New anti-abuse articles in 23 Dutch tax treaties with developing countries

1. What will happen?

Organisations such as SEO, SOMO and the IBFD have demonstrated that tax treaties based on the standard OECD Model Treaty do not always work satisfactorily for developing countries and that MNE's are able to reduce their worldwide effective tax rate by using an SPV in the Netherlands. On August 30, 2013, the Dutch ministries of Finance and Development Cooperation have therefore jointly written to the Second Chamber of the Dutch Parliament, announcing their intention to officially approach 23 African developing countries with an offer to, if they would wish so, immediately improve their tax treaty with the Netherlands by adding anti-abuse paragraphs to the dividend, interest and royalty articles in their treaty with the Netherlands.

This approach is somewhat curious because in an OECD context (the BEPS proposals, released by the OECD a few months earlier) this subject is also tabled. But the BEPS solution to potential abuse of dividend- interest- and royalty articles in tax treaties which are based on the OECD Model Tax Treaty, implies a very different approach: the introduction of Limitation on Benefits (LOB) articles. However, developing countries have more than once expressed that the BEPS program may be too ambitious for them because many of the proposals can only be carried out by countries with a mature tax assessment, tax disputing and tax collection system.

So the choice that the Netherlands now offers to these 23 countries (and the first draft tax treaty "new style" with Malawi was presented to the Dutch parliament last week) is to add a paragraph to the dividend, interest and royalty articles of their tax treaties with the Netherlands which contain the following:

"this article cannot be called into effect by a resident of either State if the legal entity, or the payment of the dividend (interest or royalty) has been structured with the sole purpose, or one of the main purposes, to benefit from this article".

This type of phrasing of a general anti-abuse rule (GAAR) is not new. In fact, it is rather similar to an article which used to appear in the 1951 Dutch / Swiss tax treaty [which was not an OECD Model Treaty type tax treaty at all].

The difficulty with this new paragraph will no doubt be the phrase "one of the main purposes". MNE's will obviously look at many things before establishing an entity in a foreign country and taxation will definitely be one of the aspects that will be studied in detail. After all, MNE's can often choose between several jurisdictions through which they can invest (in African countries or elsewhere) and taxation influences the bottom line results of such investments so one is obliged to look at taxation and it may be hard to defend that the final choice for any SPV jurisdiction was not made also on the basis of the tax analysis.

The Dutch approach in this matter therefore seems rather naïve and can only be explained as the result of pressure from some Dutch political parties, based on reports from Dutch national organisations and one or two international NGO's "to do something about the tax leakage in developing countries via the Dutch tax treaty network".

2. Risks of the one sided Dutch approach

The new GAAR paragraphs will most certainly lead to more disputes between the tax authorities of the developing countries and the subsidiaries of the Dutch intermediate holding companies that have been inserted in the MNE's group chart to invest in certain African countries. The result of it all may well be double taxation! If MNE's will be confronted with higher overall effective tax rates because of the Dutch generosity towards developing countries, they might well decide to cancel the projects in Africa and invest elsewhere. If this were to happen, the whole exercise may turn into a nightmare instead of a benefit to the developing countries. Apparently, the Dutch members of parliament that forced the new tax treaty approach towards the developing countries in Africa with whom the Netherlands has a tax treaty, have not given this any consideration.

A simple example may clarify this. If an MNE operates a legal entity in a developing country, the profits it realises there are taxable in that country. That country may not have the resources to properly assess the profit level, because one needs sustainable tax legislation (including effective transfer pricing rules), properly trained tax inspectors and tax auditors to make it all work and finally these countries also need a proper and efficient tax collection systems to ensure the tax owed by the MNE's will really end up in the hands of the revenue service, and it is widely known that these attributes are not sufficiently available in developing countries. However, this would seem to be a reason for developed countries, including the Netherlands, to assist the revenue services in developing countries in developing proper tax legislation and proper execution of these laws, including the actual collection of the tax due. But although this is also part of the new Dutch approach, the main focus was on GAAR's, which might have been a historical "mistake of the first category".

If the African subsidiary of an MNE properly computes and pays its local tax due, and then runs into a local revenue service that will defend that the Netherlands has been chosen to locate the parent company in, which clearly will also have been driven by tax considerations (the excellent Dutch tax treaty network, giving access to low rates of withholding tax in combination with the 100% Dutch participation exemption (where other European countries offer only 95% exemption), double taxation will occur: the same profit will be taxed twice: once with corporate income tax and when the after tax profits will be repatriated, via the Netherlands, to the parent company in the group, another layer of tax (dividend withholding tax) would be imposed. It is no secret that the measures to avoid double taxation which are always part of any treaty (exemption for dividends, foreign tax credit for interest and royalty payments) will often fall short to avoid that part of the profits will be subject to partial or entire double taxation. This, bottom line, will affect the earnings per share of the MNE and therewith the price of their shares and there can be little doubt that an MNE, if the difference between his effective tax rate and that of his close competitors become too big, can take no other decision than to "pull out of Africa". Developing countries are likely to severely suffer from a drop in foreign investments and the question might be asked: what is worse: some less tax or a drop in foreign investment levels?

A second risk to the new Dutch approach is, that other jurisdictions that MNE's could use to invest in Africa (think of Luxembourg, Malta or Cyprus, but also keep in mind that Mauritius itself is African!), will not offer the same GAAR articles in their tax treaties with the African developing countries. We have seen this several times before: the Netherlands gives up some favorable tax (treaty) rule under political pressure (from the EU, or from the OECD, or from NGO's) and the day after, neighboring countries like Belgium and Luxembourg introduce the very rules that the Netherlands has abolished!

This happened with the 2001 substance rules for Dutch conduit companies but also with the Dutch rule to exempt Swiss finance branches (a tax feature that was immediately introduced by Luxembourg the day after the Netherlands revised the rules) and it happened again, very recently when the Netherlands sharpened the "substance" rules for SPV's (no other country than the Netherlands even has substance rules for its own legal entities. They employ substance rules for foreign entities only).

If, as a result of the present Dutch exercise, other countries, known for their excellent tax treaty network in combination with national rules that favor MNE's, simply take over the position of the Netherlands, then nothing positive will have been achieved for the African developing countries. But the Dutch fiduciary services sector, already under severe pressure from other developments in administrative law (beyond the scope of this article) would suffer another blow, dealt by Dutch politicians who hardly understand the subjects they are toying with.

3. Background

What has given rise to this new approach by the Dutch Ministry of Finance to try and help developing countries to realise more tax income at the risk of total failure (if other countries do not follow or if MNE's pull out of Africa because their earnings per share will be hit)? Was it a coincidence that only a few months earlier "investigative journalists" started to report about the tax evasion programs of MNE's like Yahoo!, Apple, Google, Starbucks, Microsoft etc.? How did articles in Bloomberg News and similar US media spill over to Dutch "investigative journalists" with friends in the Dutch parliament? The MNE's mentioned, clearly admitted that they have not paid their "fair share" of taxes anywhere in the world over the last 15 years or so, simply because the rules to properly tax them were (and still are) completely outdated.

To me this would seem to mainly be a US tax problem; it is of course no coincidence that the reports about US multinationals "dodging" taxes in Europe and elsewhere outside the USA, were used by journalists also outside the USA, to call for far reaching measures to realign tax legislation and tax treaties "everywhere" with the business models of these MNE's to make sure they would start to pay tax in the countries they operate in. Unfortunately, nobody seems to have noticed that the entire problem is in fact caused by a defective US **tax accounting** rule under which US MNE's do not have to provide for deferred tax on their non-US earnings, which pumps up their stock prices to dangerously high levels (to the vast benefit of their management whose financial compensation, in almost every US based MNE, is coupled to the stock price of the MNE). None of "our" NGO's or investigative journalists seems able to understand what the real issue is. With the result that people active in assisting clients with their international tax issues will face many bad days in the years to come. Completely unnecessary and in fact rather dumb, certainly for an organization which has as its founding principle "economic development"!

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