NovioTax

The Dutch implementation of ATAD1

April 2019

From January 1, 2019, the first EU Anti-Tax Avoidance Directive (2016/1164) (hereafter: ATAD1) is implemented by all EU Member States. A number of its provisions impact the field of (inter)national taxation. In the Netherlands we have seen the introduction of an earnings stripping measure and CFC legislation. In addition a number of provisions limiting the deduction of interest expenses have been abolished. This contribution intends to provide a summary. To serve its' purpose we have also itemized a number of observations obtained in day-to-day to practice in relation to the earnings stripping provisions and its' relation to the Dutch fiscal unity, ECJ legislation and transfer pricing.

The ATAD1 sets out a framework and minimum implementation requirements for the Member States in order to cope with tax avoidance practices that, according to its title, 'directly affect the functioning of the internal market'. The ATAD1 contains the following provisions which will be discussed in this blog (in the same order as set out in the Directive):

- interest limitation rule;
- exit taxation rule;
- general anti-avoidance rule;
- Controlled-Foreign-Company rules; and
- the provisions on hybrid mismatches.

Art. 4: Interest Limitation / Earnings stripping rule

Article 4 of the ATAD1 provides for an interest limitation rule, also known as the earnings stripping rule. The core provision of this rule stipulates that corporate taxpayers are only able to deduct exceeding borrowing expenses incurred up to 30% of the taxpayer's earnings before interest, taxes, depreciation and amortization (hereafter: EBITDA) in a given tax period. Member States may allow taxpayers a de minimis threshold of € 3 mio (at a maximum) to deduct exceeding borrowing costs. The Netherlands has implemented a threshold of € 1 mio to deduct exceeding borrowing costs. Furthermore, Member States can choose to allow a carry-forward or carry back of exceeding borrowing costs, with or without time limitation and a limited carry-forward of unused EBITDA capacity.

The Dutch Corporate Income Tax Act (hereafter: CITA) already contains a number of specific anti-avoidance rules aimed at limiting the deductibility of interest, however none of these are based on the EBITDA as stipulated in the ATAD1. In effect, the earnings stripping rule, included in article 15b CITA, restricts the net interest deduction to the highest of either:

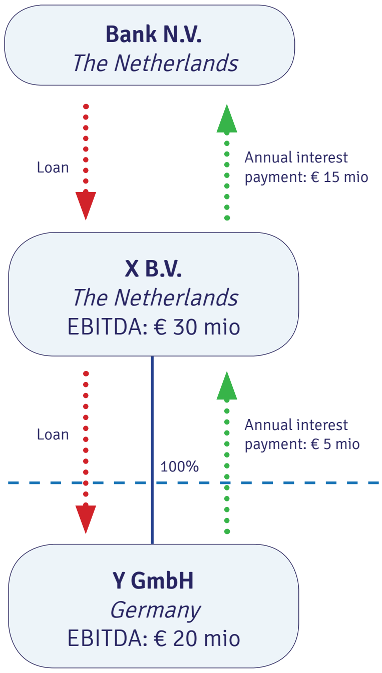
- 30% of the EBITDA as determined under the fiscal accounts; or
- € 1 mio.

It should be noted that the EBITDA amount is determined using Netherlands tax principles, which includes the arms' length principle. The applicable EBITDA amount is thereafter affected by a number of adjustments (i.e. amount of depreciation or devaluation of an asset, amount of recapture of earlier devaluations of an asset and by the net amount of interest paid or received).

An unlimited carry forward applies for non-deductible, excess interest expenses. For the deduction, the "first in first out" method applies. However, in case of a change of control in a company of more than 30% of the aggregated voting power, any unused interest deduction cannot be carried forward, and thus, is forfeited. Dutch legislation does not provide for a (potentially relieving) group ratio, an exception for separate entities and financial institutions and/or a grandfathering provision for existing financial arrangements (as indicated in the Directive).

Lastly it should be noted that in connection with the implementation of article 4 of the Directive, the interest deduction limitation rules for participation debt (art. 13l CITA) as well as for acquisition holding debt (art. 15ad CITA) have been abolished.

Observations art. 15b CITA



Article 15b CITA can best be illustrated by the following example.

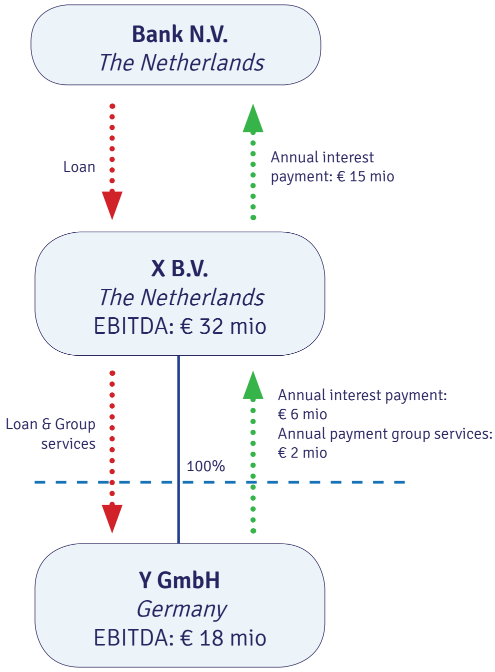
X BV receives a loan from Bank NV, which is partly lend onward to its 100% owned subsidiary, Y GmbH. Y GmbH performs manufacturing activities. It functions as a routine contract manufacturer, producing sensors and motors that are subsequently sold by X BV.

Y GmbH additionally performs full-fledged process R&D activities aimed at enhancing the effectiveness of the production activities of Y GmbH. Observing the technical nature of the production process this strongly enhances the value of the products manufactured by Y GmbH X BV pays a yearly interest amount of € 15 mio to Bank NV, and in turn receives a yearly interest payment of € 5 mio from Y GmbH. X BV has an EBITDA of € 30 mio from ordinary business activities.

The net deductible interest amount is € 15 mio -/- € 5 mio = € 10 mio. The maximum allowable tax deduction is 30% of the EBITDA, which is € 9 mio. Hence, the net interest expenses cannot be fully deducted from X BV's tax base, i.e. the remaining amount of € 1 mio is not deductible in X BV's current tax year. This amount can be carried forward, and may be eligible for deduction in subsequent years based on a first in first out methodology.

The application of the interest deduction limitation as set out above could conceptually be resolved by converting part of X BV's capital investment in Y GmbH into a loan (provided sufficient paid in capital is available). The commercial reality and business rationale for such a conversion are however leading and should be considered. Via a conversion both the interest amount as well as the applicable interest rate increase. If X BV partly converts its capital issued to Y GmbH, such that the interest expenses will increase to € 6 mio, the result would be as follows. In this scenario X BV settles its interest paid and interest received, resulting in a net interest expense of € 9 mio (€ 15 mio -/- € 6 mio), which is then fully deductible since 30% of the EBITDA also amounts to € 9 mio. Additionally, Y GmbH can normally still fully deduct its interest expenses of € 6 mio since 30% of the EBITDA also amounts to € 6 mio observing the German earnings stripping provisions. In this respect however consideration should be given to the activities of Y GmbH and the arm's length interest rate. If the R&D activities aimed at enhancing the manufacturing activities are significant and the risk appreciation of Y GmbH is relative high, the arm's length interest rate may trigger discussions with the German Tax Authorities.

Interaction with transfer pricing principles



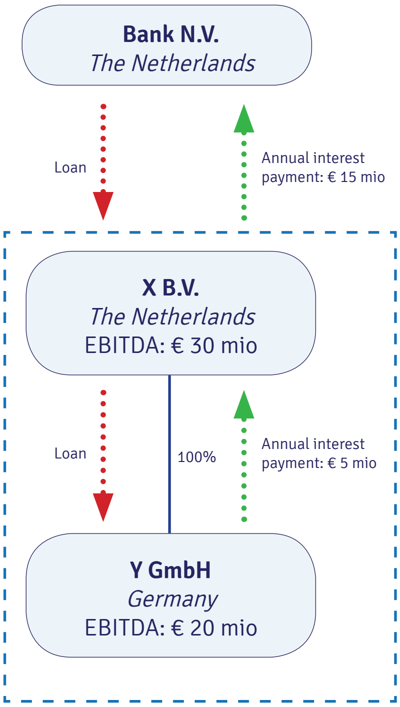
The facts and circumstances are the same as in the example above. However, for this example the Dutch tax authorities (hereafter: DTA) and the German Tax Authorities (GTA) have concluded a bilateral APA. To make the actual allocation of profits consistent with the APA concluded the DTA has recognized a deemed income of € 2mio (excess profit). Likewise the GTA has recognized a deductible expense.

The TP adjustment reduces the EBITDA of Y GmbH to an amount of € 18 mio, and in turn increases the EBITDA of X BV to an amount of € 32 mio. This has consequences for the allowed interest deductions (i.e. earnings stripping provisions) in both countries. In this respect we have assumed that any TP adjustment impacts the respective EBITDA level in Germany. Although the interest expenses can be fully deducted at the level of the Netherlands, the TP adjustment may result in (partial) non-deductible interest expenses at the level of Y GmbH. Hence, a bilateral APA or any TP adjustment may trigger effectively non-deductible interest within groups and result in a suboptimal tax position.

Partial non-deductible interest expenses, may occur in the event that Y GmbH has an insufficient EBITDA to deduct all annual interest expenses (i.e. € 6 mio). Since a tax deduction is only allowed up to 30% of the EBITDA of Y GmbH (€ 5,4 mio in interest deductions), the remaining amount of € 600k is not deductible in the current tax year. This amount can be carried forward, and will be deducted in future tax years on the basis of the first in first out method. This however results in a higher tax base at the level of Y GmbH (€ 600k higher) Opposite to the conversion of debt into equity as clarified in the original example X B.V. may consider converting part of its loan into equity. The commercial reality and business rationale for such a conversion are however leading and should be considered.

Alignment with Groupe Steria

The facts and circumstances are similar as in the original example. However, for this example Y GmbH is a Dutch incorporated BV. In this scenario, the Dutch fiscal unity is recognized as a single (consolidated) taxpayer for article 15b CITA. Subsequently, loan arrangements (and the connecting interest expenses) issued between affiliated companies within the fiscal unity are consolidated prior to calculating the EBITDA and connecting interest costs. This results in a consolidated EBITDA (of the fiscal unity) of € 50 mio, thus permitting a maximum interest deduction of € 15 mio (€ 50 mio * 30%). Therefore, the (settled) interest costs of € 15 mio would have been completely allowable for tax deduction.



If, in the example above, Production BV would have been a German incorporated GmbH, the tax position would have been suboptimal due to the earnings stripping measures in the Netherlands and Germany. In the example above without changing the facts and assumptions despite having a Netherlands production affiliate vs. a German production affiliate, the group would not trigger a limitation of the deduction of interest. It should be noted that this differences is related to the fact that Dutch companies can enter into a fiscal unity, whereas this opportunity does not exist for non-Netherlands companies. This potentially could trigger an ECJ discussion (see for instance Groupe Steria (C-386/14). A Netherlands company may have an incentive to acquire and/or set up Netherlands production companies vs. European companies. This may limit the opportunities for companies in other Member State that do not fulfil the criteria imposed by the Netherlands legislator to form a fiscal unity.

Art. 5: Exit taxation

Article 5 of the ATAD1 contains an exit taxation rule. The four scenarios covered by article 5(1) of the ATAD1 provide for a comprehensive protection. The rule contained in article 5 of the ATAD1 factors in settled case law of the European Court of Justice (ECJ) in recent years on the subject of exit taxation (i.e. ECJ National Grid Indus (Case C-371/10), the right to a deferral of payment for corporate taxpayers, as provided for by article 5(2) of the ATAD1). ECJ National Grid Indus has also lead to the options granted under article 5(3) of the ATAD1 to charge interest on the outstanding amount of exit tax or to require a bank guarantee.

Articles 15c and 15d CITA provide for taxation in situations in which a taxpayer ceases to be a tax resident of the Netherlands. In such instances, the difference between the market value and the book value of the transferred assets are, in principle, subject to corporate income tax. Before the amendments of January 1st, 2019, companies that had transferred the place of effective management to another EU Member State had three options in respect of the exit taxation. The first option was to directly pay the taxes due, the second option was to defer the taxes until the moment of actual realisation of the profit, while the third option was to pay the arising tax claim in 10 instalments, (equally) divided over a time period of 10 years. As a result of the Directive, this period has been reduced to 5 years. The tax authorities may also request that a guarantee is provided if the tax inspector deems it plausible that a serious risk exists that the tax claim cannot be collected.

The Dutch rules on exit taxation were already in large part aligned with the provisions of the Directive. However, the Dutch government has slightly modified article 25b of the Tax Collection Law of 1990, to align it with article 5 of the Directive. Before the modification, a transfer of an asset from a head office to a Permanent Establishment (hereafter: PE) was not an event that triggered exit taxation. This was amended to align the national law with the Directive, specifically article 5(1)(a) and (b) thereof.

In addition, article 5(2) of the Directive provides for the option to pay the tax due in instalments (rather than upon emigration/transfer) over a period of five years. As mentioned above, Dutch law provided for the possibility of payment in ten instalments, a provision that is significantly more lenient than as contained in the Directive and thus required amending. EU Member States are obliged to implement these new rules for tax years starting from January 1st, 2020.

As to this feature of the Directive, it should be noted that not all EU Member States have implemented the legislation before January 1st, 2019.

In this context a recent ECJ decision is also relevant (ECJ Wächtler (Case C-581/17)). In this case a EU-citizen (German national) had moved to a non-EU / non-EER country (i.e. Switzerland), where to a free movement of persons agreement applies. Upon migration the German Tax Authorities imposed an exit charge upon the capital gain on the taxpayer's shares in a German company, without deferral of taxes due. The reason for this decision was based on the fact that Germany did not have a treaty in place with Switzerland to assist in tax recoveries. The ECJ however decided that this measure went beyond the scope of (what is necessary to collect) the German exit taxation, and that imposing a bank guarantee would also suffice in guaranteeing the payment of taxes that were due.

This decision was based on the fact that Member States oblige taxpayers that migrate to another country to pay their taxes due over shares in companies. These taxes due can be paid in instalments, the ECJ however decided that this is unjustified in light of the freedom of movement that is provided by the agreement in place between Germany and Switzerland, and that these taxpayers should be permitted a deferral of taxes until the actual disposal of those shares.

Following the aforementioned ECJ Wächtler decision, it remains to be seen if the exit taxation that results from ATAD1 can be upheld for domestic CIT purposes. Although the aforementioned decision was based on personal income taxation, similar reasoning could however be applied to a CIT situation. Moreover, it is supposable to state that protection under the Treaty for the Functioning of the European Union (hereafter: TFEU) is more extensive than protection under the agreement between Germany and Switzerland. In other words, the exit taxation regimes as a result of ATAD1 could constitute an unjustified restriction on the freedom of establishment provided for by the TFEU.

Art. 6: The General Anti-Avoidance Rule

The general anti-avoidance rule (hereafter: GAAR) is set out in article 6 of the Directive. It displays various elements of anti-avoidance doctrines, most notably the substance-over-form ideology. When applying the GAAR, tax authorities may disregard a chosen legal structure (or arrangement). This is however only possible if such a legal structure (arrangement) was put into place with the main purpose, or one of the main purposes, of obtaining a tax advantage that frustrates the object or purpose of the applicable tax law <u>and</u> is not genuine with regard to all the relevant facts and circumstances.

As mentioned, the GAAR targets situations in which the only objective of a transaction is to obtain a tax advantage, the non-tax objectives are very general and not specifically connected with the underlying transaction, or the non-tax objectives, although connected with the underlying transaction, are immaterial. In applying the provision, the tax authorities only have to prove the existence of abuse. This provides tax authorities with a smaller burden of proof, since the main reason for the taxpayer to opt for a transaction or series of transactions does not have to be proven, but only that abuse exists.

The GAAR, as provided by the Directive, has not been introduced because this requirement is deemed to be met by the *'fraus legis'*-doctrine, which is developed under Dutch case law. The doctrine applies to a case where two requirements are met:

1. the decisive reason for entering into a (set) of arrangement(s) must be the frustration of taxation – a subjective element that considers the intent of the taxpayer; and
2. the arrangement must be contrary to the object and purpose of the legislation – an objective element.

If these two requirements are met, the tax authorities may ignore the taxpayer's arrangement and even replace it with a close equivalent that allows for (greater) taxation.

Art. 7&8: Controlled-Foreign-Company legislation

Controlled foreign company (hereafter: CFC) rules have the effect of re-attributing income of a low-taxed controlled subsidiary to its parent company. Depending on the policy priorities of the Member States, CFC rules may target an entire low-taxed subsidiary, specific categories of income or be limited to income that has been artificially diverted to the subsidiary. The Directive allows for different options, which reflects a political agreement that had to be reached to get the Directive approved. These different options of implementation, provided by the Directive, are displayed as option A (art. 7(2)(a)) and option B (art. 7(2)(b)). In short, the two options are described below:

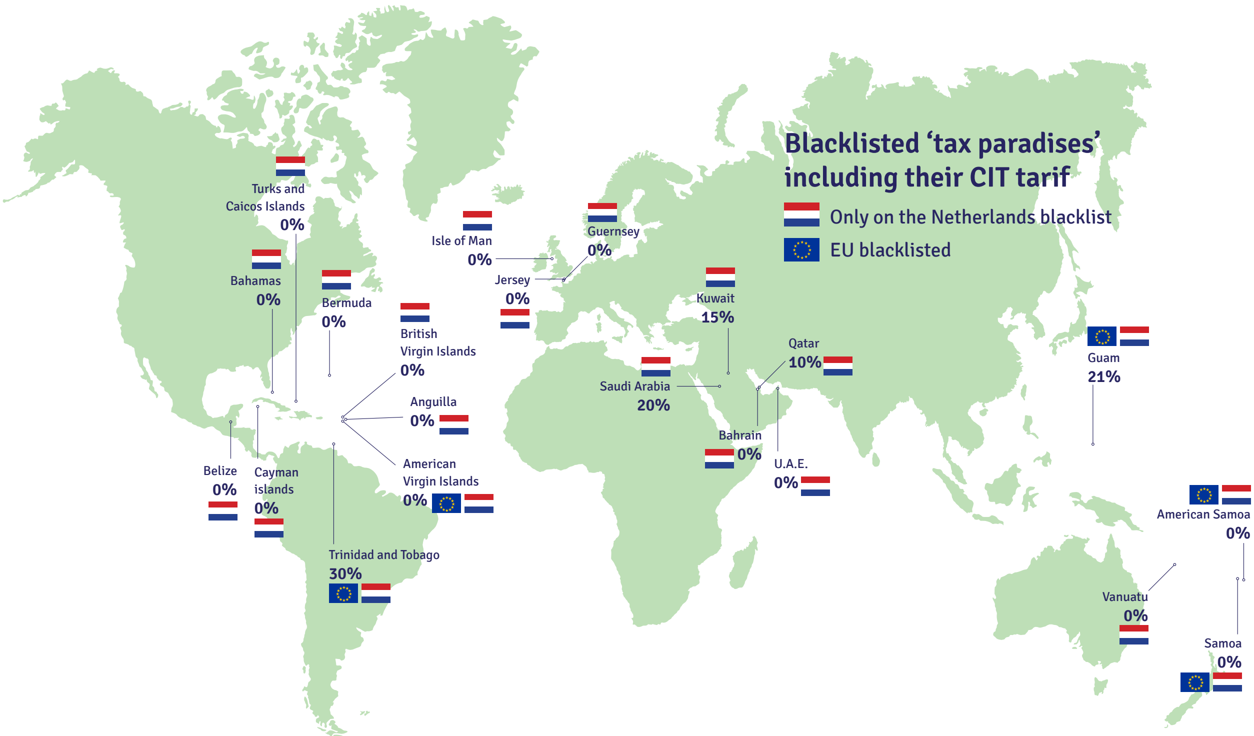
- **Option A** provides the obligation for Member States to include categories of non-distributed income derived by the CFC (dividends, interests, royalty's, et cetera), in the tax base of the parent company of the CFC.
- **Option B**, more general in nature, provides the obligation for Member States to include non-distributed income of CFCs, arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage, in the tax base of the parent company of the CFC.

As the income of a CFC must, under the arm's length principle, already be allocated to the controlling company to the extent that the income is generated by significant people functions in the Netherlands, the Dutch government is of the opinion that a substantial part of option B of the Directive was already implemented. However, the Dutch government aims to go beyond the necessary legislation provided by the Directive. In addition to the (already) enacted option B, the Dutch government decided to implement legislation that is similar to option A, however such with a slight deviation.

The additional CFC legislation determines that income generated by controlled companies (i) established in jurisdictions with a statutory rate of less than 9% or (ii) established in non-cooperative countries that are blacklisted by the EU, have to be included in the tax base of the parent company of the CFC. The new CFC rules are included in the new article 13ab CITA.

With reference to the first constraint, income generated by controlled companies established in jurisdictions with a statutory rate of less than 9%, it should be noted that the joined cases Deister Holding and Juhler Holding (Case C-504/16, C-613/16) do not apply. In the joined cases, that were based on the freedom of establishment, the EU ECJ decided that provisions that establish a general presumption of fraud and abuse go beyond what is necessary to achieve the result of countering wholly artificial arrangements, and are in conflict with the Parent Subsidiary Directive.

With reference to the second constraint, income generated by controlled companies established in non-cooperative countries that are blacklisted by the EU, it should be noted that the Dutch government recently published a document which greatly extends the list of blacklisted countries. On December 28th, 2018 the Netherlands government extended its list of tax paradises that fall within the scope of article 13ab CITA. The list contains five jurisdictions that are currently blacklisted by the EU, and in addition the Dutch list includes another 16 low-tax jurisdictions. The 21 blacklisted low-tax jurisdictions are depicted below



For the application of the CFC rules, a controlled foreign company is defined as a company in which a company (alone or together with related persons) directly or indirectly holds and interest of more than 50% in the capital, voting rights or an entitlement to the profits. The CFC rules, as stated in article 7(2)(a), apply to the following types of income:

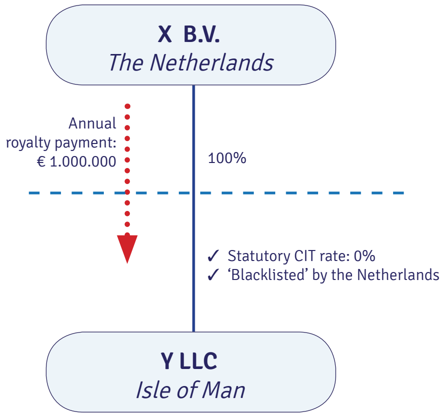
- interest or other benefits from financial assets;
- royalties or other benefits from intangible assets;
- dividends and capital gains derived from the sale of shares;
- benefits from finance lease activities;
- benefits from insurance, bank or other financial activities; and
- invoicing activities which add little or no economic value.

The total amount of this income is reduced with the related costs. The remaining amount of income is only allocated to the controlling company to the extent it is not distributed before the end of the calendar year.

Example art. 13ab CITA

The practical application of the CFC legislation is illustrated by the following example. A Dutch taxpayer, X BV has a 100% owned subsidiary, Y LLC, located in the Isle of Man, a country that is 'blacklisted' by the Netherlands. Y LLC exploits several patents, for which X BV pays an annual royalty of € 1 mio to Y LLC. Y LLC does not distribute any profits.

In accordance with provision 13ab CITA, income generated by controlled companies (i) established in jurisdictions with a statutory rate of less than 9 % or (ii) established in non-cooperative countries that are blacklisted by the EU, have to be included in the tax base of the parent company of the CFC. Since the statutory CIT rate in the Isle of Man is 0%, and moreover, the country is blacklisted, the profits minus the connected costs of the profits, must be attributed to X BV. In the case at hand, this would be € 1 mio to be added to X BV's taxable annual profits.



As a concluding remark, the CFC rules do not apply to companies mainly earning 'non-tainted' income, or financial institutions mainly receiving income from third parties. Also, the CFC rules also do not apply if the controlled company performs a genuine economic activity. The explanatory statements of the Dutch 2019 Tax Plan explained that this is deemed to be the case if the controlled company meets the minimum Dutch substance requirements, which was later implemented in art. 2d & 2e *Uitvoeringsbeschikking vennootschapsbelasting* 1971 (implementation resolution of the Dutch CIT). This means (among others) that the controlled foreign company must have its own office and should satisfy a salary requirement of at least € 100.000. For more information about the minimum Dutch substance requirements, we refer to our April 9, 2018 news item 'New developments regarding Netherlands substance requirements'.

Art. 9: Hybrid Mismatches

The objective of the provision on hybrid mismatches stipulated in article 9 of the ATAD1 is to neutralize the tax effects of hybrid mismatch arrangements that exploit differences in the tax treatment of an entity or instrument under the laws of two or more Member States, with the aim to achieve a deduction in both states or a deduction of the income in one state without inclusion in the tax base of the other. The rule contained in article 9 is in line with the recommendations contained in the final report on Action 2 of the OECD's BEPS project. The scope of the Directive's provision is, however, limited to intra-EU scenarios.

A new legislative proposal was presented by the European Commission on October 25th, 2016 with further rules on hybrid mismatches. This new legislative proposal, part of which amends article 9 of the ATAD1 1, is known as ATAD2. ATAD2 amends the scope of article 9 by expanding it to include hybrid mismatches between EU Member States and third countries. The measures contained in ATAD2 will need to be implemented in domestic law of EU Member States before January 1st, 2020. Because of this, the Dutch government decided to postpone the implementation of the hybrid mismatch provisions for both ATAD1 and ATAD2, and started separate implementation proceedings.

Yoran Noij
+31 (0) 6 38 27 23 92
yoran.noij@noviotax.com

Patrick Schrievers
+31(0) 6 10 24 61 40
patrick.schrievers@noviotax.com