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The district court of Arnhem has found (AWB06/290, Mar. 7, 2007) that a Hong Kong company was not subject to Dutch corporate income tax.

Facts

During 2001 and 2002, two Dutch resident individuals, Mr. E and Mr. F, each owned 50 percent of the shares in a company (X Ltd.) incorporated under the laws of Hong Kong. X Ltd. was established in 2001. The directors of X Ltd. were Mr. E and G Ltd., a trust company. Mr. E and Mr. F also held indirectly the shares in a Dutch resident company (X BV), which was active in the wholesale of products related to gardening. The products were mainly purchased in the People's Republic of China.

X Ltd. had an office and showroom in China, where it employed five persons, including Mr. B and Ms. C, who were responsible for handling the company's daily affairs. Mr. B was responsible for the start-up of X Ltd. in China. The core activities of X Ltd. in China consisted of: quality control of the products manufactured in China; logistic services; order tracing; product development; and purchase and sales (including attending trade fairs). In China, X Ltd. was treated as a representative office.

During 2001, X Ltd.'s sales were only to X BV, while in 2002, 6 percent of X Ltd.'s transactions were with unrelated parties. X Ltd. received for its activities consideration from X BV, which was equal to the purchase price paid to the Chinese suppliers plus a markup of 10 percent. The markup was included in the sales price charged by X Ltd. to X BV.

Issue

The Dutch tax inspector claimed that Mr. E had a guiding and managing role and that, accordingly, X Ltd. was a resident of the Netherlands. For that reason, the tax inspector imposed a corporate income tax assessment against X Ltd.

The Law

Under Dutch domestic law, a foreign company is subject to corporate income tax in the Netherlands if it is a resident of the Netherlands. Whether a foreign company is considered a resident of the Netherlands depends on certain facts and circumstances. (A company incorporated under Dutch law is generally deemed to be a resident of the Netherlands.) Relevant case law has indicated that the decisive criterion is the place of effective management. Generally the effective management of a company is conducted by its management board, and the place of effective management (residence) is where the board exercises its management tasks. However, when it is plausible that someone other than the management board exercises effective management, this could produce an exception to the above general rule so that the company's place of effective management is where this other person exercises the management (see Dutch Supreme Court decision 27293, (Sept. 23, 1992) published in BNB 1993/193).

Decision

In its decision, the Arnhem District Court referred to the law and to Supreme Court decision 27293. Moreover, the district court mentioned that the examination of the place of effective management should be based on the core activities that are actually performed. The court determined that the core activities of X Ltd. were conducted by the employees working in the office in China and managed there by Mr. B and Ms. C. The district court found that Mr. E visited the China office a couple of times per year and, from the Netherlands, paid some attention to the activities in China was irrelevant.

Apart from whether Mr. E's role was based on his position as shareholder or as a member of the management board, it did not appear that he was involved with the core activities. Based on the facts and circumstances, the district court decided X Ltd. was a resident of China and not of the Netherlands, and that there was no Dutch tax liability.

Discussion

It is not clear from the facts, but it can be assumed that no real management activities took place in Hong Kong. Because the other member of the management board of X Ltd. was a trust company, the tax inspector must have based his assessment on the argument that Mr. E in his capacity of board member was in fact the person who conducted the effective management. That Mr. E was a resident of the Netherlands should presumably have led the tax inspector to conclude that X Ltd. was also a resident of the Netherlands.

The district court did not discuss the application of the tax treaty between the Netherlands and China because it had already determined that Dutch domestic law did not allow the Netherlands to tax the profits of X Ltd. (From the decision, it appears that the tax inspector had not argued that X Ltd. had, at least, a permanent establishment in the Netherlands.)

The district court reasoned that the exception formulated by the Supreme Court in its abovementioned decision of September 23, 1992, applied to X Ltd. It was made plausible by X Ltd. (which had the burden of proof) that the formal management board did not exercise the effective management but that Mr. B and Ms. C did. In this respect, the district court considered the management of the "core activities" to be relevant. This wording was also used in another case by the Court of Amsterdam and confirmed by the Supreme Court in its decision of October 14, 2005 (14050 published in BNB 2006/79). In the latter case, the court reasoned that giving general directives in the capacity of shareholder to a group company in view of strategic coordination (which is usual within a group of companies) is not decisive for determining the place of effective management. The deciding factor is the place where the core activities of the company concerned are actually managed.

Generally the outcome of this kind of case depends on the facts and circumstances. The tax inspector did present to the district court additional information that may have supported his arguments. However, because the information was presented only two days before the hearing, the district court ignored the information because it was received too late. (Court rules provide that additional information can be presented no later than 10 days before the hearing.) Therefore, the tax inspector is expected to appeal the decision with the tax court, where he will be allowed to present the additional information.[1] Perhaps this information could shed some other light on the activities of Mr. E, as well as on the place of effective management of X Ltd.

The decision indicates that there is also a district court case pending regarding the related Dutch company X BV. Most likely, the tax inspector has made an adjustment and increased X BV's profits, claiming that the prices paid for the products of X Ltd. were not determined at arm's length. ◆

♦ *Eric van der Stoel, Otterspeer, Haasnoot & Partners, Rotterdam*

[1]In the past (before 2005), when there were only two levels of courts (that is, the tax court in first instance and the Supreme Court as last resort), the tax inspector would not have been able to present the additional information during an appeal. At that time the appeal against the decision of the court of first instance (the tax court) had to be lodged directly with the Supreme Court, which is not the forum that determines applicable facts.