Dutch substance requirements

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There has recently been a great deal of debate about "letter-box companies" being used to create improper tax advantages (such as reducing foreign withholding taxes) and this debate has drawn considerable attention in the Netherlands in particular (including in Parliament).

The BEPS report presented by the OECD is one of the drivers of the debate. It focuses on combatting tax avoidance and proposes fifteen actions. A key pillar is the substance of companies. Substance requirements have received increased attention from both the Netherlands and the OECD, leading to some tightening of national and international substance regulations.

National

In the Netherlands the Decree on service entities and advance assurance (DGB 2014/31015) states that no advance assurance may be given in the form of an Advance Tax Ruling (ATR) if a company does not meet the substance requirements listed in the decree. The minimum substance requirements are:

- At least half of the total number of directors under the articles of association with decision-making authority reside or are actually established in the Netherlands.
- The directors residing or established in the Netherlands have the required knowledge to perform their duties properly. These duties include at least decision-making based on the entity's own responsibilities within the framework of normal group involvement on transactions which will be entered into by the entity and ensuring they are settled properly.
- The entity has qualified staff for proper performance and recording of transactions entered into by the entity.
- Board decisions are taken in the Netherlands.
- The entity's main bank accounts are held in the Netherlands.
- The bookkeeping takes place in the Netherlands.
- The entity has - in any event until the time of examination - properly complied with its obligations to file tax returns, including corporate income tax, payroll tax, VAT, etc.
- The entity's registered office is in the Netherlands. As far as it is aware, the entity is not considered a tax resident in any other country.
- The entity has sufficient equity for the functions it performs, taking into account the assets used and risks run.

Furthermore Decree DGB 2014/30986 states that advance assurance in the form of an Advance Pricing Agreement (APA) is shared with the tax authorities of the relevant country
or countries if the group to which the service entity belongs no longer has activities in the Netherlands other than the substance requirements in the decree or concrete plans for an expansion of substance in the Netherlands.

The State Secretary for Finance was recently asked to put forward options from the Dutch perspective to further tighten substance requirements for companies with the aim of restraining letter-box companies while not damaging companies with real economic activities.

The State Secretary has put forward the following three options:

1. Sharing information in more cases.

At the moment, information on service entities that do not meet the substance requirements is shared with the source country. The State Secretary is considering doing this more often by (A) extending this obligation to international holding companies or (B) setting higher substance requirements for earlier sharing of information on service entities and possibly on international holding companies.

2. Stricter conditions for advance assurance.

The substance requirements for obtaining advance assurance may be supplemented, for example to include the following:

- minimum expense level as an indication of a real presence in the Netherlands;
- minimum number of employees;
- higher minimum equity requirement (currently 15%) for international holding companies.

3. Tightening of Section 8c of the Corporate Income Tax Act 1969.

Section 8c of the Corporate Income Tax Act 1969 currently assumes minimum equity for interest conduit companies of the lower of 1) 1% of the outstanding loans or 2) €2 million. A rule of thumb applied in practice for royalty conduit companies is that equity held to bear risks should be at least 50% of the annual royalties or €2 million. The lower limit of €2 million is often the main determinant. The State Secretary says this lower limit could be raised or scrapped.

International

BEPS action 6 describes measures for a minimum standard to prevent tax avoidance through treaty abuse. These are mainly measures to combat treaty shopping: gaining treaty benefits improperly, for example because a company with no economic significance is incorporated in a low-tax treaty country with the main aim of saving tax.

BEPS action 6 proposes to combat treaty abuse by:

i. a principal purpose test (PPT), or
ii. a PPT combined with a limitation on benefits rule (LOB), or
iii. a detailed LOB in combination with an anti-conduit rule.

A PPT is a provision under which treaty benefits may be refused for transactions or structures whose main aim is to obtain treaty benefits. An LOB is a complex provision that describes the circumstances in which taxpayers may enjoy treaty benefits. An anti-conduit rule is to prevent dividends, royalties or interest being paid through a company in a low-tax treaty country to avoid tax.

In brief, the measures against treaty abuse described in BEPS action 6 give treaty countries the ability to refuse treaty benefits if, in general terms, there is a structure or transaction led by the intention to make use of the treaty and where commercial considerations had no or only a subordinate role.

It seems that most countries will implement the PPT. Although each country will do this differently, it is expected that it will be difficult for letter-box companies to qualify for the PPT. If, however, the company has more substance, so that additional functionality is added to it, it may be that the PPT can be complied with.

Should you wish to learn more about Dutch substance requirements, please feel free to contact us:

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