

NovioTax **Russia - Netherlands DTAA terminated by January 1 2022, will it be replaced?**

May 2021

Further to our blog on January 19, 2021, the Russian government approved a proposal for the termination of the Netherlands - Russia DTAA (1996) on 9 April 2021. On 26 May 2021, the President of Russia signed Law No. 139-FZ, ratifying the denunciation of the Netherlands - Russia Income and Capital Tax Treaty (1996). The termination may take effect on 1 January 2022 (however, negotiations may influence this). It is expected that negotiations will continue, however, unclear whether there will be a new amended treaty will be put in place by 1 January 2022.

Dutch family-owned companies and regional headquarters of multinational enterprises (“MNEs”) may be faced with increased withholding taxes on interest and dividend payments from Russia (of up to 15%). Currently, capital gains derived by a Dutch company from alienation of shares in Russian companies deriving more than 50% of their value directly or indirectly from immovable property situated in Russia are exempted from tax in Russia. We expect that this provision (which is beneficiary to the existing Netherlands – Russia DTAA compared to other DTAA’s) will be amended during the negotiations with Russia. Hence, Dutch companies owning Russian real estate may be faced with additional (exit) taxes upon transferring shares in Russian real estate companies.

Proposed amendments and recent developments

Russia has initiated (according to various news outlets) amendments to the Netherlands – Russia DTAA. It has been proposed (based on the limited information available thus far) to increase the withholding tax rates on interest and dividend payments from 0% to 15% and from 5% to 15%, respectively. As a result, the proposed amendments will treat, for instance, individuals and companies alike for dividend withholding tax purposes. Along with this we expect that the capital gains provisions will be amended. The taxation rights on the alienation of shares in real estate companies should belong to the country where the immovable property is located. This amendment mirrors the OECD Model Tax Convention and existing Russian DTAA’s.

The Russian proposal entails some exceptions to the increased withholding tax rates, which would only apply in specific cases (for example, for publicly listed companies and certain types of financial arrangements). This position follows recent successful (as in, from the point of view of Russia) DTAA (re)negotiations with Cyprus, Malta and Luxembourg. These negotiations effectively ended up in an increase of WHT from dividends distributions from Russian companies to Cypriot, Maltese and Luxembourg parent companies from 5% to 15%. Russia has also recently started discussions with Hong-Kong and Switzerland to amend the existing DTAA’s with these countries.

It should be noted that the capital gains article of the Netherlands – Russia DTAA is different from that in Russia’s DTAA with (for instance) Cyprus, Malta and Luxembourg. In the later DTAA’s, the capital gains articles give the source state taxing rights for alienation of shares where more than 50% of their value is derived from immovable property located in the source state. In the Netherlands – Russia DTAA, however, the resident state of the transferring company has exclusive taxation rights on the alienation of shares in real estate companies. Please note, and observing the Budget 2021, it remains to be seen if and how Russian domestic amendments to the taxation of capital gains interact with this (possible) amendment to the capital gains provision of the Netherlands – Russia DTAA.

State of play

Based on the information available (which is unfortunately limited), Russia has offered several exceptions to the 15% withholding tax rates applying to specific cases (like publicly listed companies and certain types of financing arrangements). The Dutch Ministry of Finance has, however, stated that these exceptions should be extended to reflect real economic activities. It should be noted that typically both (i) Dutch family owned businesses and (ii) Dutch regional (E.U.) headquarters of MNEs have a significant presence and economic nexus (supporting in key decisions like acquisitions, disinvestments, capacity rationalization, financing activities et al.) with lower tier subsidiaries (among other, Russian companies).

If the Russian proposal is accepted, it will trigger a tax leakage for these companies of 15% on every dividend distribution. The Russian dividend withholding tax is not credited in the Netherlands because, reasonably speaking (subject to a number of requirements), Russian dividends should be exempted by virtue of the Dutch participation exemption.

The Dutch Ministry of Finance has made proposals to maintain the existing dividend withholding tax rate (of 5%) for activities that reflect economic rationale and that contribute to the economy. Following the rejection of this proposal, Russia has offered to limit the exemption proposal of the Netherlands to include privately owned businesses whose ultimate beneficial owners are also Dutch tax residents. We have not been able to verify this, but we can perceive that such a provision *de facto* mirrors Article XV(3) of the protocol for the Netherlands - German DTAA.

The Dutch Ministry of Finance has not accepted this (amended) proposal. Hence, discussions between the two countries are currently at a stand-still. It should also be noted that the Russian Ministry of Finance has also [announced](#) the beginning of a termination procedure for the Netherlands - Russia DTAA. The [draft law](#) for the termination of the DTAA has been published on the Russian portal of draft legal acts (regulation.gov.ru). On 9 April 2021, the Russian government approved a proposal for the termination of the Netherlands - Russia DTAA. This proposal was considered and forwarded for signature by the President of Russia. On 26 May 2021, the President of Russia signed Law No. 139-FZ, ratifying the denunciation of the Netherlands - Russia Income and Capital Tax Treaty (1996).

Termination procedure

According to Article 31 of the Netherlands - Russia DTAA, either Russia or the Netherlands may terminate the DTAA, by giving a notice of termination *at least six months* before the end of any calendar year. In such a case, the DTAA will cease to have effect in tax year beginning after the end of the calendar year in which the notice of termination has been given. In Russia and in the Netherlands, the calendar year ends on 31 December. Therefore, if the two countries cannot successfully renegotiate the DTAA and termination becomes inevitable, Russia is likely to issue a notice of termination by the end of June 2021. As a result, the Netherlands - Russia DTAA may cease to have effect as of January 2022. A notice of termination issued after June 2021 will not affect the Netherlands - Russia DTAA at least until the end of 2022.

Impact of MLI

Both Russia and the Netherlands have signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("MLI"), including the Netherlands-Russia DTAA in their list of Covered Tax Agreements and submitted their ratification instruments. Hence, the MLI (in relation to the Netherlands-Russia DTAA) entered into force on [01-10-2019](#) and [01-07-2019](#), respectively. Furthermore, Russia has notified a [confirmation](#) of the completion of its internal procedures for the entry into effect of the provisions of the MLI with respect to the DTAA with the Netherlands as of 30 April 2020. As a result, the MLI affects the Netherlands - Russia DTAA by including, among other provisions, the principal purposes test ("PPT") and a minimum shareholding period of 365 days. The MLI, by its very nature, would, however, have no effect on the withholding tax rates of dividends or interest.

Companies that anticipate possible changes to Russian domestic law or amendments to the existing Netherlands - Russia DTA, by fast forwarding dividend distributions or perhaps (dependent upon the changes to the dividend provision) even postponing dividends, may still need to consider the application of the PPT (as applied in the Netherlands - Russia DTAA as a corollary to the MLI). The purpose of the PPT is to anticipate and defeat unacceptable tax planning. It will apply (and deny treaty benefits) if it is reasonable to conclude that obtaining a treaty benefit was one of the principal purposes of an arrangement or transaction that directly or indirectly resulted in that benefit. The term "benefit", in the context of the PPT, is likely to be broadly interpreted. It could, for example, consist of a limited dividend withholding tax that is obtained through the application of the Netherlands - Russia DTAA.

Investment guarantee and protection scheme?

Russia and the Netherlands have concluded (in 1989 - entered into force in 1991) a Bilateral Investment Treaty. This is an agreement establishing the terms and conditions for private investment by Dutch companies in Russia, and vice versa, Russian companies in the Netherlands. This agreement is essentially designed to protect investors. It needs to be checked if and to which extent any amendment to the existing Netherlands-Russia DTAA is possible and aligns with the existing Bilateral Investment Treaty. Typically, Bilateral Investment Treaty clauses are open-ended. Hence, it is not certain if Dutch companies are entitled to protection from unfavourable changes to the Netherlands - Russian DTAA and/or the (possible) termination of the Netherlands - Russian DTAA.

Takeaways

- Netherlands family owned companies and regional headquarters of MNEs may be faced with increased (up to 15%) Russian withholding taxes if the Netherlands – Russia DTAA is terminated or amended as proposed by Russia. In relation to Dutch subsidiaries of Russian companies, a full exemption from withholding tax is provided under the Dutch Dividend WHT Act based on the applicable Netherlands – Russian DTAA. In case of a termination of the Netherlands – Russia DTAA the Dutch dividend WHT would be 15%.
- Currently, capital gains derived by a Dutch company from the alienation of shares in Russian companies deriving more than 50% of their value directly or indirectly from immovable property situated in Russia may be taxed in the Netherlands (and not in Russia) and are, reasonably speaking, effectively exempt from taxation by virtue of the Netherlands participation exemption.
- We expect that the existing capital gains provision (which is beneficiary to the existing Netherlands – Russia DTAA compared to other Russian DTAA's) will be amended during the negotiations with Russia. Hence, Dutch companies owning Russian real estate may be faced with additional (exit) taxes upon transferring shares in Russian real estate companies.
- At this point we are awaiting the outcome of the discussions between the Netherlands and Russian Ministry of Finance. It should, however, be noted that on 26 May 2021, the President of Russia signed Law No. 139-FZ, ratifying the denunciation of the Netherlands - Russia Income and Capital Tax Treaty (1996).
- As, in principle, the effect of any termination (or even an amendment) will not be realized before January 2022 (based upon Article 31 of the Netherlands - Russia DTAA), companies may still have some time to consider awaiting the pending discussions between the Netherlands and Russia.
- Companies that anticipate possible changes to Russian domestic law or amendments to the existing Netherlands – Russia DTA, by fast forwarding dividend distributions or perhaps (dependent upon the changes to the dividend provision) even postponing dividends, may however still need to consider the application of the PPT (as applied in the Netherlands – Russia DTAA as a corollary to the MLI).
- If and once we receive more information, we will amend/update this blog.

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