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Court Addresses Gains in Nonresident's Reinvestment Reserve

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COUNTRY DIGEST

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The Dutch Supreme Court on March 22, in Decision 11/05599, held that a nonresident owner of Dutch real estate may place a capital gain realized on the sale of that real estate in a reinvestment reserve and that the capital gain becomes immediately taxable only if reinvestment does not take place within the prescribed reinvestment period. The case concerned an entity incorporated under Dutch law that moved its place of effective management from the Netherlands to Luxembourg, but the decision should apply to all companies that are nonresident taxpayers for Dutch corporate income tax purposes and have business assets in the Netherlands.

Background

Although a company that is incorporated under Dutch law is deemed a tax resident for most Dutch corporate income tax purposes, the company's liability may be limited to Dutch-source profits only. That is the case if the company moves its place of effective management to a country that has entered into a tax treaty with the Netherlands containing an OECD-style tiebreaker rule. The 1968 Luxembourg-Netherlands tax treaty has such a rule.

Generally, if a company is treated as a tax resident in both treaty states, the tiebreaker rule determines that for treaty purposes the company is resident in the state where its place of effective management is located. Thus, if an entity incorporated under Dutch law migrates to Luxembourg, it will remain taxable in the Netherlands only if it continues to receive profits from sources for which the tax treaty allocates a right of taxation to the source state. Effectively, that will happen only if those are specific sources within the Netherlands. Under articles 6 and 14 of the Luxembourg-Netherlands treaty, Dutch real estate is one of these sources. A move of residence triggers an exit tax on those profits and reserves that are no longer taxable in the Netherlands. If the tax residence is moved to an EU or European Economic Area state, a deferral of payment may be available.

In the case at hand, after becoming tax resident in Luxembourg, the company sold its Dutch-based real estate in two consecutive years. Both sales resulted in capital gains. The gains were placed in a reinvestment reserve (then still a replacement reserve). If a reinvestment reserve is created, the book profit resulting from the disposal of a tangible or intangible business asset can be carried forward and, subject to limitations, offset against the cost of a reinvestment asset.

Under the current rules, reinvestment must occur within three years after the year that the reinvestment reserve was established. For this case, the period was four years. If reinvestment does not take place within three years, the amount in the reinvestment reserve must be included in taxable income for corporate income tax purposes in the third year following the year in which the reinvestment reserve was established. The amount in the reinvestment reserve must be released sooner if the taxpayer no longer intends to make a qualifying reinvestment.

Two years after the last sale, the company submitted a Dutch corporate income tax return from which it appeared that the company no longer intended to make a qualifying reinvestment. The Dutch tax authorities imposed an additional assessment that took into account a taxable release of the reinvestment reserve. The taxpayer challenged the assessment, arguing that the Dutch tax authorities should have taxed the capital gains earlier and thus had forfeited their right to tax. It also argued that the capital gains should ultimately have been taxed in the year in which the last Dutch real estate was sold, as a consequence of which the taxpayer ceased to receive Dutch-source income in that year. Under the relevant rules, a final exit charge should arise when a taxpayer ceases to generate Dutch-taxable profits.

Court Decision

The Supreme Court held that as long as a taxpayer holds a reinvestment reserve, it continues to earn profits that are taxable in the Netherlands because the creation of a reinvestment reserve means the taxpayer will obtain future taxable profits from real estate situated in the Netherlands. The Court likely reasoned that either a reinvestment into Dutch real estate will be made or in the absence of a timely reinvestment, there will be a taxable release of the reserve.

The Court wrote that the provisions of article 14, paragraph 1 of the Luxembourg-Netherlands tax treaty don't change this conclusion. Under those provisions, gains from the alienation of immovable property, as defined in article 6, paragraph 2 of the treaty, may be taxed in the state where the property is situated. Therefore, if it is assumed that the place of effective management is located in Luxembourg, the benefits related to the sales of the Dutch real estate may be taxed in the Netherlands. Because the treaty doesn't address when these benefits can be taxed, it doesn't prevent taxation from occurring in a later year than the one in which the real estate was sold.

The Supreme Court noted that this result — deferred taxation of the capital gain — is consistent with EU law. However, the scope of the decision is not limited just to EU and EEA situations. Although the rules governing the reinvestment reserve and the exit taxation have changed, it seems unlikely that the Supreme Court's decision would be different when applying the new rules. ◆

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