What does the future hold for the Dutch royalty conduit companies?

Reorganising Dutch royalty conduit structures, due to several new rules and regulations that will enter into force in 2014, seems unavoidable, writes Jos Peters, the Senior Tax Partner at Merlyn International Tax Solutions Group

Introduction

On August 30, 2013 the Dutch government announced a number of measures to counter abuse and unintended use of Dutch royalty conduit companies. Curiously, this was done despite earlier announcements that the Netherlands would not take unilateral actions on this point and that any changes should be made within a multilateral context, to avoid that other countries would take lighter measures or no measures at all.

Probably the political pressure was too high: the fact that the Netherlands does not levy a royalty withholding tax allows tax payers to use Dutch legal entities to route royalty payments to tax havens. Everyone will by now have heard about the 'Double Irish/Bermuda' structures operated by big multinationals like Apple, Google, Yahoo!, Starbucks etc. In addition, the Netherlands government seems to be convinced that the OECD and the European Commission would put pressure on all countries which play a role in the royalty conduit business in the same manner, so 'staying ahead of the music' might be the best way to act under the circumstances.

A 'Double Irish/Bermuda' structure for instance only works because the royalty payments from the Irish company based in Ireland are routed to the other Irish company based in Bermuda via the Netherlands. The royalty payment Ireland – Netherlands is covered by the EU rules that prohibit Ireland to levy a royalty withholding tax. In the Netherlands a relatively small spread (1-2%) is taken out as the gross margin for the operations of the Dutch entity from which it pays all its operating expenses and realizes a small taxable profit. The onward payment of the other 98 – 99% of the royalty income of the entity in the Netherlands to Bermuda is not subject to any withholding since the Netherlands has no royalty w/h tax.

The Irish and Dutch governments have only limited possibilities to do something about this situation. The Dutch/Irish tax treaty does not contain a beneficial ownership article but in the OECD commentary to royalty articles the position is taken that such beneficial ownership is 'assumed'. In my view, if a Dutch company pays 98-99% of its income onwards under a contract to a third party, the Dutch entity is certainly not the beneficial owner of the royalties and the Irish tax authorities could in my view have done more to 'stop the bleeding'. But they haven't and the very size of the operations of Yahoo!, Apple, Google etc. in Ireland may have something to do with this.

What also plays a role here, is that the Dutch government has been heavily criticized one time earlier on the ease with which multinationals could use Holland as a stepping stone to hide royalty income in tax haven jurisdictions. This happened in 2001 as part of the 'Harmful Tax Competition' investigations by the European Commission. On that occasion the Netherlands vowed to Brussels to pay more attention to the legal end economical 'substance' of Dutch intermediate holding companies and interest and royalty conduit companies. In severe cases, if a Dutch entity would lack 'substance', this would be signalled to the foreign tax authority of the EU country where the dividends, interest payments or royalties arose, so the foreign revenue service could review the (non) withholding of tax and if needed assess the paying entity for the missing income, or get back to the Dutch conduit entity (via the usual tax treaty article dealing with mutual assistance in collecting taxes).

In practice, to my knowledge, such 'international signalling' has never taken place, however, even though the Netherlands officially put down the substance requirements in a transfer pricing Regulation on March 31, 2001. At that time the Dutch Act on the International Exchange of Tax Information was also adjusted, to allow for the signalling, by removing possible objection grounds to such signalling which were part of this Act from it.

A look into the near future

The August 30, 2013 announcement brings this international tax signalling back to life. Dutch conduit companies should have a certain legal and economical 'substance' and if they don't, the Dutch tax authorities will, without informing the Dutch company before doing so, send a detailed letter to the foreign tax authorities revealing the foreign and Dutch entities involved in the scheme, the amounts of royalty paid from year to year etc . It is then up to those foreign tax authorities to take action to recover potentially missed withholding taxes.

In the mentioned Dutch Regulation of 2001,'substance' has been defined by way of a list of requirements that should be satisfied in order for the conduit entity to qualify. There are rules in order to limit the number of non-Dutch resident directors of such entities, the books should be kept in the Netherlands, the accounts should be drawn up in the Netherlands and the (main) bank account(s) of the entities should be in the Netherlands. In the finance area there was also a requirement: the entity should have adequate capital as a buffer against business losses and financial headwind.

However, article 8c of the Dutch CIT Act, introduced in 2001, defined such adequate capital only for interest conduit companies ('finance companies'). Such Dutch entities should keep a financial buffer of at minimum 1% of the outstanding loans (with an overall maximum of €2 million.). At that time, no 'adequate capital' requirements were made for royalties, likely because royalty payments can take many shapes and forms so neither the Dutch Ministry of Finance, nor the Dutch advance ruling team, attempted to quantify the capital requirement for royalty conduits.

Now the decision has been taken to widen the scope of the international signalling program from 2001, and to use the existing 'substance' rules as the source for additional anti-abuse legislation to be applied to royalty conduit entities, the question arises: 'what will the adequate capital rule be for a Dutch royalty conduit entity as from 1-1-2014'? Signalling a flaw in a Dutch royalty conduit set-up based on unclear principles, with the potential foreign tax effects as outlined, to me, seems an unwise decision and could very well harm the Dutch reputation as a reliable country to establish a finance company or royalty company in.

This will then also have a negative effect on the attractiveness of the Netherlands to other companies that serve a number of group entities with little staff and other resources, such as intermediate holding companies. But according to the Dutch government, such holding companies are useful to avoid double taxation so the Netherlands officially promotes them!

A second draft rule that was announced will only add to this: if a tax payer that does not have any business substance in the Netherlands and just wants to operate a royalty or interest conduit entity, and takes the trouble to apply for an Advance Tax Ruling (ATR) to ensure it has sufficient risk capital, will also be subject to the signalling procedure: the ATR will be sent to the foreign tax authority in the country where the interest and/or royalty payments are intended to originate.

The trouble with all this is that 'substance' is not a defined tax treaty term. Tax treaties usually contain two other requirements for the Dutch royalty or interest conduit:

> a) The entity must be resident in the Netherlands (usually shown by way of a 'declaration of residence', an official declaration issued by the Dutch revenue service that the relevant entity is a Dutch corporate tax payer in the sense of the tax treaty between the Netherlands and the source country of the interest or the royalties); and:
>
> b) The entity must be the 'beneficial owner' of the income flow.

"Many tax practitioners tend to confuse beneficial ownership with substance"

Obtaining a declaration of residence is easy: entities incorporated under Dutch civil law are Dutch resident under the Dutch corporate income tax act by definition. Consequently, they will get their declaration(s) of residence more or less automatically, on request, from the Dutch revenue service.

Beneficial ownership is quite something else and only has an indirect, undefined, tie with 'substance'. On our website www.merlyn.eu, in the publications section, the reader may find my contribution to the *Euromoney Corporate Tax Handbook of 2013* that deals with this gap between substance and beneficial ownership. Many tax practitioners tend to overlook this gap and confuse beneficial ownership with substance, even governments!

A foreign tax authority that receives a notification from the Dutch revenue service about an ATR, which basically says that under the tax principles of the Netherlands the Dutch company has sufficient substance (including its capital buffer, which will be an essential part of the ATR negotiations), is still totally free to take the position that this statement is meaningless for the beneficial ownership test of the treaty and attack the structure, despite the ATR and the residency certificates submitted, on these grounds.

Beneficial ownership, although not legally defined in most countries, means something like 'the recipient must receive the income for himself and not for someone else'. So a conduit company in the Netherlands that can show both a residency certificate and an ATR is not out of the woods at all if it pays its royalty or interest income almost in full onwards to a destination outside the Netherlands. So the signalling of an ATR may well trigger a beneficial ownership investigation under the exchange of information article of the relevant tax treaty.

Some other new Dutch tax features that will affect conduit entities

Another part of the August 30 announcement has been that the Netherlands will approach 23 developing countries with which it has a tax treaty to discuss the introduction of a LOB provision. Such provisions basically contain a number of additional restrictions to the application of a tax treaty:

> a) The Dutch conduit company should in majority be owned by residents of the Netherlands or other EU countries or, if they don't, meet one or more of a list of not easy to meet other criteria (eg. acting as a regional

headquarters; or being publicly listed or being part of a multinational group that runs an actual trade or business both in Europe and in the treaty country with prescribed minimum ratios as regards turnover, etc).

b) The income should not be paid onwards for more than 50% to (legal) persons outside the Netherlands or other EU countries as tax-deductible items.

On top of this, both the European Commission and the OECD are developing plans to further restrict the use of Dutch conduit entities (usually called 'mailbox companies' even if they do meet the existing substance criteria mentioned above). These measures will be made public soon, because all institutions involved want to regulate the conduit business more strictly now, caused by the public outrage that some well-known large multinationals do not pay their fair share of taxes in any country.

The OECD attack will not only affect conduits in the Netherlands but also in several other jurisdictions, known for their conduit tax planning possibilities (in the EU: Luxembourg, Malta, Cyprus, but also outside the EU; countries like Mauritius, the Seychelles, Bermuda, Barbados etc.). The political atmosphere to take drastic measures in this area is more positive than ever before, because almost all countries have tax deficits to cover.

Conclusion

Continuing to operate a Dutch royalty conduit company without an advance tax ruling is dangerous. If the Dutch revenue service, upon a tax audit, determines that the entity lacks sufficient 'risk capital', it will inform the foreign tax authority of the country of source of the interest or royalty payments thereof. The foreign authority will most likely take this as a signal that the structure was also not in line with the rules in previous years and use its legal right to audit the royalty paying entity in its country 5 years retrospective.

To avoid this risk, it would seem that trying to obtain an ATR in the Netherlands, including a discussion on what an adequate capital buffer for the royalty conduit entity would be, is a solution. But in many cases these ATR's will be signalled to the relevant foreign tax authority as well and cause a discussion on beneficial ownership, because neither the declaration of residence, nor the ATR, really address this point. The fact that the Netherlands may soon have 25 tax treaties with an LOB provision (the 23 mentioned above plus the existing ones with the USA and Japan) will not make things easier either.

Obtaining an ATR is costly (€10,000 at least and probably more) because one will need a benchmark transfer pricing study to be performed to establish what capital buffer a third party would maintain. The amount resulting from the benchmark should then be kept available in the entity (eg, sitting in a deposit) and become 'dead money'.

As early as in 2010, our group has developed royalty conduit structures that meet the increased beneficial ownership challenge which I saw developing over the years. We have also solved the LOB problem with these slightly alternative Dutch structures. We have good hope, from all that has so far been said and published about yet another set of new rules for royalty conduits ('adequate capital') for the years 2014 and onwards, that our proprietary new structures are compliant with these new rules as well.

In the coming weeks or months, the OECD and the European Commission will launch their attack programs to the conduit business so it is now just too early to say whether or not we are right, but the writing on the wall is favourable. Multinational enterprises operating a Dutch royalty conduit entity should therefore keep a close eye on the developments in the royalty routing area and when the texts of all new laws, OECD guidelines, EU Directives and local country regulations are known, contact us to discuss the reorganization we have in mind for them to continue their Dutch royalty conduit business, without the adequate capital risk and without having to maintain a deposit where a substantial amount will be sitting idle.

Changes in the legal structure of the operations will have to be made, that much is certain. But the changes will be rather moderate from a business economical viewpoint. That's why some of our clients already decided in 2011 and 2012 to change over to our system. I therefore suggest you contact us at some point in time in the future, as soon as the entire new legal framework is known, to constructively discuss, free of charge, whether changing over to our system would be preferable over setting up an entirely new structure, eg. via another country than the Netherlands. Because the odds are that other countries that today may serve well as royalty conduit jurisdictions will be hit by the same attacks royalty conduits in the Netherlands are facing. ■