Netherlands and Switzerland agree on tax treatment of investment vehicles

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Two recent mutual agreements between the Netherlands and Switzerland will have significant implications for collective investment vehicles (CIVs). One of the agreements appears to place inappropriate restrictions on certain CIVs. Dutch fiscal investment institutions, Swiss contractual funds, and Swiss open-ended investment funds can take less advantage of Dutch-Swiss tax treaty benefits when it comes to the dividends and interest that they receive from the other treaty state.

The other mutual agreement confirms that Dutch closed funds for joint account and Swiss limited partnerships are tax transparent and that qualifying investors in these institutions are eligible for tax treaty benefits.

Both mutual agreements aim to set procedures for reclaiming withholding tax. Investors are advised to analyse the implications of, and opportunities created by, the two mutual agreements.

The Dutch FBI and Swiss CIVs

Investment institutions frequently use Dutch fiscal investment institutions (FBIs) due to their favourable tax treatment: a 0% Dutch corporate income tax rate, access to tax treaties and favourable Dutch dividend withholding tax treatment. But under the new mutual agreement, these institutions must now meet strict additional conditions in order to receive treaty benefits in respect of Swiss source dividends and interest.

More than 95% of the FBI’s capital needs to be beneficially owned by Dutch residents for the FBI to claim a Swiss tax exemption (for interest and dividends paid to qualifying 10% or more shareholders) or a reduced 15% Swiss tax rate (portfolio dividends). The Swiss domestic rate for Swiss source dividends and interest is currently 35%. If the 95% threshold is not met, treaty benefits will be limited to the proportion of the capital beneficially owned by Dutch residents. Apparently, Switzerland wants to avoid granting FBIs full treaty protection where the investors would not have been entitled to treaty benefits if they had made a direct investment. The same conditions apply to Swiss contractual funds (FCPs) and Swiss open-ended investment funds (SICAVs).

Unfortunately, the mutual agreement does not provide full clarity on the status of CIVs, nor does it provide for practical solutions. It is also questionable from an EU law perspective. It is therefore unlikely to answer questions about the tax treatment of CIVs.

Inconsistency with Dutch tax treaty policy

The Dutch Minister of Finance has repeatedly expressed the view that FBIs should receive all treaty benefits and that the risk of the FBI being used for treaty shopping is limited because FBIs must annually distribute profits and Dutch dividend withholding tax must, in principle, be withheld from these distributions. Dutch tax residence certificates are granted to FBIs as well.

The mutual agreement’s 95% threshold, however, appears to be an anti-abuse rule limiting the application of certain treaty provisions to FBIs. The mutual agreement specifically refers to paragraph 6.17 to 6.20 of the OECD Commentary on Article 1 of the OECD model tax treaty, which suggests various options for the treatment of CIVs and the prevention of inappropriate use of these vehicles.

In fact, the mutual agreement resembles one of the options mentioned by the OECD for limiting the CIV’s treaty entitlement to prevent inappropriate use of treaties. But we consider the risk of treaty abuse or treaty shopping for the benefit of investors in third countries by using an FBI to be effectively absent since the FBI’s distributions are subject to Dutch dividend withholding tax, which is also expressly acknowledged in the OECD Commentary.

Hence, it is surprising that the Netherlands has agreed to limit eligibility of FBIs for treaty protection by introducing the 95% threshold. This limitation is an important and unprecedented restriction to the Dutch treaty policy, since it introduces an additional strict condition for entitlement to the treaty benefits.

In fact, the limitations of the mutual agreement are somewhat comparable to the limitation of benefit provisions as set out in many US double tax treaties and suggested in OECD action 6. Other states might use this mutual agreement as a template when negotiating a new treaty or mutual agreement with the Netherlands. If the 95% threshold is also introduced in other treaties or mutual agreements, the advantages of investing with a Dutch FBI could be significantly restricted. This could set a dangerous precedent for the treatment of FBIs in other countries.

Legal status

One could argue that the mutual agreement has no binding effect on taxpayers in the Netherlands because only the Dutch tax authorities can be bound by the mutual agreement (via the principle of the protection of legitimate expectations). In the Netherlands, mutual agreements only have a binding effect for taxpayers and tax judges if they are published in the Dutch Treaty Series (“Tractatenblad”, to be consulted via www.officielebekendmakingen.nl). So far, the mutual agreement has not been published in the Dutch Bulletin of Treaties.

The more relevant question is, however, what the legal status of the mutual agreement is in Switzerland. An FBI that receives dividend or interest from Switzerland has to file a refund request in Switzerland. The Swiss tax authorities therefore have to assess whether the FBI qualifies for a withholding tax refund. If Switzerland generally considers an FBI a Dutch tax resident, whether a limitation on benefits clause can be introduced by virtue of a mutual agreement is questionable. The mutual agreement procedure is based on article 25 (3) of the treaty, which is derived from the OECD model treaty. This article provides that by mutual agreement:
the parties may resolve any difficulties or doubts arising from the interpretation or application of the double tax treaty, and double taxation in cases not provided for in the double tax treaty may be resolved or eliminated.

Introducing a limitation on benefits clause does not fall under (i) or (ii) if Switzerland generally considers the FBI a tax resident of the Netherlands. Further, the OECD published a report in 2010 on the granting of treaty benefits with respect to CIV income. On the basis of this report, the Commentary to article 1 of the OECD model treaty was amended. Paragraph 6.19 provides that: “accordingly, it may be appropriate to restrict benefits that might otherwise be available to such a CIV, either through generally applicable anti-abuse or anti-treaty shopping rules or through a specific provision dealing with CIVs.” Paragraph 6.16 provides that: “Of course, a mutual agreement could not cut back on benefits that otherwise would be available to the CIV under the terms of the treaty.”

In our view, it is questionable whether the 95% threshold can be introduced by this mutual agreement because, as suggested by the Commentary, the rule should be provided by a treaty or protocol provision instead. We believe a Swiss court would also very likely rule that the Dutch-Swiss treaty cannot be amended by introducing an anti-abuse rule in this mutual agreement. Besides, paragraph VIII of the protocol already provides for a main purpose test as an anti-abuse rule in connection with dividend distributions.

The OECD action 6 final report “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances” provides that a main purpose test can generally be combined with a limitation on benefits provision. But it does not seem sensible to include a main purpose test in the treaty or protocol while subsequently agreeing on a specific limitation of benefits provision in a mutual agreement.

EU law
The applicability of the 95% threshold is also debatable from an EU law perspective. In Open Skies and Gottardo, the European Court of Justice ruled that if an EU/EEA state concludes a treaty with a non-EU/EEA state, that treaty must comply with the non-discrimination principle included in the Treaty on the Functioning of the European Union (TFEU). The court held that the freedom of establishment (article 49 TFEU) precludes EU/EEA states from concluding treaties with non-EU/EEA states if no account is taken of certain aspects of EU law.

When an EU/EEA state concludes a bilateral international treaty with a non-EU/EEA state, the fundamental principle of equal treatment requires the EU/EEA state to grant the same advantages to resident companies with resident shareholders and resident companies with shareholders residing in other EU/EEA countries. On this basis, the European Commission put the Netherlands on notice in 2015 in connection with the tax treaty with Japan, because the limitation on benefits provision in the treaty did not grant Dutch companies with shareholders in other EU/EEA states the same advantages as those with shareholders residing in the Netherlands.

Based on Open Skies and Gottardo, the mutual agreement is incompatible with EU law because it contains a beneficial ownership test without a general EU dimension. The mutual agreement provides that a Dutch FBI only qualifies for all the benefits of the treaty if more than 95% of the FBI’s capital is beneficially owned by shareholders residing in the Netherlands, and not if 95% or more is owned by Dutch and other EU/EEA residents. If the 95% threshold is not met, the FBI’s right to treaty benefits will be limited to the proportion of the capital beneficially owned by Dutch residents.

In our view, limiting the beneficial ownership test to Dutch investors is discriminatory and restricts the EU freedom of establishment and the free movement of capital. The Dutch Minister of Finance could argue that the discriminatory provisions in the mutual agreement are justified by their anti-abuse purpose and are proportionate because proportional application of the treaty is still available if the threshold is met. The latter is different from the all or nothing tests in the treaty with Japan. However, we do not believe that such justification would apply.

Regulated FBIs
The mutual agreement provides that, in the case of the Netherlands, the relevant vehicles are FBIs, which are regulated tax liable entities under the Dutch Corporate Income Tax Act. It is not clear what is meant by ‘regulated FBIs’. The Dutch Corporate Income Tax Act differs between regulated and non-regulated FBIs. Regulated FBIs are FBIs whose shares are traded on a recognised stock exchange, and FBIs which operate with a licence from the Dutch Authority for the Financial Markets (AFM).

It does not seem logical to limit the mutual agreement to listed and AFM-licensed FBIs. The 2010 OECD CIV Report provides that a publicly-traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually have control over it. We therefore believe the better view is that the mutual agreement applies to any FBI as defined in the Dutch Corporate Income Tax Act.

Administrative burden
The 95% threshold introduces an adverse administrative burden for FBIs. The CIV manager must assess whether more than 95% of the CIV investors are resident of the Netherlands or Switzerland. If the 95% threshold is not met, the CIV manager must sort out the proportion of the capital beneficially owned by Dutch or Swiss residents.

The relevant tax authorities will ask the fund manager to prove this by providing information such as: (i) a schedule of investors who are residents of the Netherlands or Switzerland and third states, (ii) statements confirming each investor’s entitlement to treaty benefits, and (iii) certificates of residency of the investors.

While investments in a CIV are typically long term, a CIVs shareholder base may change every day as new shares are issued and existing shares are redeemed (or if shares are traded on a stock exchange). Participations in CIVs are frequently offered through distributors, so the CIV manager will only know the net purchases or sales for a given day, not the change in underlying investors. Therefore, it is often practically impossible for a CIV
managers to comply with this requirement.

In theory, the effective Dutch tax treatment of a closed FGR and an FBI with only Dutch investors should be the same in many portfolio investment structures. The closed FGR is tax transparent and therefore not subject to Dutch CIT and is not entitled to the treaty benefits itself. The treaty benefits can be claimed by qualifying Dutch investors in the FGR. Therefore, a distribution to the FGR and a subsequent distribution to the investors is only subject to foreign or domestic withholding tax once, and the foreign withholding tax may be reduced by a treaty and credited by the investors.

The FBI on the other hand is subject to a 0% Dutch corporate income tax rate and has itself access to tax treaties. In principle, the FBI must withhold and remit Dutch dividend withholding tax on dividend payments. However, the withholding tax to be remitted may, subject to certain limitations, be reduced by Dutch or foreign dividend withholding tax levied on dividends or interest paid to the FBI (the remittance discount). Distributions to the FBI and subsequent distributions to the investors in an FBI are therefore effectively only subject to withholding tax once, which can be credited by the Dutch investors.

The advantage of using an FBI as investment vehicle is that many FBIs are not obliged to monitor their investors to claim a refund of withholding tax, and FATCA and Common Reporting Standards reporting is done by the distributors. Introducing the 95% threshold introduces an administrative burden that jeopardises this administrative benefit of using an FBI rather than a closed FGR.

**Tax transparent Dutch FGRs**

The second mutual agreement confirms the tax transparent status of the closed FGR and the eligibility of qualifying investors in these institutions for treaty benefits. In this manner, the agreement is comparable to mutual agreements concluded between the Netherlands and Canada, the UK, Denmark, Norway, the US and Spain.

Closed FGRs are frequently used as investment vehicles by domestic and foreign pension funds and other types of investors because of their flexibility and favourable tax treatment. An FGR is considered a closed FGR if:

1. participations may only be issued or transferred with the consent of all other investors (the consent requirement), or
2. participations may only be redeemed to and re-issued by the FGR itself (the redemption alternative).

Because of its tax transparency, all items of income derived by the closed FGR are allocated to the investors in proportion to their respective participations. A closed FGR itself is not entitled to the benefits under the tax treaty in relation to profits from Swiss investments, but qualifying Dutch investors may be.

In principle, the investors in a closed FGR must themselves claim the refund of withholding tax, rather than the closed FGR’s manager claiming the refund. The mutual agreement aims to provide, however, a simplified solution for the reclaiming of withholding tax for investors in closed FGRs, allowing the closed FGR’s manager or depositary to reclaim the withholding tax on behalf of Dutch investors.

FGRs or their authorised representatives are required to indicate, at least once a year, the percentage of ownership of the capital in the FGR held by Dutch investors. The fund manager may be asked to provide relevant information, such as: (i) a schedule of investors who are residents of the Netherlands and third states, (ii) the allocated items of income relevant to a claim, (iii) statements confirming the investor’s entitlement to treaty benefits, and (iv) investor certificates of residency.

In addition to other mutual agreements concluded by the Netherlands, the closed FGR may request protection under treaties with third countries on behalf of investors in those countries, if Dutch residents hold at least 95% of the participations in the closed FGR.

**Tax transparent Swiss limited partnerships**

On the basis of Dutch domestic tax law, the consent requirement is also used to examine whether a foreign LP investment funds or asset pooling structure such as the Swiss LP is tax transparent from a Dutch perspective. Swiss LPs are used for collective capital investments and are regulated by article 98 of the Swiss Federal Act on Collective Investment Schemes of 2006.

The first mutual agreement clarifies the treatment of Swiss LPs under the double tax treaty. Normally, the Dutch tax authorities examine whether a foreign LP meets the Dutch transparency criteria on a case by case basis. The mutual agreement, however, confirms that all Swiss LPs are tax transparent.

Even if a Swiss LP does not meet the Dutch tax transparency criteria, the Netherlands treats it as tax transparent due to this mutual agreement. This is a deviation from other mutual agreements concluded by the Netherlands because the other mutual agreements only contain provisions regarding the Dutch closed FGR.