

# The Use of Dutch Legal Entities in International Tax Reduction Strategies, Part II



Jos Peters is the Senior Tax Partner at Merlyn International Tax Solutions Group

Dutch legal entities can surprisingly easily be “hybridised” for international tax reduction purposes. In a previous article (*WCR December 2009*) we have depicted how this might work with a Dutch “Cooperative Association”. This month’s contribution deals with hybridisation of the standard Dutch limited liability company: BV.

## Introduction

- Hybrid entities are legal entities which in the country of the parent of the multinational group are seen as legal entities, so they are considered to be subject to tax of their own accord, whilst the foreign investment jurisdiction considers them as “partnerships”. Such entities are not subject to tax themselves but their owners/shareholders may be, if they are deemed to run a permanent establishment in the investment country. Or the other way around (“reverse hybrids”). Many legal entities can be hybridised or are even hybrid by nature, due to the differences in the classification rules for foreign entities between the tax laws of countries;
- This may well lead to double taxation (one country taxes the entity, the other country taxes the partners on the same income). However, the opposite is also possible: the entity is not taxed by either tax authority of the countries it does business in; this is especially true for Europe where many countries exempt foreign dividends from local tax;
- Countries do not normally take foreign legal or tax aspects into account when establishing their tax classification rules for foreign entities: they invariably use their own criteria. These criteria differ manifestly per country, however. There are no signs that countries are planning to, or are even willing to, align their entity tax classification rules with one another, any time soon.
- In many cases one can make deliberate use of “automatic” hybrids: no tax authority, neither at home nor abroad, will consider them odd or artificial, because they are widely used by others in a non-hybrid way.

## The automatic hybridisation of a standard Dutch BV

The Netherlands, like many other tax jurisdictions, recognizes the notion of tax consolidation, widely known amongst tax practitioners in the Netherlands as “fiscal unity”. Any Dutch parent company which was incorporated in the format of an NV a BV, an SE or a Cooperative Association (“Coop”) can form a tax consolidated group with one or more of its subsidiary NV’s, BV’s or SE’s (Coops can only act as parents in such a group, not as subsidiaries). NV’s and SE’s are not different from BV entities as regards hybridisation and will therefore not be discussed separately in this article. What I describe for a BV will also work for an NV or an SE in my country.

When taking a closer look at this feature, a few key points come to light which make the Dutch tax consolidation rules differ markedly from those of other countries.

Dutch “fiscal unity” is optional and a request must be filed on a subsidiary by subsidiary basis to achieve such a position. A Dutch parent can elect to form a fiscal unit with any combination of its BV, NV and SE subsidiaries which it deems appropriate. If it is better to leave one or more subsidiaries out of the fiscal unit, one is fully free to do so: “junction” is always possible at a later moment. Tax payers are also free to choose the moment when the fiscal unity starts and stops: this can be any workday throughout the year, also on a subsidiary by subsidiary basis.

A crucial element of a subsidiary entering a Dutch fiscal unit is, that

from that moment onwards, the subsidiary becomes invisible for Dutch corporate income (CIT) tax purposes. The subsidiary, for CIT, ceases to exist. Its assets and liabilities are deemed to have been absorbed by its parent and the entity, from the junction moment onwards, is treated as a Dutch branch office of the parent. As a consequence, the subsidiary can no longer file a Dutch CIT return of its own.

Many tax practitioners worldwide are familiar with this Dutch “fiscal unity” procedure and it is often applied almost automatically: if a Dutch entity incorporates or acquires a Dutch subsidiary of which it owns 95% or more, a request for fiscal unity is filed with the tax authorities, often without further input from tax counsel: “the bookkeeper can do it” (and he/she usually does so).

This automatic pilot approach is by no means obvious, however. Fiscal unity in the Netherlands is subject to strict anti-abuse rules, both for a subsidiary entering a fiscal unit and for a subsidiary leaving the tax group, to avoid that tax claims get lost in the process. Such provisions could well kick in, also in cases of non-abuse, because of the way they were written. Or they may lead to unwanted side-effects. This should really be looked at in some depth before a fiscal unit is requested or enlarged and I have seen many cases whereby avoiding fiscal unity gave much better tax results long term than filing for it. After all, saving yourself the expenses of filing an extra CIT return should not be the driving factor, but this is often not well understood.

In this article I will not go into these side-effects of the fiscal unity concept, however. I just want to address an – equally often overlooked – main effect: if a Dutch company, which is a subsidiary of another Dutch company, files for fiscal unity, it ceases to exist only for Dutch CIT purposes and ONLY in the Netherlands. If such a company has business abroad, it will continue to be subject to foreign corporate income tax abroad in its own name and for its own account, regardless of the fact that it no longer exists for Dutch CIT purposes! After all, the company continues to exist for Dutch legal purposes and for all Dutch taxes except CIT.

Filing for Dutch fiscal unity treatment, for Dutch BV entities which operate foreign permanent establishments or possess foreign assets which give rise to foreign tax liabilities (eg. foreign real estate), therefore implies an automatic hybridisation of such entities: they cease to exist for CIT purposes in the Netherlands but continue their lives for CIT purposes abroad.

## The stunning overall tax effects of an automatic hybridisation of a Dutch BV

It is easy to overlook the ultimate consequence of the notion, in Dutch corporate income tax law, that upon tax consolidation, the Dutch subsidiary company of a Dutch parent company “ceases to exist”, because it is not primarily a tax effect which arises, but a legal effect. But this legal effect may have huge tax consequences.

If a company which forms part of a Dutch tax consolidated group “ceases to exist”, as article 15 of the Dutch corporate income tax act describes it, this may have very significant consequences for any agreements which this entity may have entered into with the other companies in the Dutch tax consolidated group, including its parent

company:

1) Intra-tax-group contracts will have to be ignored for Dutch CIT purposes as well. One cannot borrow money from oneself, one cannot enter into a licensing agreement with oneself, one cannot put employees to the disposition of oneself, one cannot rent equipment from oneself, etc. etc.

2) Any income resulting from these intra-tax-group contracts therefore becomes invisible for corporate income tax purposes in the Netherlands. And invisible income cannot be taxed...

So the bottom line, for the Netherlands taxation of such a hybrid standard Dutch BV entity, is:

*An entity which disappears for Dutch CIT purposes upon filing a Dutch fiscal unity request, will see all of its intra-tax-group contracts disappear in the Netherlands, which in its turn leads to disappearing income in the Netherlands from such contracts, which might otherwise, if earned outside a fiscal unity context, have formed regular taxable income in the Netherlands.*

As observed, the Dutch entity – if it has foreign operations - does not disappear abroad. There the entity continues to be a foreign tax payer with the obligation to file an annual CIT return. Its agreements with other Dutch entities in the Dutch tax consolidated group do not become invisible abroad and the income from such agreements does not disappear from the foreign tax radar either.

Income for one group company, under an intra-group agreement of whatever form, means expenses for the other group company. Hybridising a Dutch BV with foreign operations may therefore cause very significant tax reductions for the multinational involved, since one country must allow tax deductions for expenses incurred whilst the country where these expenses form income, does not recognize this income for CIT purposes.

#### **An example in the area of “intra-group leasing of trucks”**

Say a US fruit transportation company “Frutrans Inc.” seeks to invest in similar activities in Europe, for instance the transportation of fruit from South-Spanish harbours (where it comes in from fruit producers in Northern-Africa) to France, Holland, Germany, Sweden and other areas north of Spain. Frutrans Inc. sets up a Dutch (Parent) Company X BV which sets up a 100% Dutch Subsidiary Company Y BV, and both BV’s form a Dutch tax consolidated group by filing a standard request form. The Dutch tax authorities will normally always accept such a request as the law contains no grounds for a refusal.

X BV subsequently purchases a number of specialized trucks and trailers, suitable for fruit transportation. This is done from a capital infusion which it will obtain from its US parent Frutrans Inc. Let’s say BV X invests €100 million. The trucks and trailers are subsequently leased out to Y BV which sets up a substantial branch office in Spain (virtually all business activities of BV Y will take place in Spain where the customers are which seek transportation of their fruit to Northern-Europe). The lease contracts between BV X and (the Spanish branch of) BV Y are drafted in such fashion that they meet the “arm’s length” standard for transfer pricing: BV X charges BV Y no more than a third party would charge BV Y for similar lease contracts under similar circumstances.

Let’s assume that a transfer pricing study shows that the arm’s length lease fee which Y BV has to pay to X BV for these trucks and trailers amounts to €17.5 million per annum. The Spanish branch office of X BV will be able to deduct these rental fees from its taxable profits in Spain, both under regular Spanish corporate income tax law and if needed under article 7-3 of the Dutch/Spanish tax treaty, which would override any Spanish limitations. The Spanish CIT reduction attributable to the lease contracts is around €5.5 million per annum.

But because Y BV does not exist in the Netherlands, its rental agreement with X BV also does not exist for Dutch corporate income tax purposes, so the Dutch tax consolidated group “X BV” (Y BV has disappeared) cannot recognize the rental income which Y BV paid to X BV for Dutch corporate income tax purposes and this income remains

untaxed in the Netherlands. The net/net tax benefit of this setup is then equal to the Spanish tax savings from being able to deduct lease fees rather than depreciation of, some €10 million per annum, which equals €2.5 million each year; if the lease continues after the 10 year depreciation period, the tax benefit increases to 35% of €17.5 million or almost €6 million per year.

Intercompany contracts might of course cover all kinds of relationships, not just the rental of vehicles. Also in these other areas, the Dutch income disappears and the multinational group will be able to save itself millions of tax in the countries of their operations. You might think of:

a) A production environment, where foreign branches of Y BV produce goods under a licensing agreement for the US patents in use (X BV obtains the exploitation rights for these US intangibles, for use outside the USA, from its parent company in the form of a contribution to capital and licenses them to (the foreign branch of) Y BV;

b) A sales environment: X BV enters into a commissionaire agreement with sales and service subsidiary Y BV, which operates via permanent establishments (branch offices) abroad. The commissionaire agreement substantially reduces Y BV’s taxable income abroad but the income which flows to X BV as a result of this remains untaxed in the Netherlands because the commissionaire agreement does not exist from a Dutch viewpoint, so X BV files for a much higher amount of foreign profits (exempt from CIT in the Netherlands) than actually reported abroad.

#### **A case like this has been litigated in the Netherlands with astonishing results**

The Dutch Supreme Tax Court decided in a long and well documented decision which it handed in 2003, after more than 12 years of litigation concerning a case of “disappearing income” as described above, that the phenomenon of disappearing entities in Dutch tax consolidated groups does indeed lead to disappearing income from intra-tax-consolidated-group transactions and that the tax payer concerned was right in not reporting taxable income from such transactions as profit for Dutch corporate income tax purposes. The Supreme Court saw no reason whatsoever, despite repeated pleas by the Dutch Ministry of Finance during the appeals process, to take any tax effects in the country of the foreign operations of the Dutch subsidiary company into account. The verdict was firm and unambiguous.

The Supreme Tax Court also made it clear that this was not a decision in the case at hand only (factual decision), but an affirmation of a cornerstone of the Dutch CIT system, also in other cases where income might disappear as a result of the fiscal unity rules. The court even emphasized that the tax planning behind these structures can in no way be regarded as “abusive” under any Dutch “abuse of law” rule.

#### **Will the law now change in the Netherlands to prevent this outcome?**

Tax legislators have the opportunity, if court cases get lost by the revenue service, to adapt the law if they can convince Parliament that the outcome is unwanted. This was also the base attitude in the Dutch Ministry of Finance when the case was first litigated in the late eighties of the previous century. In fact, an anti-abuse article was introduced in the Dutch CIT Act in 2002 to make sure that the Dutch foreign income exemption for a tax payer of running foreign operations in its own name (via branches or the possession of foreign real estate) would not be higher than the income declared abroad.

But after the Dutch Supreme Court decided in 2003 that the tax payer was not only right, under the old law, to not report certain income under the Dutch fiscal unit rules, but that this approach also did not constitute any form of abuse under Dutch tax law and tax principles, the Ministry of Finance unexpectedly decided to remove the anti-abuse rule. It did so per 01/01/2005 when several fiscal unity rules were up for revision and clarification.

Per today there is only one anti-abuse element still in force: if a group entity in a Dutch fiscal unit grants a loan to another tax group

member, which loan is used in a foreign permanent establishment of the subsidiary entity or for the financing of foreign real estate owned by that subsidiary entity, the interest on that loan will be added to taxable income in the Netherlands even if it does not exist under fiscal unity principles, unless the tax payer proves that the interest has not been tax deductible abroad. All other types of intercompany agreements between members of a Dutch fiscal unit have been taken out of the anti-abuse rule and tax payers are free to use the Dutch fiscal unity rule, which allow for disappearing income, to their financial advantage.

**Multinationals without Dutch business can also benefit from the Supreme Court verdict**

Setting up a Dutch intermediate holding company, which incorporates a Dutch subsidiary which operates foreign branches, can not only be financially beneficial for Dutch multinationals. These tax planning structures are equally open to multinationals from other countries. Nothing should stop a Swedish multinational with

plans to start production in Singapore to put the above described Dutch "sandwich" in between: Singaporean CIT will substantially be reduced, the Netherlands will levy no tax and Dutch dividends will be tax exempt in Sweden. In fact, almost any multinational in a country which exempts foreign dividend income from taxation can benefit.

Even multinationals in "tax credit" countries such as the USA, Australia, the UK, Canada, China and Japan may benefit substantially from this "Holland routing" of part of their corporate income. This might be the case if they are looking for low-taxed foreign source income to avoid excess credit situations at home, or it might, in the absence of CFC type tax legislation at home, lead to at least very substantial tax deferrals for the group, with a corresponding rise in earnings per share! ■

*For further information please contact:*

*Joseph Peters MBA, tel: +31 10 201 0820 Mob: +31 654 702084*

*Email: jos@merlyn.eu*