for dividends (and capital gains, although under most tax treaties the right to levy capital gains can not be effectuated) only if the shares do not belong to the assets of a business and the main purpose or one of the main purposes for holding the shares is the avoidance of income tax or dividend withholding tax.

Proposed legislation in the Netherlands

Effective 2016, article 1 EU PSD contains controversial new and extended anti-abuse provisions. As part of the 2016 budget measures, the Dutch Government proposes to include this new anti-abuse provision in the Dutch tax legislation, but surprisingly not in the DWT Act but only in article 17 CIT Act,

concerning non-resident tax liability in abusive situations. As a result, the legislative proposal only impacts non-resident entities which hold a substantial shareholding in a Dutch entity, it does not impact non-resident portfolio investors. Under the EU PSD, a parent entity holds a substantial shareholding if it owns at least 10% of the shares in another company. For purposes of article 17 CIT Act however, a substantial shareholding already exists if the parent entity owns at least 5% of the issued share capital in a Dutch company. In this respect, the legislative proposal goes even beyond the commitments of the Netherlands under article 1 EU PSD.

Like the legislative proposal on hybrid mismatches, the legislative proposal on general anti-abuse rules is not limited to profits distributed to parent companies in the EU/EE, but also has a worldwide scope.

Under the legislative proposal, a non-resident entity which holds a substantial shareholding in a Dutch entity will be subject to Dutch CIT if the substantial interest is held with the purpose to avoid income tax or Dutch DWT by way of artificial arrangement.

The amendments in more detail

Currently, non-resident entities holding a substantial interest (broadly a shareholding of ≥ 5%) in a Dutch entity are subject to Dutch CIT only if (a) the shareholding does not belong to the assets of a business of the parent and (b) the main purpose or one of the main purposes for holding the shares is the avoidance of income tax or dividend withholding tax. Under the legislative proposal, both criteria are replaced by the criterion of article 1 §§ 2-3 EU PSD: CIT liability of the parent company arises if the parent company holds the substantial interest for the main purpose or one of the main purposes of obtaining a tax advantage to avoid the levy of income tax or DWT at the level of another person, within the framework of an artificial (series of) arrangements.

According to the legislative proposal, a (series of) arrangement(s) cannot be considered artificial to the extent that it has been put into place for valid commercial reasons which reflect economic reality. This should be the case if there is sufficient substance at the level of the entity which owns the shareholding in the Dutch entity (we refer to our TNB dated 20 January 2014 on substance requirements) or if the shareholding is attributable to the capital of a business enterprise (i.e. if the shareholding is not held as a passive investment). As from 2016, also the function of an intermediate holding company should be reflected in the substance of this company. This is an important change compared to the current practice.

Dutch co-operatives

Finally, Dutch resident cooperatives will be obliged to withhold DWT on dividends distributed to their members if the avoidance of Dutch DWT or foreign tax is the main purpose or one of the main purposes and an artificial (series of) arrangement(s) has been put in place. Compared with the current legislation, the proposed amendments are in line with the amendments to article 17 CIT act (please refer to our comments above).

Closing remarks

It is remarkable that the legislative proposal extends the scope of the hybrid mismatch and general anti abuse provisions beyond EU situations, when the amend EU PSD does not. In our view, this would only be effective if all EU member states adopted this approach, which is not the case.

It is also remarkable that the Dutch government follows the European Commission by implementing a main purpose test with reference to artificial arrangements, while the current test applicable under primary EU law is still more narrow and refers to wholly artificial situations. This test was first introduced in the ECJ Cadbury Schweppes case, but has been repeated by the ECJ as the applicable test in recent case law. We sincerely doubt whether the broader anti abuse test of the EU PSD and the legislative proposal would be upheld in the event of litigation before the ECJ.