Going Dutch

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Introduction

As we forge ahead as a nation with rapid reforms being undertaken by a strong central leadership, it is expected that India will remain one of the bright spots of the world economy. The year 2016 has seen a flurry of reforms in the tax domain, the biggest being the bold demonetisation drive. Along with such big bold measures on the domestic front, the current government has been bold and active in the international scene also, by finally amending the India – Mauritius treaty where the proposed amendment had been in a state of flux for a long duration. Post the amendment of India – Mauritius treaty numerous other treaties such as India – Singapore, India – Cyprus treaties have been amended in quick succession to curb the menace of jurisdiction shopping and unfair tax avoidance.

However, one of the treaties which have not been amended which could be used for tax planning purposes is the India – Netherlands treaty. In this article, we shall explore the contentious clauses of the India-Netherlands treaty from an all-round perspective taking into account the domestic law in Netherlands and the impending BEPS Action Plan.

Article – 11 of India – Netherlands Tax Treaty – Interest

1. Interest arising in one of the States and paid to a resident of the other State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to laws of that State, but if the recipient is the beneficial owner of the interest the tax so charged shall not exceed 10 per cent of gross amount of the interest.

On reading of the above article, it can be seen that, if the payment of interest is from an Indian company to a resident of Netherlands, the income-tax charged cannot exceed 10%, and the same is true in a vice-versa situation.

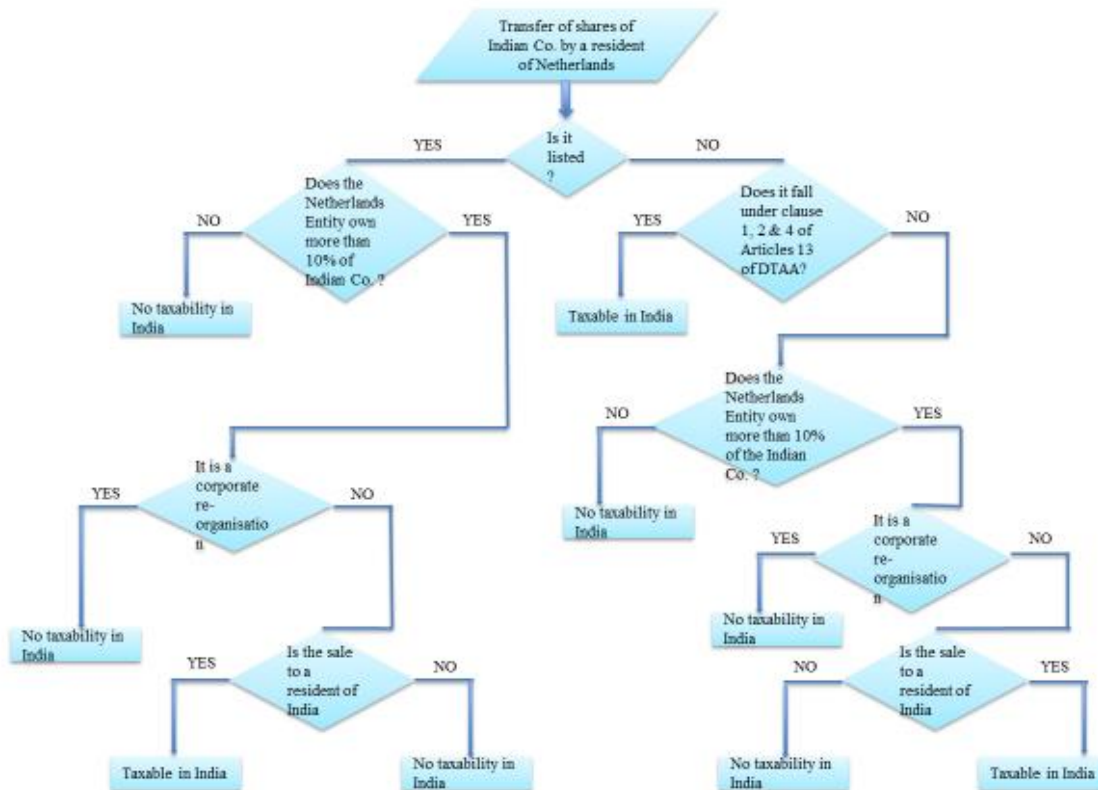
Until the year 2016, if a Netherlands based entity owned more than 5% of an Indian company and earned interest income from the same company, as per Netherlands law it would have been eligible for a participation exemption in Netherlands and such interest income would have been exempt in Netherlands. However, from the year 2016, if any interest income is tax deductible in the source country, the same will be taxable as per the prevailing tax rates in Netherlands (Corporate Tax Rate in Netherlands – 25%) and foreign tax credit can be availed, if any. Therefore, earlier to 2016, a loan could have been structured to arrive from a Netherlands based company and the interest income generated from such loan would have suffered only 10% effective rate of taxation, on satisfaction of the participation exemption.

Article – 13 of India – Netherlands Tax Treaty – Capital Gains

1. Gains derived by a resident of one of the States from the alienation of immovable property referred to in Article 6 and situated in the other State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of one of the States has in the other State or of movable property pertaining to a fixed base available to a resident of one of

the States in the other State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the State in which the place of effective management of the enterprise is situated. For the purposes of this paragraph, the provisions of paragraph 3 of Article 8A shall apply.
4. Gains derived by a resident of one of the States from the alienation of shares (other than shares quoted on an approved stock exchange) forming part of a substantial interest in the capital stock of a company which is a resident of the other State, the value of which shares is derived principally from immovable property situated in that other State other than property in which the business of the company was carried on, may be taxed in that other State. A substantial interest exists when the resident owns 25 per cent or more of the shares of the capital stock of a company.
5. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4 shall be taxable only in the State of which the alienator is a resident. However, gains from the alienation of shares issued by a company resident in the other State which shares form part of at least a 10 per cent interest in the capital stock of that company, may be taxed in that other State if the alienation takes place to a resident of that other State. However, such gains shall remain taxable only in the State of which the alienator is a resident if such gains are realised in the course of a corporate organisation, reorganization, amalgamation, division or similar transaction, and the buyer or the seller owns at least 10 per cent of the capital of the other.

If one focuses on sub-article (5) of Article – 13, there is an element of tax planning possible on taking into account the domestic law of Netherlands. Following chart provides a break – down of sub-article (5):



As we can see from the chart, sub-article (5) of Article – 13 provides for residence based taxation. Earlier the Indian treaties with Mauritius, Singapore and Cyprus, the Capital Gains article in the DTAA, provided for residence based taxation which was used for tax planning, to reduce the effective rate of taxation to zero owing to the domestic laws in the respective countries. In the case of Netherlands, the domestic law provides for exemption from Capital Gains if the Netherlands entity owns at least 5% in the Indian entity. But to qualify for such an exemption the following additional conditions need to be fulfilled:

1. The Indian entity is not held as a mere portfolio investment
2. The Indian entity is subject to a reasonable effective tax rate based on Dutch tax principles ("subject to tax test"), or
3. Less than 50% of the assets of the Indian entity consist of "passive" assets based on the fair market value of the assets ("asset test")

Therefore, based on the chart above and the prevailing domestic law in Netherlands, there is a possibility of Multi-national enterprises (MNE's) structuring investment into India to reduce tax costs through planning.

Conclusion

Overall, the India – Netherlands tax treaty provides an attractive prospect for tax planning option to MNE's. Apart from the Capital Gains article there are various other beneficial provisions in the India – Netherlands treaty such as "make available" clause in the Royalty & Fees for Technical Services Article, no service PE clause in the Permanent Establishment Article. Also, as per recent news reports

the Central Government does not intend to amend the tax treaty between India & Netherlands[1], as Netherlands is not currently used for tax planning.

However, the India – Netherlands treaty must be examined from the OECD Base Erosion and Profit Shifting (BEPS) action plan perspective as well, where the multi-lateral instrument under BEPS Action Plan - 15 would, as a minimum standard, modify notified bilateral tax treaties to implement either a principal purpose test (a broad treaty level GAAR) – with a simplified limitation on benefits or not, or a detailed limitation on benefits provision. The instrument will also modify the preamble of such treaties to clarify that the use of the treaty to achieve double non-taxation should not be allowed.

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[1] The Economic Times – Jan 11, 2017 - India may leave tax treaty with Netherlands unchanged