Timing issues under double tax treaties: the Dutch approach

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Timing Issues under Double Tax Treaties: The Dutch Approach

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This article explores in more detail some of the timing issues that may arise when a new tax treaty becomes applicable or when there is a relevant change in the factual situation of the taxpayer, both resulting in a shift in the allocation rights of the tax treaty states involved. In both cases, the question is to what extent this change in allocation rights is applicable ratione temporis. It is concluded that this question cannot be answered in a general sense. In each situation, it boils down to a case-by-case analysis that must be performed under both international and national law.

1 INTRODUCTION

This article explores in more detail some of the timing issues that may arise when a new tax treaty becomes applicable or when there is a relevant change in the factual situation of the taxpayer, both resulting in a shift in the allocation rights of the tax treaty states involved. In both cases, the question is to what extent this change in allocation rights is applicable ratione temporis. This question will be dealt with in this article from the perspective of Dutch tax treaties (although the analysis may be applicable mutatis mutandis to other tax treaties as well). The reason is that the Netherlands has revised a significant number of tax treaties over the past decade, and will certainly continue to do so in the near future; whereas at the same time, issues have deserved virtually little or no attention in Dutch tax treaty policy until now.

In section 2, I will discuss the main legal principles under international law (e.g., the principle of non-retroactivity of treaty application and treaty termination) and Dutch national tax law (e.g., the ‘compartmentalization’ doctrine) that are relevant for answering the above research question. In section 3, I will subsequently examine a number of concrete examples of timing issues under tax treaties under reference to a number of different tax treaty allocation rules (business profits, dividend income, capital gains, income from employment and pension income) in the light of the previously established main legal principles. The same analysis is made as concerns timing issues under the tax treaty rules for relief for double taxation.

2 TIMING ISSUES UNDER TAX TREATIES: MAIN LEGAL PRINCIPLES UNDER INTERNATIONAL AND DUTCH NATIONAL TAX LAW

2.1 Non-Retroactivity of Treaty Application

As far as the conclusion of a (new) tax treaty is concerned, the principle of the non-retroactivity of treaties under international law is relevant. This principle has been laid down in Article 28 of the Vienna Convention of the Law of Treaties (VCLT), which reads as follows:

Unless a different intention appears from the treaty or is otherwise established, its provisions do not bind a party in relation to any act or fact which took place or any

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1 The Netherlands has a large network of double tax treaties, currently amounting to approximately 100. The Dutch Ministry of Finance has developed a comprehensive policy for entering into tax treaties, the most recent version of which was published in 2011.

2 It is noted, for example, that the Dutch treaty negotiator decided, following public pressure, to start re-negotiating tax treaties with twenty-three developing countries in order to include specific anti-avoidance measures; Parliamentary Proceedings 2014/2015, Second Chamber, No. 25 087, Letter of the Dutch State Secretary for Finance dated 20 Apr. 2015. Agreement to amend the existing tax treaty has already been achieved with Ethiopia, Malawi, Kenya, Zambia and Ghana.
situation which ceased to exist before the date of the entry into force of the treaty with respect to that party.

Article 28 VCLT shows that this provision assumes an immediate temporal effect of the provisions of a new treaty, meaning that a new treaty respects anterior legal consequences of anterior facts, but not posterior legal consequences of anterior facts. This statement is supported by the comment of the International Law Commission on Article 28 of the VCLT.

If, however, an act or fact or situation which took place or arose prior to the entry into force of a treaty continues to occur or exist after the treaty has come into force, it will be caught by the provisions of the treaty. The non-retroactivity principle cannot be infringed by applying a treaty to matters that occur or exist, when the treaty is in force, even if they first began at an earlier date.4

After their entry into force, in principle, treaties should thus not interfere with anterior legal accomplished facts (\textit{facta praeterita}), yet they could interfere with on-going legal positions (\textit{facta pendentia}) and anterior incomplete facts (\textit{facta in statu nascendi}).5 The ban on retroactivity of treaties is thus limited and does not prevent that immediate effect accrues to new tax treaties.

Case law of the Dutch Supreme Court show that the Dutch Supreme Court, too, interprets Article 28 VCLT as entailing a limited prohibition on retroactivity. The Supreme Court’s decision dated 2 April 1985 concerned the question whether a request for extradition under Article 3 of the Extradition Convention of Witten is possible with regard to definite criminal offences existing before this Treaty had entered into force.6 The Supreme Court ruled that this question must be answered in the positive. Issuing the request for extradition is the crucial act regarding the question whether binding force accrues to the Extradition Convention. The Supreme Court ruled that the provision of Article 28 VCLT was not violated, as in this case the request for extradition was not issued until after the Extradition Convention entered into force.

At tax level, a similar approach is found in Swiss and English case law. The case that led to the ruling of the Swiss \textit{Bundesgericht} dated 12 April 2002 was about a request for exchange of information by the US tax authorities to the Swiss tax authorities on the basis of Article 26 of the 1996 Swiss-United States tax treaty.7 The request related to transactions occurring in the pre-1996 period when the former Swiss-United States tax treaty, dating from 1951, still applied. Referring to Article 28 VCLT, the taxpayer argued that Article 26 of the new tax treaty should not apply with respect to those pre-1996 years. The \textit{Bundesgericht} rejected this position, as acceptance of this position would mean that the new exchange of information provision would only apply years after the tax treaty entered into force. The \textit{Bundesgericht} ruled that this could not have been the contracting parties’ intention.

A similar matter was at issue in the British Ben Nevis case.8 In this case, the taxpayer argued, referring to Article 28 VCLT, that a request for assistance in recovery by the South African to the English competent authorities under the additional Protocol (from 2010) to the new tax treaty (from 2003) between South Africa and the United Kingdom (UK) may not extend to tax liabilities incurred in the period of 1998–2000. The British Court of Appeal rejected this position referring to the manifestly other purpose of the contracting parties.

Above rulings concerned procedural tax treaty rules. In view of the wording and explanation of Article 28 VCLT, however, I believe the same approach may be applied to the substantive tax treaty rules, such as the allocation provisions. In my opinion, this means that, in principle, an immediate effect accrues to new tax treaties – under international law.

Nevertheless, Article 28 VCLT allows parties to deviate from the principle of immediate effect.9 For example, tax treaty states may decide that a tax treaty also applies to anterior legal accomplished facts and thus give a tax treaty retroactive effect.10 Conversely, Article 28 VCLT also does not prohibit parties from mitigating the consequences of immediate effect of a (new) tax treaty. Strictly speaking, Article 28 VCLT does not even expresses an opinion on this matter. The reason for deviating from the principle of immediate effect may vary from case to case, and may, for example, be based on the wish to relax the adverse budgetary effects of a newly agreed allocation for the state.

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1. \textit{This is a United Nations body that prepares so-called codifying treaties.}
3. \textit{This distinction is derived from: P. Roubier, \textit{Le droit transitoire} (2ième ed., Parijs: Dalloz et Sirey, 1960), 172.}
4. \textit{Dutch Supreme Court 2 Apr. 1985, NJ 1985, 890 (conclusion the advocate general Leijten; with commentary from AHJS).}
5. \textit{See, for example, Schweizerischen Bundesgerichts 12 Apr. 2002, 2A 551/2001.}
6. \textit{Court of Appeal 23 May 2013 [2013] EWCA Civ 578 (Ben Nevis).}
8. \textit{An example of this is the 1996 amending protocol of the current Malta-Netherlands tax treaty, which has retroactive effect to years before 1996.}
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waiving its taxing rights. Another reason may be to relax the adverse effects of the newly agreed allocation for the taxpayers. The compensatory arrangement for Dutch frontier workers under Article 27, paragraph 2, of the current tax treaty between the Netherlands and Belgium is an example of this. Regarding the extended possibilities for international exchange of information, a specific transitional provision may also be found, effectuating that the extended possibilities for data exchange does not apply to ‘old’ years as a way of protecting taxpayers. Without a transitional provision, however, immediate effect of the provisions of a new tax treaty is the basic principle under international law. It is emphasized that the above analysis is based on international law and does not alter the fact that a transitional provision may be provided for – unilaterally – under national law once a (new) tax treaty enters into force. An example of this can be found in the new tax treaty between Germany and the Netherlands. As a source state under this new tax treaty, the Netherlands has obtained taxing rights regarding pensions accrued in the Netherlands and received by residents of Germany. Under the former tax treaty, the Netherlands did not have these taxation rights. This extension of the Netherlands taxation powers does not entail any transitional measures at the tax treaty level. However, a unilateral transitional provision was still inserted in the Dutch Act approving this tax treaty, in order to let the consequences of the transition of the taxation rights for taxpayers be a more gradual process. A similar unilateral transitional provision is found in the pension provision of the current tax treaty between Belgium and the Netherlands from 2001 that replaced the former tax treaty between these states from 1970.

2.2 Non-Retroactivity of Treaty Termination

The question of non-retroactivity can also arise in case of termination of a tax treaty. In this context, Article 70 VCLT is relevant. This provision states the following:

Unless the treaty otherwise provides or the parties otherwise agree, the termination of a treaty under its provisions or in accordance with the present articles:

a) Releases the parties from any obligation further to perform the treaty;

b) Does not affect any right, obligation or legal situation of the parties created through the execution of the treaty prior to its termination.

In my opinion, the scope of this provision is similar to the scope of Article 28 VCLT. This means that the termination of a tax treaty should not affect accomplished facts (facta praeterita), yet the termination could interfere with on-going legal positions (facta pendentia) and with anterior incomplete facts (facta in statu nascendi). This is inferred from the following comment of the International Law Commission:

Vested rights of a kind which will survive the termination of the treaty, although they may have their origin in provisions of the treaty, acquire an independent legal existence of their own. When the treaty terminates, it is the rights which are afterwards enforceable rather than the provisions of the treaty which gave them birth.

Hence, in my opinion, this means that, in principle, immediate effect accrues to the termination of a tax treaty. It follows that only ‘vested rights’ are protected under Article 70 VCLT. Like Article 28 VCLT, however, Article 70 VCLT allows contracting parties to deviate from this principle if they wish to do so.

3 Timing Issues as a Result of Changes of the Facts

Timing issues do not only play a part in case of changes in legislation, but may also be relevant when there are changes in facts. Also in such a case, the question comes up to what extent the change in allocation rights is

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11 See, for example, Art. 11 in conjunction with Part VIII of the Protocol to the Poland-Netherlands tax treaty and Art. 18 in conjunction with Part IX of the Protocol to the Finland-Netherlands tax treaty.

12 Without any further provisions, the transition from taxation in the State of residence under the old tax treaty to taxation in the State of employment of the Belgian earned income under the new tax treaty would imply a comparatively large loss of income for residents of the Netherlands. A transitional provision has been included to compensate for this loss of income.


16 Law dated 12 Dec. 2002, Law Gazette 2002, 796. This regulation has effectuated that, under certain conditions, regular pension benefits are exempt from Dutch tax in the first two calendar years after the entry into force of the treaty, and are taxed for up to 25% as from the third up to and including the seventh calendar year after the entry into force of the treaty.

applicable *ratione temporis*. In this matter, in Austrian literature a distinction is made according to the type of allocation provision. Depending on the wording of the allocation provision in question, either the moment of actual payment or the moment on which the income has accrued is the decisive factor when applying the allocation rule at stake. A similar categorization is found in the Netherlands, for example, in a number of opinions by the Dutch Advocate General Wattel. The Advocate General observes, for example, that, regarding tax treaty provisions related to business profits and employment, the historical moment of accrual is the decisive factor in the allocation taxation rights to those items of income. Following this doctrine, it must therefore be considered whether the relevant allocation provision finds the moment of actual payment decisive, or rather the moment of when the income had accrued when dealing with timing issues in case of changes in the facts.

4 **Timing issues and the Dutch 'compartmentalization' doctrine**

In the context of timing issues, the Dutch doctrine of 'compartmentalization' becomes relevant as well. The Dutch doctrine of 'compartmentalization' had originally been developed by the Dutch Supreme Court. An example can be found in BNB 1986/305. In this case the question was whether a capital gain realized by a Dutch parent company on the sale of its substantial shareholding in a tax-exempt investment company had to be exempt under the Dutch participation exemption. Under the Dutch participation exemption, gains arising from substantial shareholdings (i.e., dividends and capital gains) are fully exempt from taxation. As a general rule, however, the participation exemption would not apply to participations in tax-exempt companies, such as tax-exempt investment companies. In this case, however, the realized capital gain had already accrued during the period that the investment company had not yet obtained its tax-exempt status. The question therefore arose whether the capital gain had to be exempt under the Dutch participation exemption to the extent the gain had already arisen during the period in which the investment company did not have a tax-exempt status. The Supreme Court answered this question in the affirmative. It held that a reasonable interpretation of the Dutch participation exemption rules require that the participation exemption has to be applied to a gain that had already accrued during the period that the participation exemption regime was applicable, even if this gain is subsequently realized during a period that the conditions for the exemption are no longer fulfilled.

However, whereas the Dutch Supreme Court allowed compartmentalization under the Dutch participation exemption in the case of a change in the facts, it did not do so in the case of a change in the rules in BNB 2013/177. This case involved a legislative change to the Dutch participation exemption. This legislative change did not entail a specific transitional provision. During the parliamentary debate on this act, however, the legislator had explicitly indicated that upon a switch from taxation to non-taxation (and vice versa) due to the legislative change compartmentalization must take place. Nevertheless, the Dutch Supreme Court ruled that the new rule applied with immediate effect and that there was no room to apply the compartmentalization doctrine. The Supreme Court considered it to be the legislator's responsibility to explicitly provide for a transitional provision in the law.

Academic opinions diverge about whether compartmentalization can be applied under tax treaties as well. In the scholarly literature, Engelen, for example, holds the view that there is no general principle of transition law stating that compartmentalization in the context of business profits should take place in case of an amendment to a treaty. On the contrary, Albert, for example, does not rule out that treaty compartmentalization may take place in the situation of dividend payments. The Dutch State Secretary for Finance has not answered this question in the context of the 2011 Dutch tax treaty policy in the negative. In this regard, he differentiates between current income and non-recurring income such as capital gains. Regarding the first income category, the State Secretary has assumed that application of the compartmentalization doctrine will not be possible. Regarding the second category, he has not categorically ruled out the application of this doctrine, indicating that, upon adjustments to a tax treaty, strong emphasis should be placed on making explicit agreements on compartmentalization with the treaty partner in cases

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23 P.G.H. Albert, *Nederlands verbandshof en het privaatrecht van de deug*, *WFR* 2011/998, 554 ff, s. 11.
where application of this doctrine might lead to a tax leak.\textsuperscript{24} Subsequently, however, the State Secretary nuanced his views, referring to the above discussed ruling in BNB 2013/177. From this decision the State Secretary draws the conclusion that there is no room for tax treaty compartmentalization in the case of adjustments to tax treaties, unless this has been explicitly provided for in the treaty in question.\textsuperscript{25}

It follows from the above that opinions diverge as to the question whether the Dutch compartmentalization doctrine can be applied under tax treaties as well.

5 Timing Issues under Dutch Tax Treaties: Some Specific Examples

5.1 Introduction

In the below sections, I will examine a number of concrete examples of timing issues under tax treaties under reference to a number of different tax treaty allocation rules (business profits, dividend and interest income, capital gains, income from employment and pension income) in the light of the previously established main legal principles under international and national law. I will address both the situations where there is a change in the tax treaty allocation rule and situations where there is a change in the factual situation of the taxpayer.

5.2 Business Profits

Virtually all Dutch tax treaties include an allocation rule for business profits that is modelled on Article 7 of the OECD Model Tax Convention (OMC). This article provides that the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. In that latter case, the other state of permanent establishment may tax the profits of that enterprise, but only to the extent these profits can be attributed to the permanent establishment. It is noted that until 2011, the business profits provision under most Dutch tax treaties was based on the idea of limited independence of a permanent establishment. Dutch tax treaties concluded since 2011 may link up, however, with the current authorized OECD approach (AOA) for profit attribution. This OECD approach is based on a more absolute independence of permanent establishments with regard to profit attribution to a permanent establishment. This means that profit allocation under the new treaty may differ from those under the former tax treaty. For instance, this might be the case when a tangible fixed asset is temporarily made available from a tax treaty state to a Dutch permanent establishment. Under the former tax treaty, this asset would not have become part of the Dutch permanent establishment, which is in line with Dutch Supreme Court case law.\textsuperscript{26} Under the OECD authorized approach, however, the place of use must essentially be taken into account. If this approach is followed,\textsuperscript{27} this means that the Netherlands gains taxing rights under the new treaty, while these taxing rights did not exist under the former treaty. Proceeding from the principle of immediate effect of treaties based on Article 28 VCLT and Article 70 VCLT, I think that the Netherlands may nevertheless tax the reserves hidden in the asset in question under the new tax treaty, even in so far as they have accrued under the former treaty. In my opinion, there is, therefore, no room for compartmentalization at a tax treaty level.

Under national law, however, the Netherlands will still grant a step-up once a new business profit allocation rule following the AOA comes into force and, therefore, it will only tax the hidden reserves accrued in the Netherlands under the new tax treaty. This follows by analogy from BNB 2002/402. In short, this case revolved around the question to what extent the Netherlands may tax capital gains arising as a result of the sale of immovable property situated in the Netherlands by a resident of the UK under the 1980 UK/Netherlands tax treaty. The more recent 1980 tax treaty allocated the full taxing rights to the Netherlands as the state in which the property is situated, while the former tax treaty allocated the taxing rights completely to the UK. The question was whether the Netherlands would be allowed to tax the capital gain only to the extent this gain was accrued under the new 1980 tax treaty. Referring to the situation in which business assets are transferred from a foreign head office to a Dutch permanent establishment, the Dutch Supreme Court ruled that once a business asset becomes subject to Dutch taxation, valuation at fair market value must take place based on national tax law. Consequently, the tax authorities could only include that part of the gains on disposal in taxation that may be attributable to the period in which the new tax treaty was applicable. Hence, compartmentalization had to be applied. In academic

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\textsuperscript{25} Parliamentary proceedings II, 2013/14, 55613, No. 5.
\textsuperscript{26} Dutch Supreme Court 12 Feb. 1964, No. 15 068, BNR 1964/95.
\textsuperscript{27} Dutch policy does not follow the AOA, yet it adheres to the case law of the Dutch Supreme Court; see the Administrative Decree dated 15 Jan. 2011, No. IFZ/2010/457M, BNR 2011/91, s. 5.1. It remains to be seen, however, whether this deviating policy will hold before the Dutch Supreme Court under the Dutch tax treaties that follow the AOA.
literature, however, it is – rightly – assumed that the Supreme Court was compartmentalizing under national law in this case.\textsuperscript{28} Because the Netherlands had to grant a full exemption on capital gains on disposal from immovable properties under the former treaty, this meant immovable properties were fully eliminated from the Dutch tax base. It was not until the entry into force of the new treaty that national law could apply, so that tax liability with regard to the real estate arose only at that time, and an opening balance sheet had therefore to be drawn up in accordance with the actual fair market value at that time.\textsuperscript{29} Consequently, the taxpayer was granted a step-up based on national law. The Dutch Supreme Court did therefore not have to address the question whether the tax treaty demanded this.\textsuperscript{30} In my view, the same approach may be taken if a fixed business asset must not be attributed to a permanent establishment located in the Netherlands under the business profit provision of an old tax treaty whereas it must be attributed to it under the AOA-based business profit provision in a new tax treaty. Although treaty compartmentalization is not possible, the compartmentalization doctrine may indeed be applied under national law in such case.

Timing issues under the business profit allocation rule (modelled according to Article 7 OMC) may also arise in case of a change in the facts. Examples include situations in which the place of business of a resident taxpayer is shifted from the Netherlands to the other tax treaty state while the taxpayer is simultaneously emigrating to that tax treaty state as well. In that case, the question arises whether the Netherlands, as the departure State may still tax the business profit following emigration, to the extent that it has accrued during the period prior to the emigration.

In scholarly literature, it is argued that, upon application of treaty provisions corresponding to Article 7 OMC, the moment of accrual of the income is the decisive factor, and therefore not the moment of the actual payment of the income.\textsuperscript{31} The Dutch Supreme Court case law is in line with this. Prior-year income from a foreign permanent establishment is allocated to that foreign permanent establishment even if it no longer exists in the year in which the income is actually received.\textsuperscript{32} Also, income from a profit right stemming from the liquidation of an enterprise received after emigration from the Netherlands is allocated to the period during which the taxpayer was still a resident of the Netherlands.\textsuperscript{33} The moment of actual payment is not decisive in this regard.

The German Federal Finance Court in its decision of 28 October 2009 even went one step further and endorsed the above approach in a case where an entrepreneur moved his residence and his entire enterprise from Germany to Belgium.\textsuperscript{34} The Court decided that this emigration did not give rise to an exit tax under German domestic tax law. However, any later realization of unrealized reserves remains taxable in Germany if and to the extent that such reserves are attributable to the former permanent establishment in Germany. Germany was therefore allowed under the applicable tax treaty to tax in the future the gains accrued during the period the taxpayer was still a German resident. The Supreme Court of Appeal of South Africa, by contrast, arrived at a different conclusion in the Tradehold case. In this case, the question basically was whether the application of the South African corporate exit tax upon the transfer of seat of a company from South Africa to Luxembourg infringed the tax treaty between South Africa and Luxembourg. The Supreme Court in its decision of 8 May 2012 decided that it was.\textsuperscript{35}

Lastly, in a recent case that mirrors the above decision of the German Federal Finance Court, the Dutch Supreme Court took an approach similar to the German court. In this case, an independent researcher who was a tax resident in the Netherlands received prior-year income from research previously carried on in the UK. During this research, the taxpayer was not a Dutch tax resident, but resident in Belgium or the UK. The question was whether the Netherlands was allowed to tax the prior-year income. The Dutch Supreme Court answered this question in the negative. It decided that the taxpayer had carried out its research activities through a fixed base located in the UK for purposes of the Netherlands-United Kingdom Tax Treaty. The link with the UK territory had the result that the right to tax the prior-year income was allocated to the UK and that the Netherlands had to provide relief for

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\textsuperscript{29} See annex to the conclusion of Advocate General Wattel 12 Mar. 2003, No. 37 714, BBN 2004/344, para. 2.7 ff.

\textsuperscript{30} Otherwise, see also The Hague Court of Appeal, 11 May 1994, No. 91/1788, BBN 1994/068. In a similar case, the Court of Appeal ruled that there was no room for treaty partitioning. However, the Court then failed to ascertain whether partitioning under national law indeed should take place.


\textsuperscript{33} Dutch Supreme Court 4 Feb. 1987, No. 25 560, BBN 1987/131 (Spanish widow).

\textsuperscript{34} German Bundesfinanzhof 28 Oct. 2009, IR 99/08, \textit{HFG} 2010/6.10.

double taxation.\textsuperscript{36} Given this decision, it is only a small step to apply the same approach in the reverse case of emigration of a Dutch enterprise abroad. From a conceptual point of view, there is in my view a case for applying this territoriality-based approach under the business profits provision. It takes into account the fact that the state of departure has provided the public facilities provided that contributed to the operation of the profit-making activities of the emigrating enterprise and, at the same time, enhances global corporate mobility – it is no longer necessary to apply an exit tax – while at the same time respecting government’s tax claims. Future realization of the accrued gains could be determined on the basis of the actual disposal of the transferred assets or on the basis of yearly depreciation of the transferred business assets. This system is essentially already applied by the Netherlands in situations where assets are transferred from a Netherlands head office to a foreign branch. Although an exit tax will usually take place under Dutch tax law in case of business emigration, the business profit allocation provision (modelled according to Article 7 OMC) may even force the Netherlands to do this.

\section*{5.3 Dividend Income}

Virtually all Dutch tax treaties include an allocation rule for dividend income that is modelled on Article 10 OMC, paragraph 1, which provides that dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State. A large number of Dutch tax treaties, however, also stipulate that these dividends may also be taxed at a limited rate in the state in which the company paying the dividend is a resident. Timing issues may arise where, for example, a new Dutch tax treaty contains a specific provision for hybrid partnerships. For example, Article 1, paragraph 2 of the Protocol to the new tax treaty between the Netherlands and Germany stipulates that if a dividend payment made from the Netherlands is received by a hybrid partnership located outside the Netherlands, this income is considered to be received by a resident of Germany to the extent that income is treated as the income of a resident under German tax law. One of the purposes of this provision is – in line with the current recommendations under the Base Erosion and Profit Shifting (‘BEPS’) project – to combat international mismatches of income allocation, i.e., situations of non-taxation that may occur if the Netherlands as the source State considers a partnership located in a third country to be transparent, while Germany considers it to be non-transparent. In such case, the Netherlands would grant the reduced tax treaty rate whereas there would be no (immediate) corresponding taxation of the dividends in Germany at the level of the partners. Unlike the case under the former tax treaty, the Netherlands do not need to grant the reduced tax rate of Article 10, paragraph 2, DTC NL/DE (new) at the level of the partners of the partnership in such case. The question is whether this also applies to dividends that had already accrued under the former tax treaty yet were not distributed until the new tax treaty took effect. In my opinion, here too it must be assumed that the new protocol provision has an immediate effect and that the Netherlands may tax profits accrued under the old treaty but actually paid-out under the new treaty. In my opinion, the accrual of retained profits does not qualify as ‘any act or fact’ taking place or ‘any situation’ ceasing to exist before the moment the new treaty became applicable under Article 28 VCLT. Neither could it be said that the new treaty affects ‘vested rights’ in the meaning of Article 70 VCLT.

The question of timing issues under the dividend income provision may also arise in case of a change in the facts. An example is the situation in which a Dutch company with one or more non-resident shareholders expecting dividend distributions is transferred from the Netherlands to another tax treaty state shortly before distribution. In scholarly literature, it is generally assumed that the moment of payment is the decisive factor under Article 10 OMC.\textsuperscript{37} This means that Article 10 OMC has an immediate effect in the case that is outlined, meaning that there is no room for treaty compartmentalization. This conclusion is affirmed by BNB 2007/36. In this case, a substantial shareholder of a Dutch limited liability company (BV) emigrated from the Netherlands to Belgium. Shortly afterwards, the BV was transferred to Belgium as well. Subsequently, the BV was wound up. The question that came up was whether the Netherlands could levy tax on the received liquidation distribution. Proceeding from treaty compartmentalization, the Den Bosch Court of Appeal ruled that it could. It ruled that

\textsuperscript{36} Dutch Supreme Court 6 Dec. 2013, No. 12/000252, BNB 2014/58.
\textsuperscript{37} Cf. also R.C. de Smit, supra, p. 81 ff.
\textsuperscript{38} See, for example, P.J. Wattel & O. Marres, Characterization of Fictitious Income under OECD-Patterned Tax Treaties, Eur. Taxn. 3, 67 (2003); M. Lang, supra, p. 288; J. Schuch, supra, p. 230; H. Pijl, supra, p. 502; M. T enore, supra, p. 479.
the decision to liquidate had been taken in substance when
the BV was still located in the Netherlands. Referring to
the principle of a reasonable tax treaty interpretation, the
Court ruled that there was income stemming from a
Dutch source at the time of receiving the liquidation
distributions.69 The Dutch Supreme Court, however,
considered the time of the formal liquidation payment
decisive. Since the distributing company could not be
qualified as a treaty resident anymore at the time of its
formal liquidation, the Netherlands was no longer allowed
under the tax treaty to levy dividend tax. Therefore, there
is no room for treaty compartmentalization in situations
such as these.70

Another example is the situation in which the place of
residence of a non-resident shareholder holding shares in a
Dutch company is transferred to another tax treaty state
with which the Netherlands had agreed a lower
withholding tax rate, or vice versa. The moment of
payment is the decisive factor in this situation as well.
Dutch case law also points in this direction. In a ruling of
the the Hague Court of Appeal, the question arose
regarding the compartmentalization of dividends under
the Tax Arrangement for the Kingdom, a quasi tax treaty
that applies in the relations between the country of the
Netherlands and the countries of the (former) Netherlands
Antilles and Aruba (which together comprise the
Kingdom of the Netherlands). In this case, a Dutch
limited liability company (BV) made a distribution to its
Antillean parent company (February 1982), while these
dividends had accrued in the period that the shares in the
Dutch BV were still held by a limited liability company
(SA) located in Uruguay (until the end of 1975) and a
company located in Panama (from the start of 1976 to 5
January 1982). The taxpayer claimed the full exemption
for the Dutch dividend withholding tax that was provided
for under the Tax Arrangement of the Kingdom. The tax
inspector argued, however, that the exemption should not
apply to the part of the dividends that had already been
accrued during the period that the shares were not yet
held by the Antillean parent company. The Court of
Appeal dismissed the appeal of the inspector. It ruled that
neither the text nor legislative history of the Tax
Arrangement of the Kingdom and the Dividend
Withholding Tax Act give reason to assume that the
Dutch legislator intended to restrict the exemption to
‘new’ profits only.41 Hence, the compartmentalization
doctrine was – rightly – rejected in this case

Finally, timing issues may arise in case the status of the
distributing company changes. Examples include
companies located in the Netherlands that acquire the
status of tax-exempt investment institutions at any point
in time. Dividends paid-out to shareholders located in
another tax treaty state by such investment institutions
are not subject to Dutch dividend withholding tax. However,
under Article 1, paragraph 5(b), Dividend Withholding
Tax Act 1965, this exemption does not apply. However, to
dividends that had already accrued, but not yet paid-out,
at the time of the status change. The national Dividend
Withholding Tax Act therefore requires compartmen-
talization. The question comes up, however, whether such
compartmentalization is still permitted under the
dividend income provision modelled according to Article
10 OMC. Due to their status change, it can be argued that
such distributing companies will no longer be liable to tax
and therefore no longer qualify as a tax treaty resident.
Consequently, taxing rights will be allocated fully to the
state of residence from that time on, based on the other
income provision. The Dutch legislator nevertheless
believes that the national compartmentalization doctrine
may still be applied in such cases at tax treaty level.52
However, in view of the fact that the dividend income
provision states the moment of payment first and
foremost, I conclude that, in this case, there is no room for
treaty compartmentalization. However, diverging opinions
are found in the tax literature as well.53

5.4 Income from Capital Gains

Most Dutch tax treaties allocate the taxing rights with
regard to capital gains obtained from the disposal of shares
in so-called real estate companies to the contracting state
where the alienator is a resident. Some new tax treaties,
however, reallocate these taxation powers to the
contracting state where the real estate is situated. The
question then arises whether capital gains obtained after
the treaty amendment may be fully taxed in the source
state regardless of the fact that (part of) these gains accrued
in the former treaty period. The OECD commentary has
answered this question affirmatively since 2014 and,

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52 Parliamentary proceedings 1, 2006/07, 30 533, No. C.
44 Cf. P.G.H. Albert, ‘Nederlands verdragsbeleid vanuit het perspectief van de dga’, WFR 2011/6903, p. 554 ff., s. 11. The position of the State Secretary should be applied consistently no matter how, so that treaty partitioning should also take place in case of loss of the exempt status – but then in the taxpayer’s favour.
therefore, dismisses the application of the compartmentalization doctrine in this case.44 Interesting to note in this context, however, is that Germany and Austria made a reservation to this commentary and take the view that compartmentalization is possible.45

The same question arose in the context of the adjusted allocation of taxing rights with real estate companies under Article 13, paragraph 4, of the current tax treaty with the UK. Under the current treaty, taxing rights accrue to the state in which the property entity is situated, while these rights accrued to the State of residence under the former tax treaty. The Dutch State Secretary stated that he sees no reason for compartmentalization yet. I agree with this view in the sense that this provision has an immediate effect and, in fact, does not prescribe any treaty compartmentalization.46 In my opinion, the accrual of retained profits does not qualify as ‘any act or fact’ taking place or ‘any situation’ ceasing to exist before the moment the new treaty became applicable under Article 28 VCLT.47 Neither could it be said that the new treaty affects ‘vested rights’ in the meaning of Article 70 VCLT.

Timing issues under the capital gains provision may also arise in case of a change in the facts. It is assumed that only the moment of payment is the decisive factor under the capital gains provision. This means for example that treaty compartmentalization is not permitted in case a taxpayer emigrates from the Netherlands to another tax treaty state and disposes his shares in a Dutch resident company.48 Only the new resident state is allowed to tax the capital gain that arises as a result of that disposal. Case law of the German Federal Finance Court ruling that the capital gains provision does not require Germany to grant a step-up upon immigration is in line with this.49 However, the Dutch Supreme Court ruled in the mirror-image situation that the Dutch exit tax regarding the immigration of shareholders is not a treaty override.50 In my opinion, this is somewhat inconsistent with the basic principle that Article 13(4) OMC does not permit treaty compartmentalization.51 The above does not alter the fact, however, that compartmentalization may still arise under national law as long as this does not infringe the agreed allocation of taxation powers under the capital gains provision. Examples include obtaining a domestic tax base step-up upon immigration to the Netherlands of a substantial shareholder.52

5.5 Income from Employment

Virtually all Dutch tax treaties include an allocation rule for business profits that is modelled on Article 14 OMC, which provides that salaries, wages and the like derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State. Timing issues may arise under this provision may arise if a resident of the Netherlands moves to another tax treaty state and then receives compensation for employment that has taken place in the Netherlands before emigration. It is generally assumed that the moment of accrual rather than the moment of payment is the decisive factor under this provision.53 The case law of the Dutch Supreme Court also points in that direction. In, for instance, the BNB 2001/355 ruling, regarding a case of compensation for missed income as a result of the termination of employment, the Dutch Supreme Court ruled that answering the question in which country the employment is realized boils down to the question in which country the terminated employment was (or would be) taking place.54 The Dutch Supreme Court also proportionally allocates termination payments in cross-border situations on the basis of the employment history, albeit subject to a number of practical limitations.55 The German Bundesfinanzhof follows the same line; not the moment of payment, but the ‘Bezogenheit auf die geleistete Arbeit’ is the decisive factor.56 This means that, in the above case, the

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44 OC (2014) 13/3.1.
45 OC (2014) 13/32.1.
48 See, for example, M. Lang, supra, p. 286; conclusion Advocate general Wattel from 12 Mar. 2003, No. 37 565, BNB 2004/257, para. 3.5; annexe to conclusion Advocate general Wattel from 12 Mar. 2003, No. 38 112, BNB 2004/345, para. 2.11.
51 Otherwise: A.C. Rijkers in his note to BNB 2004/257, para. 4.
54 Dutch Supreme Court 10 Aug. 2001, No. 35 761, BNB 2001/253, para. 3.7.

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Netherlands retains taxing rights as the former country of employment.

5.6 Pension Income

Most Dutch tax treaties contain a pension income article that corresponds to Article 18 OMC. This provision stipulates that pensions and similar payments made to a resident of a contracting state are only taxable in that state. It is generally assumed that only the moment of payment is the decisive factor under this type of allocation provision.\(^{57}\) This means that on the moment of payment, pension accrued in the State of employment may not be taxed there if the pension beneficiary has emigrated to another treaty country. The Dutch Supreme Court case law also indicates that only the moment of the actual payment is decisive. In e.g., BNB 2009/263, the Dutch Supreme Court ruled that an exit tax on accrued pensions constitutes a prohibited treaty override of the tax treaty with France. The reason for this was that, without a final settlement tax, all income stemming from the pension rights would after emigration only be taxable in the new country of residence France under the pension income provision. The exit tax therefore overruled the agreed allocation of taxation powers for pension payments in an unacceptable way.\(^{58}\) The German Bundesfinanzhof also considers the place of residence of the beneficiary at the moment of payment.\(^{59}\)

The previous case law is the reason why some more recent Dutch tax treaties, such as those concluded with Belgium and Germany, provides that pensions and similar payments may also be taxed in the state where the pension has been accrued, if the total gross amount of pension exceeds a certain threshold in any calendar year. This rule did not exist under the former tax treaties with these countries. As a result, the former state of employment is, under circumstances, still entitled to tax pension payments that have been accrued in that state, even if the beneficiary has meanwhile become a resident of the other treaty country. In view of Article 28 VCLT and Article 70 VCLT, this provision is applicable with immediate effect and, therefore, also has an impact on existing cases of beneficiaries of pension accrued in the Netherlands living in Belgium or Germany. In my opinion, accrued pensions do not qualify as ‘any act or fact’ taking place or ‘any situation’ ceasing to exist before the time the new treaty became applicable under Article 28 VCLT.\(^{60}\) Nor can they be considered as ‘vested rights’ in the meaning of Article 70 VCLT. In my opinion, there is therefore no room for treaty compartmentalization of pension payments according to which these payments accrued under the old or under the new tax treaty.

The same question arose under the new tax treaty between the Netherlands and Belgium dating from 2001. In a Belgian case that led to the ruling of the Belgian Court of Arbitration (nowadays, the Constitutional Court) from 4 February 2004, the taxpayer, who had been resident of Belgium before the entry into force of the new tax treaty and had been receiving low-taxed pension payments in that country, argued that the application of the new convention provision touches upon a situation that had already occurred and therefore had a retroactive effect forbidden under Article 28 VCLT. The Court of Arbitration rejected this position. It ruled that the taxpayer’s position would mean that the previous rule (i.e., exclusive residence taxation) would continue to apply indefinitely and for a great number of cases in the future. Such a long transitional period would interfere with the intention of the contracting parties.\(^{61}\) Under treaty law, there is therefore no room for compartmentalization in such cases. In my opinion, this consideration is correct. This does not mean, however, that there would be no room for a transition period based on national law. The aforesaid unilateral Dutch transition provisions for pension payments under the new tax treaty with Germany and Belgium constitute a clear example thereof.

The Supreme Court did allow for a temporal split of pension income, however, in case of privatization of state companies, altering the nature of pensions. In the BNB 1995/117 case, two German residents and employees formerly employed in the Netherlands received lump sum payments.\(^{62}\) Part of these payments related to pensions accrued during the employment at the state company Staatsbedrijf der Postzegeln, Telegrafie en Telefoon (or the PTT) of those employees. The other part related to the pensions accrued at the same, but then privatized company Koninklijke PTT Nederland NV. Article 12 of the tax treaty between Germany and the Netherlands allocated the rights of taxing privately accrued pension payments to the state of residence. The right to tax paid government employee pensions, however, was held by the paying state. The Dutch Supreme Court ruled that the requirement that a state company ‘pays’ the lump sums is met to the extent the pension was accrued at the public company PTT. According to the Dutch Supreme Court, only in that case

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57 M. Lang, supra, p. 286.
59 German Bundesfinanzhof 27 Jan. 1972, BStBl II 1972 II 459.
60 Consequently, in my opinion, there is no anterior legal accomplished fact.
justice is done to the distinction between government employee pensions and private pensions. It is therefore important where the pension has been accrued; the question who pays the lump sum is not relevant. The Dutch Supreme Court explicitly affirmed this view in its BNB 2009/199 ruling. In the author’s view, however, this decision can be explained if one is to accept that the nature of the pension (public or private) was already established at the moment of accrual and not at the later moment of actual payment. Insofar, the Dutch Supreme Court does not conflict the agreed allocation rights under the Dutch/German tax treaty.

5.7 Relief for Double Taxation

Finally, timing issues may arise regarding relief for double taxation under the Dutch tax treaties that have been concluded since the late 1990s. Because, in case of a foreign no or lowly-taxed passive permanent establishment, the Netherlands had to grant an exemption under former treaties, while under the treaties concluded since the late 1990s, only a credit has to be granted. In my opinion, however, there is no room for treaty compartmentalization in this case. In this connection, a parallel may be drawn with BNB 1979/307. Case involved the sequence of relief provisions from the 1933 and 1970 tax treaties between the Netherlands and Belgium. The former treaty did not include a claw-back regime for foreign permanent establishment losses, while the new one did. An public limited liability company (NV) located in the Netherlands had suffered losses from its permanent establishment in Belgium under the former tax treaty. Under the new treaty, the NV made a permanent establishment profit. The question was whether the anterior losses could be deducted under the claw-back scheme from the posterior permanent establishment profits to be exempted. The Supreme Court ruled that they could. The wording of the tax treaty, and of its protocol, forming an integral part of it, did not support the argument of the taxpayer that losses incurred prior to the entry into force of the treaty could not be taken into account. In view of the basic principle of immediate effect of tax treaties, the Dutch Supreme Court, in the situation outlined above, probably will neither assume a treaty obligation to divide the profit into a part falling under the exemption method and a part falling under the credit method.

The question of timing issues under the provisions for relief for double taxation also arise in case of a change in the facts, for example, if a foreign permanent switches from economically active (exemption method) into economically passive (credit method). In my opinion, there seems little room for treaty compartmentalization in such case. However, there is room for the application of this doctrine under national law in such case. Up until now, the Dutch Supreme Court has only applied the compartmentalization doctrine regarding the Dutch participation exemption (i.e., in the case of subsidiaries) upon transition from the exemption method to full taxation and vice versa. As far as I know, there is no case law in which the compartmentalization doctrine is invoked in case of transition from the tax exemption to the tax credit in the case of permanent establishments. Conceptually speaking, however, I do not think this situation should be handled differently. Hence, there should be room to apply the compartmentalization doctrine in this case based on national tax law meaning that the Netherlands could still grant a (partial) exemption. In the reverse situation by contrast, the Netherlands will have to grant a full exemption as the tax treaty requires the Netherlands to do so. In other words, the compartmentalization doctrine can only be applied under the switch-over clause at the benefit of the taxpayer.

6 Conclusion

Considering the above, it can be concluded that the question to what extent a change in allocation rights under a tax treaty is applicable ratio tempore, cannot be answered in a general sense. In each situation, it boils down to a case-by-case analysis that must be performed under both international and national law. Given the increasing number of revisions of existing tax treaties, it is recommended to the Dutch tax treaty negotiator, for the sake of legal certainty, to take timing issues into account more carefully when revising existing tax treaties.

Notes

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