Netherlands

Super Tax Treaty May Kill Dutch Letterbox Industry—Or Not

By Linda A. Thompson

New Dutch rules that reflect the OECD's priorities for combating global profit shifting will kill off thousands of resident letterbox companies, lawmakers predict.

The Multilateral Instrument (MLI) is a key tool in the OECD's 15-action 2013 plan to combat base erosion and profit shifting. The MLI makes it possible to introduce anti-abuse rules into all bilateral tax treaties that countries have signed with other jurisdictions, skirting traditional government-to-government negotiations.

Snapshot

- Tool could stop treaty shopping, a goal of the OECD
- But impact depends on each country's interpretation

Dutch Finance Secretary Menno Snel said the MLI will help keep “profit-shifting structures” such as letterbox companies, entities with little to no real economic activity in the Netherlands, from abusing Dutch tax treaties, according to a letter he sent to lawmakers Dec. 20.

The bill, which was sent to the Dutch House of Representatives Dec. 19, is expected to be ratified in the coming weeks.

But views among tax professionals are still divided— practitioners and tax justice advocates interviewed by Bloomberg Tax took diverging views on whether it will spell the end of the country's large letterbox industry. Some important caveats may limit the effectiveness of the MLI, they said.

According to a 2013 study by Amsterdam-based research firm SEO Economisch Onderzoek, the inward and outward financial flows through letterbox companies per year totals 4 trillion euros ($4.8 trillion).

No Guarantees

Francis Weyzig, policy adviser on tax justice and economic inequality at Oxfam Novib, the Dutch arm of global charity, said that while the MLI will help stop some abuse, other structures that use letterbox companies need to be addressed with different measures.

For example, he pointed to the rise of “offices with a houseplant,” which he described as companies that “formally” meet all existing substance requirements but that report profits that are far out of proportion to their real activities in the Netherlands.

The effectiveness of the MLI is partially outside the Netherlands’ power, said Alexander Bosman, tax adviser at the Loyens & Loeff law

firm and an assistant professor of international tax law at Vrije Universiteit Amsterdam.

He said the Netherlands had, for instance, taken an ambitious “all-in approach” by bringing more than 80 bilateral tax treaties under the MLI. “But if you look at the choices of the Netherlands’ treaty partners, only 44 treaties are ultimately modified by the MLI,” he added.

The principal-purpose test provision will consequently only be introduced into these 44 existing treaties the Netherlands has signed with other jurisdictions.

Spotting Tax Cheats

Still, practitioners did acknowledge the MLI could curb the rerouting of profits through the Netherlands via letterbox companies—a technique known as treaty shopping—by making it easier to spot them. Ending treaty shopping was a top priority for the OECD in its BEPS project, said Marlies de Ruiter, a partner at Ernst & Young LLP.

De Ruiter added that the effects of the MLI would moreover rapidly be felt, pointing out that changes to bilateral tax treaties would take effect per Jan. 1 after two partner countries ratified the MLI. “So if you have an existing structure and the treaty changes in 2019, money flows that take place in 2019 will fall under the new rules,” she said.

Dutch implementation of the MLI would curb the rerouting of profits through the Netherlands via letterbox companies, Weyzig said.

"When it comes to letterbox companies, it will become possible to demonstrate rather easily that a letterbox company is only being used with the obtaining of a tax advantage as one of the most important objectives," Weyzig said.

The treating-shopping anti-abuse provision in the MLI will make it possible for a partner country to deny the treaty benefits and levy a withholding tax on the outgoing interest and royalty payments or service fees, he said. Known as the "principal purpose test," the provision means tax officials can disregard transactions if a company is using them to shift profits.

But successfully using the test will require the Netherlands to spontaneously exchange any relevant tax information with treaty counties, as it will sometimes be difficult for a treaty country on the other end of the world to determine whether a Dutch entity is no more than a letterbox company. "And this is something that the Dutch tax administration can very easily see," Weyzig said.

"So yes, this will help prevent profit shifting structures through letterbox companies, provided there is enough information for" treaty countries to apply the principal-purpose test, he said, adding that Oxfam Novib wants the Dutch tax administration to report how often it exchanges relevant tax information and how often anti-abuse provisions are applied.

Case-by-Case

Deciding what constitutes treaty abuse—and when the principal-purpose test should be applied—will rest with jurisdictions other than the Netherlands, Bosman said. The OECD has opted for a "flexible arrangement" with the test, Bosman said, and he described the provision as an "open norm up to a certain level."

"So it will ultimately be up to the source country to say whether they think something is a letterbox company without sufficient economic meaning, and in what situations this is or isn't the case," he said.

Varying interpretations and applications of the principal-purpose test could result in more legal uncertainty for taxpayers, he warned.

"What's tricky is that some countries are going very far in how they're applying the principal purpose test, and this could result in double taxation, and I think that that was precisely not the point" of the BEPS project, he said.

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