8 APRIL 2021

Virtual 7th Annual

International Tax Developments Seminar

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During the Virtual 7th Annual International Tax Developments Seminar, several Loyens & Loeff tax experts updated the participants on the latest international tax developments. The steady flow of OECD, EU and unilateral initiatives to tighten the rules over the last 8 years are keeping businesses busy. Staying up-to-date and taking decisions, often based on limited guidance on the interpretation of the new rules, is a real challenge these days.

Withholding Taxes – What's new

Margriet Lukkien, Linda Brosens, Imme Kam

The legislator and tax authorities are active in taking steps to combat potential abuse in relation to withholding taxes.

Danish cases

How bullet proof is your structure in terms of withholding tax exemptions after the landmark judgments in the Danish cases of the Court of Justice of the European Union (CJEU) of 26 February 2019 and what should you do to protect it? This question has been asked a lot in the last 2 years.

In 2019, the CJEU ruled on the six 'Danish cases'. In the Danish cases, the CJEU added new indications of abuse, such as the fact that all or almost all of the income is being passed on to entities or persons that cannot benefit from an EU Directive very soon after its receipt. The CJEU further clarified that the beneficial owner should not be interpreted as being the formal recipient but rather as being the entity which benefits economically from the income received.

Danish cases in practice and in court cases

By now, we are gradually seeing tax administrations in some of the EU Member States use the judgements as some kind of holy grail to attack the use of foreign holding, IP and financing structures, even for the past and even for structures having organisational substance at holding company level.

In Belgium, a dedicated inspection team was established in order to audit withholding tax exemptions claimed on dividend, interest and royalty payments made. This has led to an increase in tax audits, in particular for Belgian subsidiaries paying dividends and interest to Dutch holding companies. Often, very specific and detailed questions are asked to the Belgian subsidiary relating to substance and cash flows. The Belgian tax authorities also make increased use of the possibility of the exchange of information by asking the Dutch tax authorities for information. In such case, the Dutch tax authorities frequently ask the Dutch holding company to help answer the questions raised. It is of course key to align the answers provided by the Dutch holding company and the Belgian subsidiary.

In the Netherlands, we see there are more questions coming in from tax administrations in source countries all over the world in relation to withholding tax relief. Interestingly, these questions do not only relate to holding companies but also to companies with operational activities in addition to holding and financing functions. This is also what we see in Belgian tax audits. We do not see Dutch tax audits regarding the dividend withholding tax exemption so far.

Both in Belgium and the Netherlands, the Danish cases have been applied by the courts. In a recent Belgian court case, the court found the interposition of a Luxembourg entity in the context of a restructuring abusive and denied the withholding tax exemption on the dividend paid and the capital reimbursed. In the Netherlands, two court cases regarding dividend withholding taxes are pending. Recently, the lower court denied the withholding tax exemption in one case and granted the withholding tax exemption in the other case. The court focused on the active business enterprise test but neither addressed the beneficial ownership criterium nor assessed the indicators of abuse in the 'Danish cases'. Loyens & Loeff is litigating these cases, which are pending before the courts of appeal.

Takeaways

The key takeaways for taxpayers are to make sure to have business activities with amongst others employees and office space at the right level. Additionally, it is key to be mindful of cash flows and manage them wisely.

Withholding tax on interest and royalties | proposed dividend exit tax

As of 1 January 2021, the Netherlands introduced a withholding tax on intra-group interest and royalties which targets payments to low-tax jurisdictions. However, payments to hybrid entities, in the US for example, and to partnerships may also be in scope. It is proposed to extend this withholding tax to dividend payments as of 1 January 2024. Dividends paid by a non-holding cooperative, such as a cooperative investing in real estate, and dividend payments to entities in low-taxed treaty countries are specifically targeted.

Finally, as to how businesses deal with the proposed dividend exit tax, on the one hand Loyens & Loeff sees cases where the proposal has led to postponing a restructuring. On the other hand, in more robust cases, restructurings have been completed despite the proposal. A case-by-case assessment is required.

DAC 6 experiences

Carlijne Brinkers, Willem Bon

Businesses may consider to develop a DAC 6 policy.

Level playing field for application hallmarks

Clearly, the most important area for improvement is creating a level playing field among the EU Member States in terms of applying the hallmarks in practice. As long as there is no alignment in terms of applying the hallmarks in practice, complying with DAC 6 in day-to-day practice is not always easy. This means that DAC 6 compliance will have to be integrated in the way international transactions are planned and implemented.

DAC 6 reporting policy | controversy

It is important for businesses to have a DAC 6 reporting policy in place. The three most important elements of a DAC 6 policy are:

- An early warning system, because often time will be of the essence since there is a filing period of only one month.
- The coordination between the advisers in different jurisdictions is important as there are different interpretations of the hallmarks among EU Member States and you would like to iron out these differences.
- Being able to demonstrate that you are in control of DAC 6 and to share DAC 6 analyses if asked.

Not having a policy in place is a potential source of controversy, such as being too late with the DAC 6 analysis or not having an escalation procedure in place if it is not possible to resolve difference of views in time. Of course, the most obvious source of possible controversy is the DAC 6 reporting itself. The actual filing of a DAC 6 report may function like a red flag, provoke a reaction from the tax authorities and may ultimately result in a dispute with the tax authorities.

What's important towards the future

Towards the future, it is important for businesses:

- To be familiar with the DAC 6 rules in the countries where they have investments and where they do business and to be as consistent as possible in applying the hallmarks.

- To identify and keep a record of who their advisers are and verify which advisers are exempt from reporting because of professional secrecy or client attorney privilege.
- To agree with their advisers in the letter of engagement or elsewhere that they will involve them as much as possible in their DAC 6 analysis and that they will do so in a timely manner and in a meaningful way.
- To agree and develop a procedure to escalate matters, both internally and externally, when DAC 6 trouble looms.
- To inform all the group companies mentioned in the DAC 6 report of what is reported and why.
- To keep track and monitor all of the foregoing.

CJEU Lexel case – new insights on interest deduction limitations and more

Dennis Weber

Recent case law by the CJEU provides for new insights on the compatibility of Dutch interest deduction limitations with EU Law.

Case

On 20 January 2021, the CJEU delivered its judgment in the case *Lexel AB v Skatteverket* (C-484/19) (Lexel). The case deals with a Swedish interest deduction limitation that applies to interest paid by a Swedish group company to another group company in France. The question was raised whether the denial of the interest deduction is in breach of the freedom of establishment.

The Swedish interest deduction limitation is similar to the Dutch interest deduction limitation in article 10a Corporate Income Tax Act 1969 (CITA). That is no coincidence, since the Swedish regulation is based on Article 10a CITA. Under the Swedish interest deduction limitation, the interest expenses in relation to a debt owed to an associated company are not deductible unless the interest is subject to a nominal tax rate of at least 10% in the state of the recipient. However, even if this 10% rate is met, the interest is still not deductible if the main reason for incurring the debt is to get a substantial tax benefit. In the case at hand, the French company had available loss compensation.

Judgment

According to the CJEU, there is a discrimination in this case as the Swedish interest deduction limitation provision constituted a difference in treatment between a domestic situation and a cross-border situation. Swedish companies could use the Swedish consolidation regime in domestic situations for the deduction of interest payments. The question then arises whether there are good reasons to refuse the interest deduction in a cross-border situation. According to the CJEU, the prevention of tax evasion and tax avoidance could not be accepted as a justification as the Swedish interest deduction limitation is aimed at any substantial tax benefit and is not limited to purely artificial arrangements. Interesting to note that the fact that the interest on the loan was at arm’s length contributed to the fact that there was no artificial arrangement.

Dutch Supreme Court

The Dutch Supreme Court has always assumed that a difference in treatment between domestic and cross-border situation under article 10a CITA can be justified because it prevents tax avoidance. After the Lexel judgment, it is questionable whether this reasoning is still valid. Based on article 10a CITA, interest deduction is denied solely on the ground that a tax advantage is achieved. However, it follows from the Lexel judgment that it is also relevant whether there is a wholly *artificial* arrangement. If the Dutch Supreme Court rules that article 10a CITA violates EU law, because the provision is not limited to wholly artificial arrangements, then the game is over for article 10a CITA. Alternatively, the Supreme Court will limit the scope of article 10a CITA to cases involving wholly artificial arrangements. If so, future discussions will focus on the artificiality of loans.

Safegarding rights and other takeways

Businesses should consider to safeguard their rights by filing objections to assessments in which interest deduction is restricted on the basis of article 10a CITA. Possibly, practical arrangements can be made with the tax inspector regarding the handling of such an objection. If so, it should be possible to take advantage of the Lexel case with a minimum of effort. Outside the objection phase, the Lexel judgment may play a role in discussions with the tax authorities before assessments are imposed. Further, more discussions could arise on, for example, the artificiality of constructions. Businesses should anticipate to this by properly documenting the exact reasons for granting loans and the manner in which this is done.

Transfer pricing trends – new rules and recent case law

Mark van Casteren, Stephan Kraan

By making sure that their pricing is at arm's length, businesses can avoid the unreasonable outcome of the proposed legislation to combat transfer pricing mismatches.

Proposed legislation to combat transfer pricing mismatches

In March 2021, the Dutch government opened a consultation on proposed legislation that aims to combat transfer pricing mismatches. The proposal is a substantial change to the Dutch tax environment we operated in for decades. Based on longstanding case law, non at arm's lengths conditions of transactions between related parties are adjusted as if the transactions were made based on conditions between independent parties. The proposal is a significant deviation from the principle in Dutch tax law that only profits derived in the Netherlands are taxed in the Netherlands, taking into account upwards and downwards corrections for profits derived from shareholder relations, and without taking into consideration whether another country makes a corresponding adjustment. The proposal:

- states that downward pricing adjustments on the basis of the application of the arm's length principle will only be taken into account to the extent that a corresponding upward adjustment is taken into account at the level of the related company involved in the transaction in the other jurisdiction, and that is subject to tax in that jurisdiction; the burden of proof will be on the taxpayer.
- disallows depreciation on assets to the extent there is no upward adjustment on the acquisition price of the assets in the transferor's country.
- includes an effective retroactive effect for future depreciation on assets that have been transferred within a period of five years prior to the entry into force of the proposal; many comments were raised regarding the retroactive effect.

Not abusive consequences which may have impact

Various consequences of the proposal that are not abusive may impact businesses in a negative way, resulting in double taxation. For example:

- A situation where the corresponding adjustment does not take place at the level of the counterparty of the transaction but with the shareholder or member of the counterparty, for example, as a result of CFC legislation or if the counterparty qualifies as a hybrid entity.
- A situation where a downward pricing adjustment is disallowed but an upward pricing adjustment with the counterparty is taken into account in a later fiscal year.
- If a secondary adjustment, being. an informal capital contribution or dividend distribution, will be taken into account, resulting in dividend withholding tax for a dividend distribution; whether a secondary adjustment will be taken into account is currently unclear.

Recommendations

It is recommended that companies monitor the impact of the legislation to combat transfer pricing mismatches that will eventually be introduced, as it could be very significant. By making sure that their pricing is at arm's length, businesses can stay outside of the scope of unreasonable outcome of this proposed legislation.

Economic modelling

We were happy to see that economic modelling was mentioned in the OECD Financial Transactions Guidance for the first time as a method when reliable comparable uncontrolled transactions cannot be identified. We have been applying economic modelling in our services already for a couple of years.

Economic approach in court case

Despite reliability and comparability issues, performing benchmark studies has been considered market practice for many years. However, last year, the Dutch tax authorities successfully brought forward a more economic approach in a court case regarding an intercompany loan. In this case, the transfer pricing report including a benchmark study was largely ignored. Instead, in arguing that the intercompany loan was a non-business like loan (*onzakelijke lening*) the Dutch tax authorities focussed on the cash flow forecasts of the investment as presented to the banks to obtain bank financing and checked whether the principal amount of the loan and the interest could be paid based on these expected cash flows.

Added value of cash flow analyses

For financial transactions, in addition to the more traditional credit rating and benchmark study approach, we have developed a step plan to determine and/or evaluate the arm's length character of intercompany debt volume and coupon. The first step of this approach is to simulate the cash flows under different market scenarios. Subsequently, under the second and third steps, we test whether the remuneration of the parties providing funds, both debt and equity, i.e. the lender and the shareholder, is a sufficient remuneration for those parties considering the risks involved for them. As a fourth step, we check whether attracting the intercompany loan makes commercial sense to the borrower. Finally, we test the intercompany loan's debt servicing capacity and whether the interest is "effectively profit sharing".

Using a cash flow analysis in addition to a benchmark study, adds an additional layer of defence as we more and more see the tax authorities questioning the economic logic of entering into an intercompany transaction and its pricing. Not only in case of shareholder loans, but also in business restructurings, for example. Such analysis is also useful for existing transactions, as it may either confirm the benchmark study results on an ex-post basis, or it may be the basis to make an impact analysis, i.e. make clear what the risks are, and to see if amendments can be made to improve the situation.

Pillar 2 – principles and challenges

Charlotte Kiès

Businesses are recommended to study the impact of Pillar 2, as measures can be expected to enforce a global minimum level of effective taxation.

Tax challenges of the digitalization of the economy

Digitalization in the world comes with tax challenges. Pillar 2, together with Pillar 1, aims to address these challenges.

Pillar Two - Principles

Pillar Two focuses on achieving a global minimum taxation for large MNE groups in each jurisdiction where they are present:

- resulting in a reduction of the incentive to shift profits to low-tax jurisdictions; and
- providing jurisdictions with the ability to tax group profits that are subject to a low effective rate in certain jurisdictions.

Pillar 2 aims to come with a multilateral solution to avoid uncoordinated rules, complexity and over-taxation. It constitutes a mix of tax measures both at parent level as well as at source country level.

Pillar Two – four rules

Pillar Two effectively seeks to enforce a global, yet to be determined, minimum level of effective taxation on income derived by large MNEs. The proposal includes four different rules, being the income inclusion rule, the switch-over rule (supporting the application of the income inclusion rule), the undertaxed payment rule and the subject-to-tax rule. The rules would require changes to both domestic law and tax treaties.

The subject-to-tax rule introduces a withholding tax applicable to certain mobile payments in case the recipient is subject to a nominal tax rate below a certain threshold. The scope of application is still under discussion. Whether an MNE falls within the scope of the income inclusion rule and the undertaxed payment rule (jointly referred to as the GloBE rules) is reviewed at the level of the financial consolidation and depends on whether the MNE group exceeds the global turnover threshold of, currently, EUR 750 million. Whether the rules are actually applied to the MNE ultimately depends on the effective tax rate (ETR) in each of the jurisdictions the MNE has presence, so-called jurisdictional blending. For the calculation of the ETR, all relevant taxes are included: profit taxes, income taxes and withholding taxes. In order to mitigate the risk of double or multiple taxation, the Pillar 2 measures come with ordering rules.

There are a lot of open items. There is general consensus that simplification is necessary. The OECD is aiming to reach consensus at the end of June. If consensus is reached, one of the next steps would be to repeal existing unilateral measures. A global minimum corporate taxation also now seems to be supported by the US government. If no consensus is reached at OECD level, the EU will likely act on its own. One way or another, it seems that the GloBE measures are coming, either unilateral, at EU level or under a global approach. These measures will affect international businesses globally.

How to prepare

Businesses should start preparing themselves in order to ensure that the effect of the Pillar 2 measures can be properly addressed. Businesses are increasingly reviewing the potential impact of the Pillar 2 measures.

Such preliminary impact assessments may, for instance, include identifying possible jurisdictions where the ETR or nominal tax rate is expected to be insufficient, but also assessing information needs for compliance purposes.

Businesses should also question whether there are any areas of improvement to the Pillar 2 Blueprint. Industry representation groups interacting with governments and the OECD may provide an opportunity to join the discussion and share concerns or suggestions. However, considering the targeted consensus at OECD level within a couple of months, the window of opportunity here is closing soon.

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NL-21-04-7TDS