Bloomberg Tax

Tax Planning International

Review

International Information for International Business

JULY 2018

bna.com

Dutch Anti-abuse Legislation and EU Law: Compatibility Issues

Oliver R. Hoor and Frank Buitenwerf
ATOZ Tax Advisers (Taxand Luxembourg) and Taxand Netherlands

Dividends distributed by Dutch companies to EU parent companies may under certain conditions benefit from a withholding tax exemption. However, the application of this withholding tax exemption may be denied in accordance with Dutch anti-abuse legislation if the EU holding company does not comply with certain substance requirements.

Oliver R. Hoor, Partner, ATOZ Tax Advisers (Taxand Luxembourg) and Frank Buitenwerf, Partner, Taxand Netherlands

The EU Parent-Subsidiary Directive ("PSD") restricts EU member states in their right to levy withholding tax on dividend payments to corporate shareholders resident in other EU member states. The PSD has been designed to eliminate tax obstacles in the area of profit distributions between groups of companies in the EU by abolishing withholding taxes on payments of dividends between associated companies of different member states and preventing double taxation of parent companies on the profits of their subsidiaries.

Many EU member states, including the Netherlands, implemented severe anti-Directive shopping rules that disallow the application of the withholding tax exemption on dividends if the parent company does not fulfil certain substance requirements. However, such anti-abuse legislation has to be consistent with EU Law as interpreted by the Court of Justice of the European Union ("CJEU").

In a decision of the CJEU of September 7, 2017, the court decided that a French anti-abuse provision (broadly similar to the principal purpose test (PPT") under the 2017 version of the OECD Model Tax Convention) aiming at denying the benefits provided under the PSD was inconsistent with EU Law. On December 20, 2017, the CJEU decided that German anti-abuse legislation targeting PSD and tax treaty

shopping was incompatible with EU Law. Both decisions emphasize that in an EU context anti-abuse legislation has to be specifically targeted at "wholly artificial arrangements." On this basis, it is possible to analyze whether the Dutch anti-abuse legislation is compatible with EU Law.

Applicable Dutch Tax Law

Dividends distributed by a Dutch company to a parent company are generally subject to Dutch withholding tax at a rate of 15 percent.

In domestic situations, there is a withholding tax exemption in case the Dutch parent can apply the participation exemption to the dividends received. In cross-border situations, dividends paid by a Dutch company to a parent company that is a resident of the EU or EEA (or treaty jurisdiction) may benefit from a withholding tax exemption under the domestic implementation of the PSD. In line with the exemption applicable in domestic situations, this exemption is applicable if the parent company has (directly or indirectly) a participation of at least 5 percent in the share capital of the Dutch company.

The exemption from Dutch dividend withholding tax may, however, be denied in accordance with anti-abuse rules if the interest in the Dutch entity is held with the principle purpose, or one of the principle purposes, to avoid the levy of dividend withholding tax (subjective test) and the structure is to be considered as part of an artificial arrangement (objective test). A business structure is considered artificial if it is not put in place with business reasons that reflect economic reality. Notably, both the subjective test and the objective test need to be met for the withholding tax exemption to be denied.

Subjective Test

With regard to the subjective test, it needs to be assessed whether the direct shareholder of the Dutch company has been interposed to obtain a more favorable Dutch dividend withholding tax treatment. Here, the withholding tax rate that would be applicable in case of dividend distributions to the indirect shareholder is compared to the rate applicable in case of dividend payments to the EU parent company (the so called "disregard principle"—*wegdenkgedachte*). The subjective test would be met if the interposition of the holding company results in less dividend withholding tax being payable at the time of the distribution (without further investigating the factual circumstances of the specific case).

Objective Test

When the subjective test is met, it needs to be determined whether the structure is to be considered as an artificial arrangement. This objective test is deemed to be met if the foreign corporate shareholder:

- does not carry out a business enterprise; or
- is an intermediary holding company that does not meet specific substance requirements.

For the purposes of the objective test, an intermediary holding company is a company that fulfils a linking function between the operational business activities of the (indirect) shareholder and the operational business activities of the Dutch company or its subsidiaries.

The main substance requirements to be met by a foreign intermediary holding company include:

- at least 50 percent of the statutory managers and managers authorized to take decisions are resident in the state of the holding company;
- the managers must have the necessary professional knowledge to properly fulfill their tasks;
- the holding company's board decisions are taken in the state in which the intermediary is located;
- the main bank accounts of the intermediary are held in the state in which the holding company is located;
- the holding company's accounting is conducted in the state in which the holding company is located.

In addition, since January 1, 2018 (and enforced after April 1, 2018), foreign intermediary holding companies need to comply with the following substance requirements:

- The holding company needs to incur employment costs of at least 100,000 euros (adjusted to the Consumer Price Index, "CPI") in relation to its intermediary holding functions. Examples of CPI indexes to be taken into account with respect to other countries are 90 percent for Cyprus, 100 percent for Luxembourg, 80 percent for Malta and 100 percent for Switzerland.
- The holding company needs to have (for at least 24 months) its own office space at its disposal used for carrying out the intermediary holding functions.

The wording of the law seems to leave room for the taxpayers to prove that business reasons exist for the structure even when the substance requirements are not met. However, based on legislative history it is clear that when an intermediary holding company does not meet the substance requirements, there is an irrebuttable presumption of abuse and the dividend withholding tax exemption should not apply.

Finally, passive investments structures such as pan-European real estate funds investing via an EU holding company and Dutch property companies in Dutch real properties should not be eligible for the withholding tax exemption irrespective of the level of substance existing of the holding company. This is because it is assumed that the holding company is in these circumstances not implemented for business reasons that reflect economic reality, since it does not fulfil a linking function between operational business activities.

Anti-abuse Legislation in an EU Context

Over the years, the CJEU has had to decide in many cases relating to the application of anti-abuse legislation in an EU context. One major decision was the *Cadbury Schweppes* case in 2006 (Case C-196/04: http://src.bna.com/yXQ) which firmly established the "wholly artificial arrangement" doctrine, limiting the scope of anti-abuse legislation in an EU context. However, over the last few years the question has been raised by many as to whether the CJEU would, in today's political environment, still be as restrictive as in the past.

Then, in two landmark cases involving German anti-abuse legislation (Cases C-504/16 and C-613/16, decision of December 20, 2017: http://src.bna.com/yXR; http://src.bna.com/yXS) and a PPT under French tax law (Case C-6/16, decision of September 7, 2017: http://src.bna.com/zHo), the CJEU re-emphasized its "wholly artificial arrangement" doctrine. In its decisions, the court analyzed the compatibility of anti-abuse legislation with the PSD and the freedom of establishment.

Considerations Regarding the Parent-Subsidiary Directive

According to Article 5 (1) of the PSD, the distribution of profits by a company that is resident in an EU member state to a parent company that is resident in another EU member state should be exempt from withholding tax. This exemption is meant to avoid double taxation, to ensure tax neutrality and to facilitate the grouping of companies at EU level.

Consequently, the PSD limits the sovereignty of EU member states regarding the taxation of profits distributed by resident companies to a parent company resident in another member state. Further, member states are not free to unilaterally introduce restrictive measures that would subject the right to exemption from withholding tax to various conditions.

Article 1 (2)–(4) of the PSD only allows member states to introduce domestic or agreement-based provisions required for the prevention of fraud and abuse provided that these measures are appropriate and do not go beyond what is necessary to achieve that objective. As an exception to the general rule laid down by the PSD, such measures are subject to a strict interpretation.

Considerations Regarding Freedom of Establishment

All measures which prohibit, impede or render less attractive the exercise of the freedom of establishment must be considered to be restrictions on that freedom. Such restrictions are only permissible if they relate to situations which are not objectively comparable or if justified by overriding reasons in the public interest recognized by EU law.

In these circumstances, it is further necessary that the restriction is appropriate for ensuring the attainment of the objective that it pursues and that it does not go beyond what is necessary to achieve this.

The Wholly Artificial Arrangement Doctrine

According to the CJEU, the objective of combating tax evasion and avoidance, whether it relies on Article 1 (2) of the PSD or is a justification for an exception to primary law (i.e., the freedom of establishment) has the same scope. Therefore, anti-abuse provisions have to be targeted measures aiming specifically at "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage.

Thus, tax authorities should not easily consider the presence of fraud or abuse. Moreover, taxpayers are free to rely on their EU freedoms when structuring investments and "tax jurisdiction shopping" is a legitimate activity in an internal market, even if the choice of the jurisdiction is principally based on tax considerations.

It is, however, undisputed that member states are free to protect their tax bases by way of anti-abuse rules which are exclusively directed at wholly artificial arrangements. Nevertheless, when assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria. Instead, tax authorities have to carry out an individual examination of the whole operation at issue.

Analyzing the Substance of a Company

An abusive situation does not depend only on the intention of the taxpayer to obtain tax benefits (i.e., a motive test) but requires the existence (or absence) of certain objective factors, including an "actual establishment" in the host state (for example, premises, staff, facilities and equipment) and the performance of a "genuine economic activity." As regards the existence of an actual establishment, the CJEU does not seem to require an extensive level of substance. As a rule of thumb, the substance should be appropriate for the activities performed by the company.

The notion of "genuine economic activity" should be understood in a very broad manner and may include the mere exploitation of assets such as shareholdings, receivables and intangibles for the purpose of deriving what is often described as "passive" income. The nature of the activity should not be compromised if such passive income is principally sourced outside the host state of the entity.

When analyzing the substance of a company, it is necessary not only to analyze the situation of the entity as such but also of the group as a whole. Here, it may even suffice if a company relies on the staff and premises of other group companies in the same jurisdiction. (As a reaction to the CJEU decision in regard to the German anti-abuse provision, the German Ministry of Finance released a Circular on April 4, 2018 in which it has been clarified that the provision according to which only the substance at the level of the direct parent company is to be considered is not applicable anymore. Hence, it has been acknowledged that the substance of the entire group in the jurisdiction of the parent company needs to be taken into consideration when assessing potential cases of abuse.)

In addition, no specific ties or connections between the economic activity assigned to the foreign entity and the territory of the host state of that entity can be required by domestic anti-abuse provisions. Therefore, insofar as the EU internal market is concerned, the mere fact that an intermediary company is "active" in conducting the functions and assets allocated to it (rather than being a mere letterbox company) should suffice to be out of the scope of domestic anti-abuse legislation or the PPT in tax treaties concluded between EU member states.

Anti-abuse legislation should further not establish an irrebuttable presumption of fraud or abuse. Instead, the taxpayer must have the possibility to provide evidence of the appropriateness of the structure.

The imposition of a general tax measure automatically excluding certain categories of taxable persons from the tax advantage, without the tax authorities

being required to provide even prima facie evidence of fraud and abuse goes beyond what is necessary to prevent fraud and abuse. Accordingly, as long as the foreign company has appropriate substance, the nature (corporates vs. individuals), origin or tax status of their shareholder(s) should be irrelevant for the application of anti-abuse legislation.

From a practical perspective, the setting up of holding and finance companies with an artificially high level of equipment, facilities and employees would, however, to a certain extent, be contrary to their economic nature. The simple presence of a manager monitoring the holding and finance activities of the Luxembourg company may in some cases be considered sufficient to bring substance to the structure and, as such, prevent the structure from being (partially) disregarded due to the application of foreign anti-abuse provisions. A low level of substance is the direct consequence of the specific purpose of a "pure" holding and finance vehicle and should be accepted for tax purposes.

Analyzing Compatibility Issues

Based on the aforementioned CJEU case law, it is possible to analyze compatibility issues of the Dutch anti-abuse legislation with EU Law. The following aspects are particularly problematic from an EU law perspective.

Excessive Substance Requirements and Focus on the Parent Company

In order to benefit from a withholding tax exemption on dividends, an EU parent company of a Dutch company (that is an intermediary holding company) needs to comply with specific substance requirements. Since January 1, 2018, these substance requirements include a requirement that the parent company, among others, incurs employment costs of at least 100,000 euros and has office space at its disposal.

However, a minimum threshold of employment costs of 100,000 euros is inappropriate to detect situations of abuse. For many holding companies, this level of employment costs seems to be rather excessive.

As a matter of principle, the substance of a company needs to be appropriate for the activities performed. When a company performs holding and financing activities, the management of the company's asset does not necessarily require a lot of substance. This has been expressly acknowledged in the jurisprudence of the CJEU.

When analyzing the substance of the parent company, the organizational, economic or other substantial features of undertakings that are affiliated with the nonresident parent company (and resident in the same jurisdiction) are not considered under the Dutch anti-abuse provision. However, according to the decisions of the CJEU, it is necessary not only to analyze the situation of the entity as such but also of the group as a whole.

In practice, there are different ways to organize the substance of a holding company, ranging from cases with significant internal resources that manage most of the tasks internally, to cases that rely, for cost-efficiency purposes, on an outsourcing model where certain functions are outsourced to qualified service providers (or other group companies) and monitored by the employees or the directors of the company (for example, accounting and compliance services).

When substance is organized internally, asset managers and multinational groups may have significant substance in a master holding, a management or a service company that renders services to other group companies.

While any of these substance models may comply with the requirements set out in CJEU case law (if appropriate in view of the facts and circumstances of the specific case), based on the legislative history, the Dutch anti-abuse legislation should deny the dividend withholding tax exemption if the substance requirements are not met at the level of the intermediary holding company.

Rules not Targeted to Wholly Artificial Arrangements

When assessing the existence of fraud and abuse, tax authorities may not rely on predetermined general criteria such as the substance requirements set out under Dutch law. Instead, tax authorities have to carry out an individual examination of the whole operation at issue.

The imposition of a general tax measure automatically excluding certain categories of taxable persons from the tax advantage, without the tax authorities being required to provide even prima facie evidence of fraud and abuse, goes beyond what is necessary to prevent fraud and abuse.

Instead, national legislation must be targeted to prevent conduct involving the creation of "wholly artificial arrangements" which do not reflect economic reality and the purpose of which is to unduly obtain a tax advantage. Thus, a general presumption of fraud and abuse can justify neither a fiscal measure which compromises the objectives of the PSD nor a fiscal measure which prejudices the enjoyment of a fundamental freedom guaranteed by the EU Treaty.

Irrebuttable Presumption of Abuse

When a foreign intermediary holding company does not comply with the substance requirements set out under Dutch tax law, there is an irrebutable presumption of abuse. However, according to CJEU case law, the taxpayer must have the possibility to provide evidence of the appropriateness of the structure and the underlying business reasons.

Passive Investment Structures

Under the Dutch anti-abuse legislation, passive investment structures such as real estate funds investing via an EU holding company into Dutch companies passively holding real estate should not be eligible for the dividend withholding tax exemption. However, the notion of "genuine economic activity" should be understood in a very broad manner and may include the mere exploitation of assets such as shareholdings, receivables and intangibles. As long as the intermediary holding company is "active" in conducting the functions and assets allocated to it (rather than being a mere letterbox company), it should be out of the scope

of anti-abuse legislation. The nature of the activity should further not be compromised if such passive income is principally sourced outside the host state of the entity.

In Summary

Several EU member states implemented anti-abuse legislation in their domestic tax law requiring excessive substance requirements, which is not in line with the jurisprudence of the CJEU. The Dutch anti-abuse rules also fall into this category, violating both the PSD and the freedom of establishment.

It is self-evident that the Dutch anti-abuse rules are not specifically designed to target wholly artificial arrangements. Also, the requirement to have employment costs of at least 100,000 euros and premises will in many cases not be required for the proper management of the activities of a holding and financing company. This excludes not only letterbox companies from the benefits of the PSD but also holding companies that exist for a range of legitimate commercial reasons. As such, this criterion is inappropriate to detect situations of abuse.

Likewise, the systematic exclusion of holding companies performing cross-border passive investments (e.g. real estate) from the benefits of the dividend withholding tax exemption is incompatible with EU Law.

Planning Point

In light of the above, corporate shareholders resident in EU member states should systematically reclaim withholding tax levied on dividends paid by Dutch subsidiaries and challenge potential negative decisions before the Dutch Courts. It is interesting to note that until today national courts around Europe have not deviated from the wholly artificial arrangement doctrine laid down by the CJEU.

Oliver R. Hoor is a Tax Partner (Head of Transfer Pricing and the German Desk) with ATOZ Tax Advisers (Taxand Luxembourg) and Frank Buitenwerf is a Tax Partner with Taxand Netherlands.
The authors may be contacted at: oliver.hoor@atoz.lu; frank.buitenwerf@taxand.nl
The authors wish to thank Samantha Schmitz (Chief Knowledge Officer) for her assistance.

07/18 Copyright © 2018 by The Bureau of National Affairs, Inc. TPIR ISSN 0309-7900