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Dutch Co-ops: A Primer

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Introduction

The Dutch cooperative (“Dutch Co-op” or “Co-op”) has been in existence for more than 100 years as a legal entity in the Netherlands. Historically, the Co-op was used mainly in the agricultural sector and by certain banks and insurance companies in the Netherlands. The Co-op has recently been reinvented by international tax practitioners as a holding company and a financing or licensing vehicle due to its favourable Dutch tax treatment and its flexibility from a Dutch legal perspective.

A Dutch Co-op structure may be used in new structures or used to optimize existing non-Dutch and Dutch holding structures by inserting a Co-op between a Canadian corporation and an existing non-Dutch holding company structure, or an existing Dutch BV or NV holding company structure.² Such structures have increasingly been used by private equity investors as they allow these entities to acquire new portfolio investments, refinance their existing investments and repatriate cash to the private equity fund in a tax-free manner.

Key Characteristics of a Dutch Co-op

A Co-op is a special kind of association which, for the most part, is governed by the general rules applicable to Dutch associations. Similar to a Dutch limited company (BV/NV), a Dutch Co-op has legal personality, which means that it has its own rights and obligations, with the capacity to legally own assets and conclude agreements. A Dutch Co-op is formed under a notarial deed that contains the Co-op’s articles of association (“Articles”).

The participants in a Dutch Co-op are called members and at least two members are required to form the Co-op. The Co-op conducts its activities for its members and is considered as an extension of the businesses of its members. Accordingly, the Articles include a clause stating that the object of the Co-op is to provide for certain material needs of its members pursuant to agreements concluded between and among them.

Generally, membership in the Co-op is not restricted to individuals and legal entities. A partnership may also be a member. Further, there are no restrictions on how the Co-op chooses to address the issue of member liability, although it may be of importance in the event of liquidation of the Co-op. Member liability can be *unlimited*, *limited*, or *excluded*, and the name of the Co-op must include the appropriate suffix indicating the nature of its limitations on liability (i.e., WA, BA, or UA, respectively). *Unlimited liability* (Co-op WA) implies that all members are liable equally for the total deficit of the Co-op, unless the Articles stipulate otherwise. *Limited liability* (Co-op BA) implies that the liability of the members is limited to a certain maximum. If the liability is *excluded* (Co-op UA), this implies that the members cannot be held liable and only the contributed capital is at risk. However, the Articles may contain a provision in respect of additional internal liability of its members.

Membership of a Dutch Co-op cannot be transferred but there is no restriction on members surrendering their membership or on third parties becoming members of the Co-op, unless otherwise provided in the Articles. Each member generally has the right to cast one vote, but the Articles may prescribe that the voting rights are determined on a different basis, such as the amount of capital contributed by the respective members.

The rules governing the Dutch Co-op generally provide for greater flexibility in setting up the Co-op than the rules governing the Dutch BV and NV which include formal capital protection restrictions. Unlike a Dutch limited company (BV / NV), there is no minimum share capital and no formal government approval is required for formation, although a resolution may have to be passed by the board or members before any distribution of the Co-op’s profits.

1. Of the Toronto office of PricewaterhouseCoopers LLP, except for Jeffry van Brussel who is of the Dutch desk of the European Tax Group in New York City.
2. However, Dutch dividend stripping rules should be monitored if a Co-op is inserted in existing Dutch BV or NV structures.

The Co-op is not required to obtain an auditor's certificate when a member makes a capital contribution in kind into the Co-op. The Co-op generally allows for the repayment of any partial or full exit proceeds by way of distribution of membership capital, without the requirement for existence of freely distributable reserves.

Key Dutch Tax and Non-Tax Considerations

Dutch Tax Considerations for Co-op structures

A Co-op is treated as a regular taxpayer for Dutch corporate income tax purposes and is taxed similarly to a Dutch BV or NV.³

The Netherlands does not levy capital tax so no capital tax is due on formation of a Dutch Co-op or on any future capital contributions. Based on Dutch domestic law, the Netherlands does not impose interest withholding tax and royalty withholding tax and because a Co-op is a regular taxpayer in the Netherlands, it can also claim the benefits of the EU Parent / Subsidiary Directive and of the Dutch tax treaty network, which consists of more than 80 treaties.

The main tax benefit underlying the use of a Co-op is on repatriation of profits out of the Netherlands. Unlike a Dutch limited company (BV / NV), a Co-op is not subject to the 15% domestic Dutch dividend withholding tax rate on dividend distributions because a Co-op does not fall under the scope of the Dutch *Dividend Withholding Tax Act*, if its Articles are properly drafted. This means that even if the members of the Co-op are located in a non-tax treaty country, no Dutch dividend withholding tax will be levied. The absence of a levy of dividend withholding tax makes the Co-op a logical choice as a (top) holding company.

The typical tax planning techniques that have been used by Canadian taxpayers to reduce such dividend withholding tax often involve the use of foreign holding companies located, for example, in Luxembourg or Cyprus. In most cases, these techniques may be inappropriate or too expensive. An attractive alternative to repatriating foreign sourced dividends or mitigating tax on capital gains realized on disposition of shares held by a Dutch holding company to its foreign shareholder is to interpose a Dutch Co-op between the Canadian shareholder and the existing foreign or Dutch holding company. For new holding company structures, a Co-op can be directly set up by the Canadian taxpayer as the top foreign holding company for its foreign operating subsidiaries.

Dutch Tax Considerations of Foreign Members of the Co-op

Although a Co-op is not subject to Dutch dividend withholding tax, the application of the substantial interest rules should be monitored when a Co-op structure is set up, because they may create Dutch tax liability for the foreign members in a Co-op in certain circumstances.⁴

The substantial interest rules may apply if a foreign member has a substantial interest in the Co-op and the member does not hold its interest in the Co-op as a business asset. A foreign member is considered to have a substantial interest in the Co-op if the member has at least 5% voting rights or is entitled to at least 5% in the annual profits or liquidation proceeds of the Co-op. If the substantial interest rules apply, dividends, capital gains and interest income that the foreign member derives from the Co-op may trigger Dutch income tax obligations for the foreign member. In the case of a member of the Co-op that is a Canadian resident, these tax obligations may be reduced under the Canada-Netherlands Tax Treaty.

Exemption from the Substantial Interest Rules under Dutch Domestic Law

If the member in a Co-op has active business operations it is normally easier to determine whether the interest in the Co-op is held as a business asset. For instance, it can often be argued that the interest of the member in the Co-op is held as a business asset when the Co-op itself, or through its subsidiaries, is active in the same line of business as the foreign member. However, even when a member in a Co-op does not carry out operational activities it may still be possible to argue that the interest in the Co-op is held as a business asset by the member. In the past, the Dutch

3. For instance, the participation exemption regime may apply to qualifying shareholdings owned by a Co-op. Under the participation exemption regime, dividends and capital gains/losses derived by a Dutch Co-op from a qualifying shareholding would be fully exempt from Dutch corporate income tax.

4. The substantial interest rules may also apply when a Canadian resident corporation or individual holds an investment in a Dutch BV or NV.

Ministry of Finance has provided guidance from which can be derived the view that a foreign member should be considered to hold the interest in the Co-op as a business asset if there is a management link that allows involvement of the foreign member through the Co-op with the strategic decisions at the level of the operational companies held by the Co-op. In practice, such a management link is often demonstrated by arranging that at least one manager or director at the level of the non-individual member in the Co-op also acts as a director at the level of the Co-op and its operational subsidiaries.

The foreign members may consider requesting a ruling from the Dutch tax authorities to confirm that their interests in the Co-op are held as business assets to ensure that they will not be subject to the substantial interest rules.

Non-Tax Considerations

The Netherlands has a stable economy. The high quality of the Dutch financial service industry, existing infrastructure and critical economic and industrial mass provide for less burdensome substance compliance issues than other typical (offshore) holding locations.

Canadian Tax Considerations

Entity Classification

The corporate status and residency of a Dutch Co-op is relevant in determining its proper Canadian tax treatment, in particular, whether it is a non-resident of Canada and is a corporation that should be treated as a foreign affiliate of the Canadian taxpayer.

Subject to certain other conditions in subsection 95(1) of the *Income Tax Act* (Canada) ("Act"), the statutory definition of a foreign affiliate requires that the foreign entity be a corporation for Canadian tax purposes and that it not be resident in Canada. Subsection 248(1) of the Act defines a corporation to include an incorporated entity. Because a Dutch Co-op is not an incorporated entity, other factors must be considered to determine whether it has the characteristics of a corporation.

At the 2006 Canadian Tax Foundation Annual Conference Roundtable, Wayne Adams of the Canada Revenue Agency ("CRA") stated that the CRA will use an approach based on Marc Darmon's paper⁵ in determining how to classify an entity for Canadian tax purposes. The approach outlined in that paper is to:

- determine the entity's characteristics under foreign commercial law; and
- compare those characteristics with the types of recognized categories under Canadian commercial law and consider:
 - the nature of the rights in the entity's assets;
 - the right to participate in profits or receive distributions;
 - the right to vote or participate in decisions;
 - the right to share in distribution of assets on windup; and
 - the liabilities of the various parties.⁶

A review of the Dutch law respecting Co-ops and an analysis of a Dutch Co-op's Articles is required in order to determine its classification for Canadian tax purposes.

The Dutch Corporate Law

Under Canadian corporate law, a fundamental principle is that a corporation has a separate and distinct legal personality from its owners.⁷ For example, a corporation has the ability to acquire rights and assume liabilities that are separate from those of its shareholders and, therefore, limit its shareholders' liability.

As discussed above, pursuant to the Dutch Civil Code, a Dutch Co-op is regarded as a legal entity that exists separate and apart from its members and is generally subject to Netherlands corporate income tax. Therefore,

5. "Characterization of Foreign Business Associations", 53(2) *Canadian Tax Journal* 481-505 (2005).

6. See Sherman's Notes to the definition of a "corporation" in subsection 248(1) of the Act.

7. See, for instance, *Salomon v. Salomon*, (1897) AC 22 (HL).

notwithstanding other characteristics, a Dutch Co-op would most closely resemble a corporation under Canadian commercial law.

Although in and of itself separate legal personality is not indicative of an entity's status as a corporation, it is important to consider the rights and characteristics a separate legal personality has under the particular foreign law. Separate legal personality is helpful in characterizing an entity as a corporation only because of the specific rights usually associated with such status.

Pursuant to the Dutch Civil Code, with respect to the law of property, rights and interests, a Dutch Co-op is considered to be equivalent to a natural person. Therefore, the members of a Dutch Co-op have no interest in the property held by the Co-op. Since ownership rights are one of the fundamental characteristics of a corporation, it is also one of the most important characteristics for a Dutch Co-op to encompass for it to be considered a corporation for purposes of the Act.

Other Characteristics

By reviewing a Dutch Co-op's Articles, one should be able to determine if the Co-op has other important corporation-like characteristics that would enable it to be classified as a corporation for Canadian tax purposes. The most important characteristic one should look for is that the profits of the Dutch Co-op are profits of the Co-op and are only distributed to the members after a vote or members' meeting.⁸ Other characteristics that are important to classify a Dutch Co-op as a corporation include the following:

- the Co-op's Board represents the Co-op and has the authority to bind the Co-op; and
- the members of the Co-op are not liable for the Co-op's debts and obligations.

If any of the above characteristics are not present in the Articles, the Articles may be amended accordingly.

Nonetheless, some characteristics of a Dutch Co-op resemble a partnership, such as the right of members to receive the residual value of the Co-op on wind-up and a restriction on the transferability of membership interests. These characteristics are not heavily weighted, however, and if the corporation-like characteristics are also present, such factors should not affect the Co-op's classification as a corporation for Canadian tax purposes.

In evaluating all of the above factors, the most important factors are the ownership of assets and that its members do not have a right to its profits until they are properly distributed. Although, a Dutch Co-op may have a few characteristics of a partnership, they do not outweigh the many indicators of a corporation.

The CRA's Position

The CRA has provided similar views on the classification of a Dutch Co-op as a corporation in CRA Document Nos. 2006-0208571R3, 2006-0206961R3, 2007-0260861R3, 2007-0259921R3, 2007-0255241R3 and 2008-0264671R3. In these rulings, based on its review of the specific Articles and facts in respect of each particular Dutch Co-op, the CRA has confirmed that a Dutch Co-op should be considered a corporation for Canadian tax purposes. It should be noted that the CRA will not necessarily consider a Dutch Co-op to be a corporation as a general rule and will only provide a view on its classification based on the specific facts and circumstances of each case.

Dividends

Other considerations that should be addressed in using a Dutch Co-op include whether the membership interests in a Dutch Co-op qualify as "shares" and whether distributions in respect of such interests are "dividends" for Canadian tax purposes.

The CRA's administrative position regarding the interpretation of the term "share" provides that where foreign business entities are corporations, it considers that the ownership of foreign business entities is divided into shares.⁹

8. See: *Memec PLC v. IR Commrs.* [1998] BTC 251 (CA).

9. See IT-392 "Meaning of the Term Share" dated September 26, 1977. See also CRA Document Nos., 2000-0053595, 2001-0083545, 2001-0067735, 2001-0084805 and 2002-0120085 where the CRA stated that in accordance with IT-392, an LLC was considered to have capital stock consisting of shares for the purposes of the Act.

If a Dutch Co-op is considered a corporation for the purposes of the Act, a membership interest in a Dutch Co-op should be viewed, based on the CRA's administrative position, as a share investment for purposes of the FAPI provisions and, more generally, the Act and the Regulations. In each of the rulings noted above, the CRA has also expressed a view that based on IT-392, the membership rights of a Dutch Co-op should be considered shares for Canadian tax purposes.

Where a foreign entity is considered a corporation and its membership interest is viewed as a share for Canadian tax purposes, the CRA considers an amount distributed in respect of the earnings of such entity as a dividend for Canadian tax purposes.¹⁰ Therefore, based on the CRA's position, any distributions made by a Dutch Co-op on its member interests may be considered dividends for the purposes of the Act.

Foreign Affiliate Status

For a Canadian corporate taxpayer to be eligible for special deductions that would fully (or partially) offset the inclusion in income of dividends to be received from a Dutch Co-op, a Dutch Co-op must be a "foreign affiliate" of the taxpayer for purposes of the Act. Foreign affiliate status is also important for applying various other provisions of the Act.

Under the Act, all of the following conditions must be satisfied for an entity to be a "foreign affiliate" of a particular taxpayer resident in Canada:

- the entity must be a corporation for Canadian tax purposes;
- the taxpayer must have, directly or indirectly, an "equity percentage" of at least 1% in the corporation, and the total "equity percentage" in the corporation of the taxpayer and persons related to the Canadian taxpayer must not be less than 10%;¹¹ and
- the corporation cannot be resident in Canada.

A foreign corporation may be resident in Canada for purposes of the Act on the basis of the common law test of residency that has been derived from U.K. tax jurisprudence. Under the common law test of residency, for a Dutch Co-op to qualify as a foreign affiliate central management and control must not be in Canada.¹² A Dutch Co-op must not be considered resident in Canada; otherwise, the Dutch Co-op will be subject to Canadian tax on its worldwide income, such as any corporation formed in Canada is taxed.

The location of central management and control is a question of fact and will generally be determined on the basis of where the directors (or equivalent) meet and exercise control of the corporation. A corporation that would be resident in Canada under the common law test may be able to rely on subsection 250(5) of the Act if (i) the particular corporation qualifies for the benefits of a bilateral tax agreement entered into between Canada and its country of formation, and (ii) the particular tax treaty has a provision that resolves the issue of residence in favour of the jurisdiction of incorporation. Unfortunately, Article 4 of the Canada-Netherlands Tax Treaty lacks a decisive tie-breaker rule, referring the matter instead to the competent authority to resolve. As a result, subsection 250(5) can probably not be relied on in most cases and it is crucial to ensure that the Co-op not be resident in Canada under common law principles.

10. See CRA Document No. 2003-0004415 where the CRA states that "an interest in an Arizona LLC would constitute "shares" and that "each amount distributed on account of profits by the Arizona LLC to its owners will be considered dividends for purposes of the Act and the Regulations."

11. The facts of a particular situation will determine if a Canadian taxpayer has the appropriate "equity percentage" in a Dutch Co-op. The term "equity percentage" is defined in subsection 95(4) of the Act.

12. The definition of "foreign affiliate" in subsection 95(1) of the Act requires the corporation to be a non-resident corporation. A non-resident is defined in subsection 248(1) as not resident in Canada. Therefore, if a Dutch Co-op is considered to be a resident of Canada, it will not qualify as a foreign affiliate of a taxpayer.

Assuming that a Canadian resident taxpayer owns, directly or indirectly, at least 1% and together with non-arm's length persons owns at least 10% of the shares of a Dutch Co-op that is not resident in Canada, it appears that the Co-op meets all of the conditions required for it to be a foreign affiliate under subsection 95(1) of the Act.

Subsection 85.1(3)

Depending on an organization's structure and tax strategies it may be beneficial to transfer existing foreign affiliates into a Co-op structure. In order to do so in a tax efficient manner, taxpayers generally rely on the application of subsection 85.1(3). Subsection 85.1(3) applies where shares of a foreign affiliate of a Canadian taxpayer are transferred by the taxpayer to another foreign affiliate in exchange for shares of the acquiring foreign affiliate. This provision deems the taxpayer to dispose of the shares of the foreign affiliate for proceeds of disposition equal to the taxpayer's cost of the shares and the acquiring affiliate is deemed to acquire the shares for an amount equal to the taxpayer's cost of the shares. As a result, no gain or loss is realized by the taxpayer on the transfer.

Subject to the anti-avoidance rule in subsection 85.1(4),¹³ subsection 85.1(3) may apply to transfers of shares of a foreign affiliate by a Canadian resident taxpayer to a Dutch Co-op if the following conditions are met:

- the shares disposed of by the taxpayer are considered capital property of the taxpayer;
- the shares being transferred are shares of a foreign affiliate of the taxpayer;
- the Co-op is a foreign affiliate of the taxpayer immediately following the disposition; and
- the Co-op issues share consideration to the taxpayer in exchange for the shares.

As indicated above, a Dutch Co-op may be considered a corporation for Canadian tax purposes and, provided other conditions are met, the Co-op may also be a foreign affiliate of the Canadian resident taxpayer. In addition, the member interests in the Dutch Co-op may be considered shares. Further, an increase in a member's interest in a Dutch Co-op as a result of the transfer should indicate that the Dutch Co-op issued shares in exchange for the transfer. The CRA has reviewed transactions involving a Dutch Co-op and the application of subsection 85.1(3) and has ruled that in those cases subsection 85.1(3) would apply to a transfer to a Dutch Co-op in exchange for a membership interest.¹⁴

Exit Planning

Dutch Tax Considerations

There should be no dividend withholding tax implications on a distribution by a Co-op provided its Articles are properly drafted and there should be no Dutch tax implications for the foreign members in the Co-op on exit distributions unless the substantial interest rules apply or the foreign members have a Dutch taxable branch to which the membership interest in the Co-op can be allocated. A Dutch Co-op may be dissolved by resolution of the general meeting of members or in the event the Co-op no longer has any members. Upon dissolution, the Co-op shall continue to exist to the extent required for the liquidation of its assets. The dissolution of a Co-op is generally considered to give rise to a deemed transfer of the assets and liabilities of the Co-op at their fair market value for Dutch corporate income tax purposes. The availability of a participation exemption may mitigate any Dutch income tax liability.

Canadian Tax Considerations

The rules in proposed subsection 88(3) will likely apply to the liquidation and dissolution of the Co-op into a Canadian resident taxpayer where the Co-op is held directly by the taxpayer. Otherwise, either paragraphs 95(2)(e) or

13. A detailed discussion of subsection 85.1(4) is beyond the scope of this article.

14. See CRA Document Nos. 2006-0208571R3, 2006-0206961R3 and 2008-0264671R3. The CRA has not ruled on the application of paragraph 95(2)(c). However, given that paragraph 95(2)(c) applies in essentially the same manner as subsection 85.1(3), except that it involves a transfer of shares of a foreign affiliate between other foreign affiliates of a Canadian resident taxpayer, it is likely that the CRA would view such a transaction to be one to which paragraph 95(2)(c) may apply.

95(2)(e.1) will apply on the liquidation and dissolution of the Co-op into another foreign affiliate of the Canadian resident taxpayer.

As the rules relating to the liquidation of a foreign affiliate are in a state of flux, an analysis of the Canadian tax implications on the liquidation of the Co-op under current law, proposed February 27, 2004 Technical Amendments ("Proposed Amendments") and modifications to the Proposed Amendments (recent comfort letters issued by the Department of Finance), as applicable, will need to be made.

Conclusion

The Netherlands has historically been used as a location for holding, financing and licensing activities for international groups including Canadian multinationals. Co-op structures have recently become increasingly popular and eliminate the necessity of additional planning to avoid the 5% Dutch dividend withholding tax that would otherwise apply. However, in order to fully reap the benefits of a Co-op structure, one should be mindful of the potential application of the Dutch substantial interest rules, and ensure that the Articles of the Co-op are properly drafted such that the Co-op is considered a corporation for Canadian tax purposes.