

GENERAL AGREEMENT ON TARIFFS AND TRADE

INCOME TAX PRACTICES MAINTAINED BY THE NETHERLANDS

Report of the Panel

1. The Panel's terms of reference were established by the Council on 30 July 1973 (C/M/89, paragraph 7):

"To examine the matter referred by the United States to the CONTRACTING PARTIES pursuant to paragraph 2 of Article XXIII, relating to income tax practices maintained by the Netherlands and to make such findings as will assist the CONTRACTING PARTIES in making the recommendations or rulings provided for in paragraph 2 of Article XXIII."

2. The Chairman of the Council informed the Council of the agreed composition of the Panel on 17 February 1976 (C/M/112, paragraph 17):

Chairman: Mr. L.J. Mariadason (Counsellor, Permanent Mission of Sri Lanka, Geneva)

Members: Mr. W. Falconer (Director of Trade Policy, Department of Trade and Industry, Wellington)

Mr. F. Forte (Professor of Public Finance, University of Turin)

Mr. T. Gabrielsson (Counsellor of Embassy, Permanent Delegation of Sweden to the European Communities, Brussels)

Mr. A.R. Prest (Professor of Economics of the Public Sector, London School of Economics)

3. In the course of its work the Panel held consultations with the United States and the Netherlands. Background arguments and relevant information submitted by both parties, their replies to questions put by the Panel as well as all relevant GATT documentation served as a basis for the examination of the matter.

4. The Panel met on 16-18 March, 28 June-1 July and 26-30 July 1976 and concluded its report through a postal procedure.

5. The United States requested the Panel to find that the tax practices of the Netherlands violated Article XVI:4 and that there was therefore a prima facie case that these practices were nullifying or impairing benefits accruing to it under the General Agreement.

6. The United States also suggested that the four complaints on the DISC legislation and income tax practices in France, Belgium and the Netherlands should be considered together because they raised the same principles concerning the application of the GATT.

Factual aspects of the practices in question

7. The following is a brief factual description of the tax practices complained of by the United States as the Panel understood them.

8. The Netherlands system of levying income tax and corporation tax is that profits made by an individual or an enterprise should be taxed in the country where the profits were made. In principle, however, income tax on resident corporations and individuals is levied on the world-wide income. If a treaty provides for different tax treatment the treaty rules will prevail over Dutch national law, and if no treaty exists, unilateral relief will be granted through a proportional reduction in Dutch taxation for foreign source profits if an income tax is in principle due in the foreign country. The portion of profits or income which is not taxable in the Netherlands is thereby important when determining the tax rate to be applied to the portion that is taxable in the Netherlands. This means in practice that for individuals who are subject to a progressive rate of income tax, the Dutch tax is affected by the amount not taxable in the Netherlands. For resident corporations this system has effects which are similar to those of the territoriality principle. One difference between the Dutch system and the territoriality system in its pure form is that foreign losses of a permanent establishment (the concept includes the location of the principal office of management) or dependent permanent representative are deductible when computing liability to Dutch tax, provided that tax is in principle due in the foreign country.

9. This method amounts to a credit, not for foreign, but for Dutch tax on foreign income, and is the principal method for avoiding double taxation. (Royal Decree providing Unilateral Regulations for the Avoidance of Double Taxation of 1965.)

10. In the Netherlands the taxation of dividends is governed by the territoriality principle applied to the residence of the person entitled to dividends. As a general rule, therefore, no relief from Dutch tax is granted to dividends. However, the Decree provides a relief for all income earned by a permanent establishment,

which in practice means that dividends can qualify for relief if they are channelled through a permanent establishment and are subject to tax in the other country. Under Dutch double taxation agreements these rules apply even if the other country does not make use of its taxation rights. A 1970 amendment to the Decree also introduced a special foreign tax credit for interest and royalties paid to Dutch residents from developing countries.

11. An "affiliation privilege" laid down in the Corporation Tax Act of 1969, constitutes an exemption for intercompany dividends and other profits connected with a substantial participation in ownership, (normally 5 per cent) and was enacted to prevent double taxation of profits when a company receives dividends or other gains from a qualified company. This privilege is also applicable if a resident company participates in a foreign company which is formally subject to some kind of income tax under the laws of a foreign State. The rate of the foreign tax is immaterial but, liability to foreign local or regional taxes is not sufficient. In the case of participation in a foreign company, the tax inspector may refuse to grant the exemption on the grounds that it is a portfolio investment.

12. Under Dutch legislation the profits of an enterprise must be calculated in accordance with "Sound business practice". There are no administrative guidelines for the application of the arm's-length principle.

Main arguments

A. Article XVI:4

13. The representative of the United States recalled that Article XVI:4 prohibited the use of export subsidies, that the Netherlands had signed the Declaration giving effect to that paragraph and that the Netherlands therefore had an obligation not to grant export subsidies which led "to the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market". He also recalled that the illustrative list of measures to be considered as subsidies in the sense of Article XVI:4, which was proposed by France included the following items: (c) "The remission calculated in relation to exports, of direct taxes ... on industrial or commercial enterprises" and (d) "The exemption in respect of exported goods of ... taxes, other than ... indirect taxes levied at one or several stages on the same goods if sold for internal consumption ..."

Effects of the Netherlands' tax practices for taxation of foreign profits

14. The representative of the United States pointed out that the Netherlands, at least in practice, followed the territoriality principle of taxation and that, as a result, did not tax the export sales income of foreign branches or foreign sales subsidiaries of domestic manufacturing firms. Taxes on such income were for

the most part permanently forgiven rather than merely deferred. This system of remitting or exempting taxation of profits from export sales by foreign branches or subsidiaries created a distortion in conditions of international competition in that it afforded a remission or exemption of direct taxes in violation of the Netherlands' commitment as a contracting party under Article XVI:4. The relative tax burden on the sale of products for export as against domestic sales was lower as a result of the remission of taxes on a portion of export sales income.

15. The representative of the United States argued that sales by a Dutch corporation through a foreign branch permanently established abroad represented the most obvious case of a remission of direct taxes. He stated that, unlike France and Belgium, the Netherlands subjected its corporations to the full rate of tax on their entire income from all sources, but when part of the income was generated through a foreign branch the branch profits were made subject to Dutch tax and the tax then remitted, the proportional relief given being equal to the Dutch tax which would have been imposed on the foreign income if it had been earned domestically. The tax exemption which it afforded was permanent and could be freely used by the domestic manufacturing firm. The representative of the United States said that the relief was not subject to a requirement that foreign tax actually be paid, and that the requirement was satisfied even if the income were exempt from foreign tax because of a tax treaty or a tax holiday.

16. The representative of the United States further argued that, by organizing a foreign branch or subsidiary in a low-tax country, a Dutch manufacturing firm could enjoy the low-tax rate on that portion of the total export sales income which was allocated to the foreign branch or foreign sales subsidiary, that the amount of exports sales income allocated to foreign sources was generally substantial and that under the Dutch system, the right to tax foreign income was given up. He concluded that as a minimum the sales element of export earnings was exempt from taxation and therefore subsidized in violation of Article XVI:4.

17. The representative of the Netherlands replied that in general the Netherlands followed the territoriality principle, that this principle was widely used and that it and the world-wide principle on which the United States' system was based had been accorded equivalent status internationally. Under the territoriality principle neutrality was achieved by taxing profits in the country in which they were made and in accordance with the regulations and tax rates in force in that country.

18. The representative of the Netherlands went on to state that the tax base was always the same, irrespective of whether the sale was effected by the exporter to an independent third party, to its subsidiary or to a branch abroad, the relations between the Dutch company and its branch or subsidiary having to be those that would have existed with an independent third party.

19. The representative of the Netherlands added that under Dutch case law the only exclusion permitted from the tax base was profits derived from activities which were separable from the Netherlands' exports, i.e. profit derived from an enterprise or such part thereof which was carried on through a permanent establishment situated outside the Netherlands or through a permanent representative outside the Netherlands, these terms being defined in a way which was nearly entirely comparable to the terms "permanent establishment" as worked out in Article 5 of the OECD Draft Double Taxation Convention. He also stated that income obtained through a foreign branch was only exempt from the Netherlands tax if such income was subject to tax in the host country where the permanent establishment of the enterprise or the subsidiary was established and that was introduced to ensure that if a tax haven did not levy any tax on the income of such a branch the income was fully subject to Dutch tax. He stated that the "subject to tax" requirement had been introduced to prevent the use of tax havens. He further stated that many developing countries attempted to create an attractive climate for foreign investment by means of tax holidays or reduced tax rates and that the territoriality principle prevented the sacrifices which the developing countries made in the fiscal sphere from being nullified by higher taxation in the investor's home country. If the "subject to tax" requirement were to be replaced by a stricter criterion, for example, by a requirement that tax was actually to be paid on profits made abroad, serious harm would be done to the interests of the developing countries. Although the "subject to tax" requirement did have certain inherent dangers with regard to certain tax havens, the Netherlands was of the opinion that these dangers must not be avoided at the expense of developing countries.

20. The representative of the Netherlands said that his Government could be accused of contravening GATT obligations only if it were to treat sales income more favourably than other profits in some way but he concluded from the above that there was no exemption from direct tax in respect of exports that could afford a direct or indirect aid to the exporter. The territoriality principle therefore complied with the principles and the text of the General Agreement.

21. The representative of the Netherlands added that the territoriality principle was established as a basis of Dutch income tax long before the GATT came into being and that the Netherlands was surprised to learn of the complaint by the United States several decades after the signing of the General Agreement.

22. Commenting on this reply, the representative of the United States argued that it was the effect of the legislation and not the intent behind it which was important. He argued that the statement to the effect that the tax base was always the same failed to indicate the significance of sales profits allocated to foreign sources and escaping Dutch taxation. Furthermore, the fact that the practices of the Netherlands had been in operation for several years was irrelevant. The language of the 1955 amendments to the General Agreement (which, inter alia, introduced paragraph 4 of Article XVI), and the 1960 Declaration giving effect to Article XVI:4 as well as the Standstill Declaration made it absolutely clear that contracting parties adhering to the 1960 Declaration were obligated to cease to grant any subsidies whether or not the subsidies were granted pursuant to legislation existing in 1947 unless a specific reservation was made.

Inter-company pricing rules

23. The representative of the United States argued that when the profits of a foreign subsidiary were not taxed, the inter-company pricing rules of the country of manufacture became more important. The United States maintained that Dutch tax authorities could be willing, in some cases, to allow favourable pricing on export sales. This would mean that the distortions created by the tax system became even greater.

24. The representative of the Netherlands replied that under the Netherlands tax legislation the profits of an enterprise had to be calculated in accordance with "sound business practice". According to Dutch theory, jurisprudence and practice which accorded with the provisions of the Draft Double Taxation Convention of the OECD, the term included the application of the arm's-length principle in transaction between related parties. Such provisions also constituted an important part of almost all double taxation conventions concluded by the Netherlands. In contrast to the situation in the United States, there were in the Netherlands no administrative guidelines for the application of the arm's-length principle; transactions were looked at on a case-by-case basis, having regard to all the particular circumstances of each case. The representative of the Netherlands added that the Netherlands had no choice but to deny the suppositions and presumptions of the United States offhand since they were made without supporting details. No government could in his opinion give assurances that mistakes were never made in the application of the arm's-length principle, whether caused by false information given by the taxpayer or by wrong estimation of a situation by the tax authorities themselves. He stated, however, that such cases could never be invoked as a proof that the principles underlying the Dutch tax system were not in fact observed.

Effects of the Netherlands tax practices for taxation of foreign dividends

25. The representative of the United States noted that the profits of a foreign subsidiary were not consolidated with the profits of its Dutch parent and no Dutch tax was directly imposed on the subsidiary's profits. He also noted that there was not a mere deferral of Dutch tax until profits were repatriated in the form of dividends, since in most cases, there was exemption from tax on those earnings because the dividends were fully tax exempt, thereby resulting in remission of Dutch tax on the subsidiary's profits from Dutch exports. He also stated that Dutch companies were exempt from Dutch taxes on all "benefits" connected with qualifying shareholding including dividends in cash and kind, bonus shares, "hidden" profit distribution and capital gains, providing certain conditions were met. The exemption was also applicable to dividends from a domestic company, but there was no similarity of tax treatment because a domestic subsidiary was subject to Dutch tax, whereas the foreign subsidiary was not.

26. The representative of the Netherlands replied that the Dutch system made no distinction relating to the nature of profits or income, and that the "affiliation privilege" stemmed from the idea that profits made abroad should be taxed abroad in the country in which the permanent establishment was situated or in which the subsidiary had been organized - the Netherlands having no right to add an additional tax. The representative of the Netherlands said that the United States was, in fact, attacking the basic tax principles of the Netherlands in this respect.

Relation to the DISC legislation

27. The representative of the United States argued in general that, if the DISC legislation violated the General Agreement, then the tax practices of the Netherlands, which operated to exempt a portion of sales income of exporting firms from direct taxes, must be found to constitute even clearer subsidies in violation of Article XVI:4. Whereas the DISC legislation provided only a deferral, the tax practices of the Netherlands amounted to a remission or exemption. The United States compared the effects of the principles behind its tax policy regarding foreign source income and the effects of the principles behind Dutch legislation. It did not question the territoriality principle in so far as it represented a reasonable approach to the avoidance of double taxation, but argued that the intent of nations was irrelevant and that the effect of the Dutch practices was that foreign income which included the sales element on exports was not taxed by the home country and that there was therefore a remission or exemption of taxes. The focus should not, according to the United States, be on the tax rates of host countries, but on the home country and its potential for shifting export income abroad thus escaping virtually all tax. The United States added that if it had utilized the territoriality principle it would have collected significantly less than the \$3.8 billion which, it was estimated, would be collected on foreign source income in 1976.

28. The representative of the Netherlands said that his country had no provisions which discriminated in favour of exports as the DISC legislation did and that the territoriality principle achieved a neutrality which the United States' system did not. He added that the United States' tax legislation did not prevent, as did Dutch legislation, the sacrifices which developing countries made in the fiscal sphere from being nullified by higher taxation in the investor's home country.

29. The representative of the Netherlands went on to argue that if the mere fact that the Netherlands applied the territoriality principle were sufficient evidence of failure to meet obligations under Article XVI:4, the consequence could then be inter alia that any country imposing less tax on sales income than the United States was failing to meet its obligations to the United States under the GATT, even if the former country taxed export sales income in the same manner as other profits. Such consequences which emerged logically from the United States conception were not in any way covered by Article XVI:4.

30. Commenting on this last point, the representative of the United States said that he rather contended that if the DISC legislation violated the GATT, then any system which taxed export profits at a differentially lower rate than profits on domestic sales was in violation of the GATT.

Bi-level pricing

31. Referring to the provision in Article XVI:4 relating to the sale of products for export "at a price lower than the comparable price charged for the like product to buyers in the domestic market", the representative of the United States argued that, if the Panel on DISC found that when the CONTRACTING PARTIES agreed that exemption of direct taxes in respect of exported goods was generally to be considered a subsidy within the meaning of Article XVI:4 they intended to create a presumption that such tax practices resulted in lower export prices in relation to domestic prices, and if the DISC Panel went on to find that the deferral of taxes on export sales income provided by DISC resulted in lower export prices, then the Panel on Dutch Tax Practices had likewise to find that the tax practices of the Netherlands, providing for the total or partial exemption of export sales income of exporters located within the Netherlands, were more likely to result in lower export prices and, therefore, were even more clearly prohibited by Article XVI:4.

B. Article XXIII:2 nullification or impairment of benefits

32. The representative of the United States argued that a prima facie case of nullification or impairment was established where it was determined that the

measure complained against violated the General Agreement and that, since the tax practices of the Netherlands constituted prohibited subsidies within the meaning of Article XVI:4, they had resulted in the prima facie nullification or impairment of benefits accruing to the United States under the General Agreement.

33. The Dutch position was that its practices were not in contravention of the GATT and that there was not, therefore, a prima facie case of nullification or impairment.

Conclusions

34. The Panel started by examining the effects of the income tax practices before it in economic terms. The Panel noted that the particular application of the world-wide principle by the Netherlands, in conjunction with the qualified exemption in respect of foreign income, allowed some part of export activities belonging to an economic process originating in the country, to be outside the scope of the Netherlands' taxes. In this way the Netherlands has foregone revenue from this source and created a possibility of a pecuniary benefit to exports in those cases where income and corporation tax provisions were significantly more liberal in foreign countries.

35. The Panel found that however much the practices may have been an incidental consequence of the Netherlands' taxation principles rather than a specific policy intention, they nonetheless constituted a subsidy on exports because the above-mentioned benefits to exports did not apply to domestic activities for the internal market. The Panel also considered that the fact that the practices might also act as an incentive to investment abroad was not relevant in this context.

36. The Panel also noted that the tax treatment of dividends from abroad ensured that the benefits referred to above were fully preserved.

37. In circumstances where different tax treatment in different countries resulted in a smaller total tax bill in aggregate being paid on exports than on sales in the home market, the Panel concluded that there was a partial exemption from direct taxes. This resulted from the fact that, even though it followed the world-wide taxation principle, the Netherlands did not levy a tax on profits from export sales by foreign branches or subsidiaries when these were subject to tax abroad irrespective of whether these tax rights were exercised. The Panel further concluded that the practices were covered by one or both items (c) and (d) of the illustrative list of 1960 (BISD, 9 Suppl. p.186).

38. The Panel noted that the contracting parties that had accepted the 1960 Declaration had agreed that the practices in the illustrative list were generally to be considered as subsidies in the sense of Article XVI:4. The Panel

further noted that these contracting parties considered the practices contained in the illustrative list could be presumed to be bi-level pricing and that this presumption could therefore be applied to the Netherlands' practices. The Panel concluded, however, from the evidence "to be considered" that these contracting parties did not consider the presumption was absolute.

39. The Panel considered that, from an economic point of view, the presumption that an export subsidy would lead to any or a number of the following consequences in the export sector: (a) lowering of sales effort, and (c) increase of profits per unit. Because the Netherlands was an important supplier in certain export sectors it was to be expected that some of these effects would occur and that, if one occurred, the others would not necessarily be excluded. A concentration of the subsidy benefits on a few firms could lead to substantial reductions in prices. The Panel did not consider that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. The Panel added that the extent to which tax havens existed was well known and that they considered this some evidence of the extent to which bi-level pricing had probably occurred.

40. The Panel therefore concluded that the Netherlands' tax practices in some cases had effects which were not in accordance with Dutch obligations under Article XVI:4.

41. The Panel noted that the allocation of profits between companies and their foreign operations was made in accordance with the rule of sound business practice. This might not always coincide with arm's-length pricing. The Panel concluded that the benefit would be increased to the extent that arm's-length pricing was not fully observed.

42. The Panel noted the argument of the Netherlands that its tax practices were in part designed to ensure that they did not nullify tax incentive policies of developing countries. The Panel fully recognized this problem in relation to developing countries. The argument advanced did not, however, lead it to modify its conclusions in that the practices of the Netherlands did not differentiate between developed and developing countries.

43. The Panel considered that the fact that these tax arrangements might have existed before the General Agreement was not a justification for them and noted that the Netherlands had made no reservation with respect to the standstill agreement or to the 1960 Declaration (BISD, 9 Suppl. p.32).

44. The Panel was of the view that, given the size and breadth of the export subsidy, it was likely that it had led to an increase in the Netherlands' exports in some sectors and, although the possibility could not be ruled out that the tax arrangements would encourage production abroad and a decrease in exports in other sectors, nonetheless concluded that it was also covered by the notification obligation of Article XVI:1.

45. In the light of the above, and bearing in mind the precedent set by the Uruguayan case (BISD, 11 Suppl. p.100), the Panel found that there was a prima facie case of nullification or impairment of benefits which other contracting parties were entitled to expect under the General Agreement.