KPMG Meijburg & Co Tax & Legal

Report of the Conduit Companies Committee

On November 22, 2021, the 103-page report 'Op weg naar acceptabele doorstroom' (The road to acceptable conduit activities) of the Conduit Companies Committee (hereinafter: the Committee) was published. The report contains 15 recommendations, divided into six tax and nine non-tax policy options. At the same time, the Deputy Minister of Finance sent the government's response to this report to the Lower House of Parliament. In brief, it appears from this that the government believes that the soon to be expected EU measures for letterbox companies should be followed as far as the possible withholding of benefits for conduit companies is concerned. And that the next government should consider tightening in the fields of information exchange, transparency and supervision. Conduit companies should prepare for these developments.

In this memorandum, we therefore discuss in more detail the findings and recommendations of the Committee as they appear from the report and the government's response.

Concise summary

The Committee notes that many measures have already been taken at the national level to prevent the flow of funds, mainly in the field of taxation. Many measures have also been taken to combat money laundering and terrorist financing. However, it is not yet clear how effective the tax measures are in preventing the channeling of funds, partly because the effects are not yet visible in the (lagging) figures.

The Committee goes on to say that, in its view, agreements at the international level are indispensable in order to combat tax avoidance through conduit companies. Developments in this area have been accelerating for a few years now. This all leads to a combined uncertainty about (i) the effectiveness of national measures already taken and (ii) the outcome of international negotiations in this field. The Committee combines these two elements and takes the position that it is wise to closely monitor the effects of the (tax) measures already taken and the outcome of the international tax negotiations. The Committee also recommends that the Netherlands adopt a constructive and, where possible, initiating attitude towards current international initiatives.

However, the Committee sees opportunities for measures in the area of greater transparency, strengthened supervision and reporting requirements. The Committee divides its recommendations into tax and non-tax policy options. The tax recommendations concern the withholding of tax benefits or securities, improving the exchange of information and tightening the Dutch stance in treaty and multilateral

negotiations on tax matters. The Committee recognizes a number of risks under EU law. The Committee therefore sees all the more reason to take an energetic, coordinating and initiating approach to the European initiative against conduit companies. With the latter, the Committee refers to the European Commission's proposal for a directive to combat tax avoidance through the use of *shell entities* (i.e. conduit companies), which is expected this year.

The non-tax recommendations concern, among other things, withholding the legal benefits that investment protection agreements (*investeringsbeschermingsovereenkomsten*; hereinafter: IBOs) offer to conduit companies, increasing the transparency of legal entities by, for example, tightening the obligations with regard to the identification of the Ultimate Beneficial Owner(s) (hereinafter: UBO(s)), the UBO register, and the accounting and reporting rules ('403 statement'), as well as combating financial crime through stricter supervision, better international cooperation and additional research.

Tax

Role of taxation

The Committee explains that the position of the Netherlands as a conduit country has historically grown as a result of tax policy aimed at facilitating the cross-border activities of Dutch companies and attracting foreign investment. The most relevant elements of the Dutch tax system that have made the Netherlands attractive for conduit companies, at least until recently, are the participation exemption, the extensive treaty network, the absence of withholding tax on interest and royalties and the ruling practice. In combination with its well-organized financial advice and service sector, the Netherlands became a frequently used intermediary for these elements in order to avoid withholding taxes elsewhere.

It appears from a comparative law study that the Dutch system has not been unique in the abovementioned respects for some time; other countries, for example, (now) also have an extensive treaty network and a participation exemption.
Moreover, in recent years, the Netherlands has taken and announced several measures that make certain types of flows less attractive. For example, a conditional withholding tax on interest and royalties was introduced in 2021, the ruling practice was tightened on July 1, 2019 and the Netherlands is striving to ensure that all tax treaties include a *Principal Purpose Test* (hereinafter: PPT; an anti-abuse provision). The effects of many of these measures are not yet visible in the statistics, but should be in the coming years.

The Committee concludes that 'policy stacking' has occurred to a certain extent, while the effects of the measures taken are still unclear to a great extent, partly because the relevant figures only become available after a number of years. Furthermore, the Committee notes that internationally there is also much to be done in terms of combating tax avoidance through the use of conduit companies. Therefore, the Committee takes the position that it is wise to closely monitor the effects of the (tax) measures already taken and the outcome of the international tax negotiations. The Committee also recommends that the Netherlands adopt a constructive and, where possible, initiating attitude towards current international initiatives.

That is not to say that there is no room for improvement. However, some of the recommendations carry risks under EU law. The Committee therefore sees all the more reason to settle these matters in the soon to be expected European initiative against conduit companies.

Tax measures

1. Scrapping the safe harbour for interest and royalty conduit companies

The Committee's first recommendation concerns the amendment to an open standard of the existing 'equity requirement' for interest and royalty conduit companies as referred to in Section 8c Corporate Income Tax Act 1969 (CITA). The running of a real risk is currently linked to holding a minimum amount of equity to cover risks. This unintentionally acts as a *safe harbour*. This recommendation is aimed at making the Netherlands less attractive for conduit entities or conduit activities. The Committee does, however, draw attention to the EU law aspects of this recommendation.

2. Expansion of the spontaneous exchange of information on companies

The second recommendation is that the spontaneous exchange of information to source countries, as now provided for in Section 3a(7) of the Decree implementing the International Assistance in the Levying of Taxes Act, should be extended to companies that do not meet the (new) risk requirements of Section 8c CITA. The Committee notes that it sees scope for extending this information exchange (even further) to, for example, dividend conduit companies. However, the extension must be worthwhile, in other words, the genuine business sector must not be affected. The provision of information should therefore be limited to companies belonging to a group that has no other relevant activities in the Netherlands and of which the Netherlands would agree, in a mutual agreement procedure with the other country, to withhold the benefits in question. This demarcation entails risks under EU law. To mitigate these risks, the forthcoming proposal for a directive could possibly be a solution.

3. Spontaneous exchange of information on exempted gains on disposal

The third recommendation concerns the introduction of spontaneous information exchange with countries that have a source state tax on the disposal of shares. Under many tax treaties, the right to tax these gains on disposal is in principle assigned to the country of the disposing shareholder. If the Netherlands is the country of the disposing shareholder, the gain on disposal usually falls under the participation exemption, as a result of which no tax is levied. For this reason, a Dutch entity may be interposed.

However, the (international) principle that the country of the disposing shareholder has the right to tax the gains on disposal is subject to an exception when the source country can successfully invoke the PPT. By means of information exchange, the Netherlands is in a (better) position to enable the source country to apply the PPT. To ensure that the genuine business sector is not affected, the exchange should only cover situations where an entity established in the Netherlands with little substance disposes of shares in a foreign company. The assessment of whether there is sufficient substance in the Dutch entity should take place on a nexus basis.

4. Extension of the PPT to the entire tax treaty (if not multilaterally arranged)

The fourth recommendation concerns the PPT. The PPT is included in the Multilateral Instrument (MLI) and applies to all provisions of the applicable tax treaty. By means of the MLI, the Netherlands aims to make this extended PPT applicable in the treaty relationship with as many countries as possible. Where this is not possible, the Netherlands should (actively) approach other countries to include a comprehensive PPT in the treaty.

5. A proactive stance on the forthcoming EU directive proposal on conduit companies

The fifth tax recommendation calls on the Dutch government to adopt a positive attitude towards the European Commission's announced proposal for a directive on combating tax avoidance through the use of conduit companies.

6. Clear interpretation of the anti-abuse principle of EU law

The final tax recommendation calls on the government to argue within the EU for a clear interpretation of the anti-abuse principle of EU law. Especially now, since combating tax avoidance through the use of conduit companies is on the European agenda and a proposal for a directive on this has been announced. According to the Committee, the Danish judgments (see our memorandum of February 28, 2019) provide good starting points for a tightening of the Interest and Royalties Directive and the Parent-Subsidy Directive. A tightening of the Parent-Subsidiary Directive could,

according to the Committee, be partly directed towards removing or restricting tax benefits such as the participation exemption for interposed (substance-poor) holding companies.

Intended information exchange for intermediate holding companies that are virtually without substance as of 2022

Against the background of the above, the government's response to the report refers to the decision that, for the time being, the government will refrain from introducing information exchange of as of January 1, 2022 for intermediate holding companies that are virtually without substance which make use of the participation exemption (see our Budget Day memorandum 2020, section 9.9). A possible Dutch amendment to the information exchange will therefore be included in the broad consideration of the final proposal for a directive on conduit companies from the European Commission that is expected at the end of this year.

Non-tax

Role of non-fiscal factors

In addition to tax reasons, the Committee's investigation shows that there are also numerous other factors for establishing a conduit company in the Netherlands. The report specifically mentions the general business climate, which, in addition to tax factors as described above, includes factors such as a reliable physical and digital infrastructure, a well-educated labor force, efficient and predictable regulations and legal and political systems that offer certainty and stability. Not all of these factors are equally relevant to conduit companies, which is why the Committee looked more specifically at the importance of independent, effective and stable government institutions using the World Bank's Governance Index. This shows, for example, that the Netherlands scores better than the EU and OECD average on all indicators in this index. The Committee found that the law is perceived to be accessible and that the Enterprise Chamber has a good reputation. In addition, the large legal infrastructure is a reason for conduit companies to establish themselves in the Netherlands.

As far as the flexible Dutch company law is concerned, the Committee's view is that the advantage of establishing a company in the Netherlands lies partly in the possibilities for protecting interests, especially of management and incumbent shareholders, but also for protecting or ring-fencing foreign assets. In addition, IBOs can play a role in the establishment of conduit companies here. The Netherlands has concluded over 90 such agreements, particularly with emerging economies. In order to prevent the undesirable use of IBOs by companies without any links to the Netherlands, the Minister of Foreign Affairs recently presented a new model text with

various amendments. In order to invoke investment protection, *substantial business activities* would be required, thereby excluding conduit companies. According to the Committee, this is a good step, but it is not yet sufficiently clear when *substantial business activities* are involved.

The Committee then discusses the connection between tax avoidance and money laundering risks. Conduit companies and the infrastructure surrounding them are not only an important element in tax avoidance, but can also be used to conceal criminal financial flows. After all, the limited real presence of these companies means that there are fewer leads for (criminal) investigations. In addition, the size of the financial flows through the Netherlands and its reputation as a reliable and legitimate trading nation can also provide opportunities for concealment. In addition, the extensive infrastructure of service providers is an important element in tax avoidance, with (illegal) trust companies being mentioned in particular. The latter are also associated with money laundering risks.

Non-tax measures

In the meantime, numerous measures have already been taken, often at European level, or announced, in order to counter the use of the abovementioned elements by money launderers. The Committee has been looking for further possibilities to limit the attractiveness of the Netherlands for less ethical and criminal money flows, without losing sight of the good business climate in the Netherlands. In particular, the Committee advocates intensifying supervision and tightening access to an IBO. The Committee also proposes bringing the reporting requirements for conduit companies more in line with those for companies with Dutch operations, for example by scrapping the 403 exemption and by always including data from participations when determining the size of a company and, if relevant, the financial income as well.

Furthermore, the Committee sees opportunities to tighten the anti-money laundering framework. The Committee has in mind here more and better insight into the identity of ultimate beneficial owners and, as the case may be, making it compulsory to include an explanation as to why only pseudo UBOs are included rather than real UBOs, as well as making it easier to search the data in the UBO register that is already publicly available. The Committee also recommends the Netherlands to continue its lobbying efforts for the introduction of UBO registers worldwide as UBO registers with public data are only the norm within the EU. Furthermore, the Committee advocates international cooperation in supervision and investigation and follow-up studies into money laundering and conduit activities.

Meijburg & Co
November 2021

The information contained in this memorandum is of a general nature and does not address the specific circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.