THE SINGLE MARKET'S DUTCH AUCTION

How the EU's Single Market fosters corporate tax avoidance schemes that costs the UK billions

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WHILE it may seem unfair to pick out the Netherlands as an exemplar of how our European "partners", as they are customarily known, have used the structure of the Single Market to their own advantage and the UK's detriment, there are so many strings to the Dutch bow in this area that it deserves comment. The Netherlands supports a whole professional services orchestra: high value jobs, employment for hundreds of law firms and trust companies, and a reasonable flow of tax revenues, the latter following the normal mantra of "We'd rather have 6% of something than 100% of nothing".

This paper's conservative calculation shows over £650 million per annum of tax leakage from the UK due to our "partner" the Netherlands: this is an army of lawyers and accountants showing the highest measure of devotion to depleting the UK's tax base.

Schemes used and area of impact

The impact on the UK of all of this is invisible day-to-day, but important because:

- Multinationals are able to pad out the interest rates their UK subsidiaries pay to sister companies on intercompany loans, increasing interest deductions against tax, and reducing corporation tax paid;
- Multinationals are able to impose off-market Transfer Pricing, extract UK profits as a tax-deductible charge, and eliminate their UK corporation tax liability;
- Imports from outside the EU are being conduited into the EU through Swiss branches of Dutch companies, avoiding EU import duties, thereby diminishing the EU's revenues from Customs Levies, effecting an increase in the Member State cash contributions, including the UK's; and,

- Multinationals are able to side-step controls on the amounts of their intercompany debts (called Thin Capitalisation controls) by using a Dutch bank that disguises intercompany loans as bank loans, so that the UK subsidiaries can take on higher debt, increase their deductions against tax, and reduce their corporation tax paid.

These practices are common amongst the smaller EU Member States, who are the winners, whereas the UK – amongst others – is the target of these practices and the loser. The practices enabled by the Netherlands and examined in this paper may not be the largest leakage of cash caused by our membership of the Single Market, in terms of the loss as a percentage of the face value of business being transacted, but because the techniques are being operated on an industrial scale, the annual loss to the UK runs into a range between hundreds of millions and billions of pounds.

Competition for job-creation

There is nothing really new about EU Member States competing with one another to create professional-level jobs. This started in the 1980s. Belgium was first out of the blocks with its Belgian Coordination Centre, a special type of company that could be established only by Royal Decree, signed by the monarch, it was:

- Intended to be the European base of a multinational;
- Only able to interact with other parts of the same multinational, not with third-parties; and
- Required to employ at least 10 local staff, and at all levels of management – not just the cleaners.

It enjoyed an initial Belgian tax rate of 0%, which later rose to 10%, until the scheme was abolished. Since the employment costs for local hires were initially the main expense, these staff costs were regarded as a fixed taxation amount.

This was then an invitation to the multinational to build up a big throughput of volume, since the marginal tax rate on every extra piece of volume would be zero. Multinationals built up a large Belgian Coordination Centre doing internal finance, R&D, market research, and all manner of internal work, not touching the multinationals’ external suppliers or customers.

The noisy neighbour

The Netherlands was distressed by the actions of its noisy neighbour, especially when Belgian Coordination Centres ("BCC") were established near to Dutch territory – for example in Antwerp or Beerse - and so they responded in several ways:

1. To promote to the same multinationals that Belgium lacked a comprehensive network of Double Taxation Treaties upon which to base an international financing structure, since withholding tax on interest would apply to many of the intercompany loan constructions contemplated by the BCC, if the BCC borrowed direct from some subsidiaries and lent direct to others;
2. To propose that the BCC be incorporated as a subsidiary of a Dutch registered finance company – a B.V. standing for limited liability company or "Besloten Vennootschap met beperkte aansprakelijkheid" – so that intercompany loans or deposits between the BCC and subsidiary companies could be managed by the BCC, but contractually be dog-legged through the Netherlands with:
    a. One transaction between the BCC and the BV;
    b. A back-to-back transaction between the BV and the respective subsidiary company;
    c. No withholding tax would apply on either leg, and whichever direction the money was flowing in.
3. To work out a way of replicating the fixed tax charge experienced by the BCC at the BV as well; and,
4. To work out a way of the BV being managed so that:
    a. It would pass all the required tests to prove Dutch tax residency;
    b. The effort in passing these tests could be done in a low-cost way for the multinational.

Tax "management" built to an industrial scale

The Netherlands is a very pragmatic operator. It is prepared to share so that they do not have to insist on 25% of something rather than 100% of nothing: 12.5% of something or 5% of something or even less can float their canal barge if the "something" is big enough. The model of co-operation with Belgium in the case of the BCC has been extended to the Dutch/Swiss sandwich, and the Dutch/Irish sandwich. If the cake is big enough, even an effective tax rate of 1% can be sufficient.

Withholding tax "management"

The bedrock of the Dutch approach is its wide network of Double Tax Treaties, the objective of such a treaty being to relieve Withholding Tax on money flows between the residents of the two countries that are party to the treaty.

The essence of any Withholding Tax ("WHT") is that it is an advance payment of tax owed by the receiver on a given stream of income, and it normally applies on streams of dividends, bank interest and royalties, and less on payments for goods and services. We would call the WHT a "payment on account".

A given country might have a domestic tax regime that specified a corporation tax rate, and WHT deductions, as follows:

Corporation tax rate	25%
WHT on dividends	25%
WHT on interest paid to related companies	20%
WHT on interest paid to banks	15%
WHT on royalty payments	10%

Note that the rate relating to interest paid to banks is lower than when interest is paid to related companies, and that royalty payments attract the lowest rate.

The legitimate objection to these deductions is when the recipient of the monies is a non-resident of the country concerned. They will not have a tax bill to pay in that country, against which the WHT is a payment-on-account.

Where there is a tax bill in the country concerned, their payment-on-account can be applied to that bill: if they suffered a EUR 5,000 WHT deduction and later had a total tax bill of EUR 25,000, they would only have to pay over EUR 20,000 at year-end because the EUR 5,000 payment-on-account could be offset.

This is where Double Tax Treaties ("DTAs") come in and why the Netherlands and the Republic of Ireland have invested so much time and effort into having a wide network or treaties and with such advantageous terms.

What is a DTA?

A DTA is a treaty signed between two countries that relieves the WHT deductions that would otherwise be levied on the income streams received by a resident of one of the countries when the income is coming from another. The terms of a DTA are normally reciprocal.

The most normal type of DTA is a so-called "credit treaty". In other words, under a putative Dutch/Ruritania treaty and looked at from the Dutch end, Dutch residents with income streams from Ruritania could use the deductions made in Ruritania to offset their Dutch tax liability, up to the same levels of deduction as were applied in Ruritania.

Mechanically, the Dutch resident must obtain and present a Certificate of Deduction of WHT to the Dutch tax authorities, but this certificate has to be obtained from the Ruritanian tax authorities. The Ruritanian tax office would issue the Certificate of Deduction of WHT to the Ruritanian resident who is the source of the money flow, against the payment of the WHT:

- The certificate is addressed to the Dutch resident, because it is their payment-on-account;
- The Ruritanian payer needs to obtain the certificate and send it to the Dutch receiver;
- As long as the Dutch resident files the certificate with their Dutch tax return, they do not have to pay any Dutch tax on the same money earned:

Ruritanian deductions	**Rate**	**Offsett available under DTA**	**Dutch tax payable**
WHT on dividends	25%	25%	0
WHT on interest paid to related companies	20%	20%	0
WHT on interest paid to banks	15%	15%	0
WHT on royalty payments	10%	10%	0

Alternatively and even better if the DTA is a so-called "exemption treaty"; then the flow of money is exempted from WHT in Ruritania because of the tax residency of the receiver:

- In corporate structures the receiver is a “B.V.”;
- It is domiciled in the Netherlands for tax purposes;
- Nothing must be allowed to occur that might supply evidence to the tax authorities of other countries that the “B.V.” was being controlled from a different country than the Netherlands.

The Netherlands’ DTA network

The DTA network of the Netherlands is simply superior to that of every other country in the three Critical Success Factors:

- The number of countries with which a DTA has been signed;
- The degree of offset available where WHT is deducted at source from the income attributable to the Dutch resident;
- The number of countries that have agreed to exempt one or more of the types of income from any WHT completely.

“Credit treaties” can contain elements of “exemption treaties”, and the two lines of income most commonly exempted are:

- Interest paid to banks in the other country;
- Royalty payments.

So in substance the Dutch B.V. can receive and make investments in all sorts of forms and be unaffected by any WHT regime in any foreign country. This a major selling point towards international corporations seeking a focal point for their financing structures.

That takes care of the revenues flowing in and out of the Netherlands: what about tax in the Netherlands?

The Netherlands had set it as their aim to work out a way of replicating, at the B.V. level, the fixed tax charge experienced by a Belgian “BCC”.

That needed to be made compatible with having a mainstream corporation tax rate at the level of the large EU Member States, in the range 20-25%.

This fusion-of-opposites is achieved with the valuable assistance of the Dutch Ministry of Finance in the form of a Dutch “Tax Ruling”. The Ministry of Finance carries out an examination of the size of the multinational concerned, and estimates the throughput of the B.V. from it: if the multinational has a global balance sheet of USD 4 billion, it would not unreasonable to imagine that USD 500 million of it would consist of monies belonging to one subsidiary being deposited at the B.V. and re-lent by the B.V. to other subsidiaries in need of financing.

Then the Ministry of Finance posits that the B.V. would take a 1/8% interest turn on the money and - using a 1:1 USD/EUR exchange rate - the taxable profit of the B.V. should be:

Net interest margin	EUR 625,000
Running costs	EUR 50,000
Profit before tax	EUR 575,000
Tax at 20% on the first EUR 200,000	EUR 40,000
Tax at 25% on the remainder EUR 375,000	EUR 93,750
Total Dutch tax	EUR 133,750
Profit after tax	EUR 441,250
Effective marginal tax rate	23%

The Ministry of Finance then writes a letter to the B.V. stating that its Dutch tax liability will be EUR 133,750: the letter does not state any of the assumptions that led to this determination.

In reality it turns out that the global balance sheet of USD4 billion was a result of window-dressing at year-end and that the true ongoing figure is USD7 million, and that the major source of short-term funding is the recycling through the B.V. of the accumulated earnings of USD1.5 billion that are held in a sister company based in the Netherlands Antilles.

On top of that the multinational believes that the interest rates it can achieve are:

- To pay the overnight interbank rates – offer side – to the Netherlands Antilles;
- To charge the borrowing subsidiaries offer side plus ½%.

So the Netherlands Antilles can receive a very high deposit rate from the B.V. and receive it without WHT, into a country where it will pay no tax on its income.

The borrowing subsidiaries – including UK – pay a borrowing rate that is padded out, and the Profit-and-Loss account of the B.V. turns out to look like this, once again using a 1:1 USD/EUR exchange rate:

Net interest margin: ½% on USD 1.5 billion	EUR 7,500,000
Running costs	EUR 50,000
Profit before tax	EUR 7,450,000
Fixed Dutch tax amount under Tax Ruling	EUR 133,750
Profit after tax	EUR 7,316,250
Effective marginal tax rate	1.8%

The net interest margin is four times as large as in the assumptions behind the Tax Ruling, and on an amount three times as large. But the Tax Ruling does not state the assumptions, and the tax payable is for a fixed amount for all time, regardless of whether the assumptions hold true or not.

The Netherlands gets its 1.8% of something rather than 100% of nothing, and fully delivers on the objective of replicating the fixed tax charge experienced by the BCC at the B.V. as well.

How the EUR 50,000 running costs are delivered

The achievement of the Tax Ruling and the installation of the loans/deposits around the B.V. still leaves two other criteria to be dealt with, which should deliver a way of the B.V. being managed so that:

a. It would pass all the required tests to prove Dutch tax residency;
b. The effort in passing these tests could be done in a low-cost way for the multinational.

This is where the “professional services” industry of Dutch tax lawyers and trust companies shows its mettle. Here the Dutch professionals show an admirable measure of devotion to their task. The B.V. has to pass certain tests in order to maintain its Netherlands tax domicile, including:

- Registered address and office in the Netherlands;
- Board meetings held there;
- Majority of directors resident there;
- Management control exercised from there.

As an example a Finance B.V. representing BigCo Inc. will typically have three directors:

1. Mr Thijs van Hauta, partner at Hauta en Naersolte, 891 Herengracht, Amsterdam
2. Mr Rene van der Naersolte, partner at Hauta en Naersolte, 891 Herengracht, Amsterdam
3. Ed Barge, Group Treasurer, BigCo Inc., 1001 Mechanics Plaza, Louisville, Kentucky

The company registered address and location of all Board Meetings are 891 Herengracht, Amsterdam.

How a typical Board Meeting is run

Here we have taken as an example a Board meeting with just one item of substance on the agenda, that BigCo Finance B.V. should issue a EUR250m ten year bond appointing Morgan Sachs as lead manager, and on-lend the proceeds to the German subsidiary in order to fund an acquisition. This is where things can get a bit dicey as management control needs to appear to be being exercised from the Netherlands. Both the bonds documents and the on-lending documents need to be signed by directors of the B.V. and so there needs to be a Board meeting to consider these financing operations, the appropriate terms, potential lead managers, market conditions and so on.

It would be straining credibility to imagine that, prior to the meeting being called, BigCo – out of Louisville - had not been in deep discussion with both its German subsidiary, Morgan Sachs as a potential lead manager of a bond issue, and other investment banks. But when it comes to the written records:

- The German subsidiary needs to send a formal request for funding to BigCo Finance B.V.;
- Morgan Sachs needs to send a formal offer to lead manage a bond issue to BigCo Finance B.V.; and,
- BigCo Finance B.V.'s main office needs to convene a Board Meeting to agree to both the bond issue and its on-lending.

So BigCo Finance B.V. draws up and issues an agenda for that meeting as set out below, in other words a paralegal at the lawyers running BigCo

Finance B.V. does it, and prepares a nice little fan dance to take place to give the outward appearance of management control being exercised from the Netherlands.

Please note the timing as 15:00 CET as Ed Barge will be phoning in *from Louisville.*

Please note also the need for a quorum: this will be all three directors, not allowing that Ed Barge and one other could have a valid Board Meeting, because Dutch resident directors need to form a majority in the Board's proceedings at all times.

Agenda for a meeting of the Board of BigCo Finance B.V. 15:00 CET on 3rd November 2016 At the company offices at 891 Herengracht, Amsterdam		
To be present in person:	Thijs van Hauta Rene van der Naersolte	
To be present by teleconference:	Ed Barge	
Resolutions:	*Proposed by:*	*Seconded by:*
1. Review of agenda and identification that a quorum of directors is present.	*Thijs van Hauta*	*Rene van der Naersolte*
2. Resolution to open the meeting.	*Thijs van Hauta*	*Rene van der Naersolte*
3. Approval and signature of minutes of previous meeting.	*Thijs van Hauta*	*Rene van der Naersolte*
4. Resolution to approve that Mr Rene van der Naersolte will take the minutes of this meeting.	*Thijs van Hauta*	*Ed Barge*
5. Review and approval of management accounts for the months since the previous meeting.	*Thijs van Hauta*	*Rene van der Naersolte*
6. Review and approval of schedule of Board Meetings for the year.	*Thijs van Hauta*	*Rene van der Naersolte*
7. Discussion of funding requests submitted by eligible borrowers of the company, prioritisation, and resolution to approve which ones will be acceded to.	*Thijs van Hauta*	*Rene van der Naersolte*
8. Discussion of medium-term funding needs of the company caused by the agreement to funding requests, and resolution to agree what funding options should be mobilised.	*Thijs van Hauta*	*Rene van der Naersolte*

9. Review of recent funding options explored, discussion of benefits and drawbacks of each, and resolution to agree programme of debt issuance, with target maturity, interest basis and interest rate.	*Thijs van Hauta*	*Rene van der Naersolte*
10. Resolution to permit any two directors signing together to accept offers received that meet the target criteria.	*Thijs van Hauta*	*Rene van der Naersolte*
11 Resolution to permit any two directors signing together to appoint a lead manager from amongst the approved list of the company's main bankers to arrange the debt issuance.	*Thijs van Hauta*	*Rene van der Naersolte*
12. Resolution to permit any two directors signing together to enter into a loan agreement to on-lend the funds so raised to eligible borrowers whose funding requests were approved pursuant to (7) above.	*Thijs van Hauta*	*Rene van der Naersolte*
13. Any other business.	*Thijs van Hauta*	*Rene van der Naersolte*
14. Closure of the meeting.	*Thijs van Hauta*	*Rene van der Naersolte*

Please note:

- The amount of padding in the agenda: items 1-6 and 13-14;
- That all the resolutions except who will take the Minutes are proposed and seconded by the Dutch directors: it's as if Ed Barge was some kind of dumb terminal;
- The wording of the agenda makes it sound as if the Dutch directors are in daily contact with eligible borrowers (i.e. the subsidiaries of BigCo group) and that they maintain active dialogue with investment banks and have their fingers on the pulse of the world bond markets;
- The Minutes will record that all resolutions were passed unanimously.

The substance of the meeting is to tick-box the bond issue and the loan whose terms have been pre-agreed amongst BigCo Inc, BigCo Deutschland AG, and Morgan Sachs, but this is dressed up in an appearance of management control of the B.V. from the Netherlands.

One would, on inspection of the Dutch Trade Registry, find that Mijnheren van Hauta and van der Naersolte are directors of 252 B.V. companies, and a fly-on-the-wall at 15:00 on 3rd November 2016 would find that the meeting took at most 30 minutes. One does not have to go as far as the Oudezijdsvoorburgwal to find Dutch professionals for hire by the ½ hour.

Hauta en Naersolte's fixed fee for running all Board Meetings, supplying two directors, producing the accounts, making all statutory filings etc.: EUR 50,000 per annum. No need for any "extras".

Dutch/Swiss sandwich for really big companies where 0.4% of something is good enough

If we are talking SuperBigCo, though, they might find the Dutch tax amount a little too high for their taste, and then they can make use of the Dutch/ Swiss sandwich where SuperBigCo Finance B.V. opens a branch in one of the Swiss cantons, where it would have an office with staff.

The Dutch tax authorities are willing to amend their Tax Ruling assumptions in this case on the basis of a recognition that 80% of company activities will be conducted through the Swiss branch and be subject to Swiss tax.

If we base ourselves on our earlier example of the B.V. that is on-lending USD1.5 billion, we can re-cast the Dutch tax return in two ways:

- The actuality of the previous example represents the assumptions made by the Dutch Ministry of Finance to issue the Tax Ruling in this example; and then,
- The actuality for this example is once again a multiple of the assumptions, but in this case not so large a multiple: the financing volume here is four times as large, but at an interest margin only ¼% higher – the margin in this example is ¾%;
- This delivers the following numbers, once again using a 1:1 USD/EUR exchange rate:

Assumptions made upon issuance of the Tax Ruling:

Net interest margin: ½% on USD 1.5 billion	EUR 7,500,000
Running costs	EUR 50,000
Profit before tax	EUR 7,450,000
Tax at 20% on the first EUR 200,000	EUR 40,000
Tax at 25% on the remainder EUR 7,250,000	EUR 1,812,500
Total Dutch tax	EUR 1,852,500
Profit after tax	EUR 5,597,500
Effective marginal tax rate	24.8%

Actuality, with the tax fixed as per the Tax Ruling and with no Dutch/Swiss sandwich:

Net interest margin: ¾% on USD 4.5 billion	EUR 33,750.000
Running costs	EUR 50,000
Profit before tax	EUR 33,700,000
Fixed Dutch tax amount under Tax Ruling	EUR 1,852,500
Profit after tax	EUR 31,847,500
Effective marginal tax rate	5.5%

It is not the marginal tax rate of 5.5% that is the blocker in this case: it is the tax amount of nearly EUR 2 million. This is what the multinational objects to and where the Dutch Ministry of Finance is willing to show "fiscal flexibility" on the basis of the existence of the Swiss branch.

The Tax Ruling is issued by the Dutch Ministry of Finance with its 80% deflator factor applied, on the understanding that the main profits will be booked and taxed in Switzerland at the branch. The Dutch figures alter to the revised actuality in terms of business volume, but with much lower Dutch tax.

Actuality, now with the Dutch tax deflated as per the Dutch/Swiss sandwich:

Net interest margin: ¾% on USD 4.5 billion	EUR 33,750.000
Running costs	EUR 50,000
Profit before tax	EUR 33,700,000
Fixed Dutch tax amount under Tax Ruling x 20%	EUR 370,500
Profit after tax	EUR 33,329,500
Effective marginal tax rate	1.1%

Of course this is a lower percentage rate than the 1.8% the Netherlands was getting in the example where there was no Dutch/Swiss sandwich, but the quantum is EUR 370,500 instead of EUR 133,750.

This is not the end of it though, because the Swiss branch is taxed, and – assuming an exchange rate of CHF/USD of 1:1 as well, for ease of comparison – the Swiss cantonal tax authorities take a very relaxed and realistic view as well.

They see a Swiss branch and assume that 80% of the profits are being booked and taxed at the Head Office level, and so exempt 80% of them from Swiss tax. There are greater running costs in Switzerland because the branch has its own office and staff.

The Swiss are looking at the same revenues as the Dutch: the revenue does not double. But the Swiss costs and the Swiss tax are on top of the Dutch costs and tax.

The Swiss branch's figures on their own are:

Net interest margin: ¾% on USD 4.5 billion	CHF 33,750.000
Running costs	CHF 350,000
Profit before tax	CHF 33,400,000
Swiss tax at cantonal rate of 4% x deflator of 20%	CHF 267,200
Profit after tax	CHF 33,132,800
Effective marginal tax rate	0.8%

The combined figures for the B.V., show both the Swiss and Dutch costs and tax and expressed in Euro but assuming 1:1 exchange rates all round, are therefore:

	Dutch B.V. costs & tax	**Swiss branch costs & tax**	**Total P&L account**
Net interest margin: ¾% on USD 4.5 billion			EUR 33,750.000
Running costs	EUR 50,000	CHF 350,000	EUR 400,000
Profit before tax			EUR 33,350,000
Tax	EUR 370,500	CHF 267,200	EUR 642,200
Profit after tax			EUR 32,707,800
Effective marginal tax rate			1.92%

- The Swiss are happy with CHF 350,000 spent there and on graduate-level jobs, plus CHF 267,200 in tax.
- The Dutch are happy with EUR 50,000 spent there on professional services jobs and minimal workload, and EUR 370,500 in tax, with no extra burden on the Dutch welfare bill.

For both sides 1% of something is a lot better than 100% of nothing.

Leveraging the Dutch/Swiss sandwich to circumvent customs duties via "false flag" operations

There is a further but opaque usage to which the Dutch/Swiss sandwich is being put, and it is to obfuscate the country-of-origin of imported goods for the purposes of minimising EU Import Duties.

This can be done in conjunction with Transfer Pricing which is well padded out, so that a multinational, let's called it StarTurn, can run chains of cafes and charge each one USD 35 for a pound of its Arabica coffee, as opposed to a World Market price of USD 4. But then of course the StarTurn coffee has been subjected to complex internal processes that raise its value to a level where the subsidiaries like StarTurn UK, which buy the coffee from StarTurn B.V., see their taxable profits eliminated and the entire EMEA regional profits land at StarTurn B.V., Swiss branch, let's say in Neuchatel for the sake of argument. (The same process could apply to a multinational transferring and selling toner ink cartridges or other goods etc.)

The issue regarding import duties is that, when the coffee arrives in the UK, it is presented as being the legal property of StarTurn B.V., a Dutch resident entity and therefore an EU legal person. Under the terms of the Single Market and its Customs Union no customs duties apply.

This operation needs to be understood in the context of the ownership of customs duties in the EU. They belong to the legal person, *that is the European Community*. Any customs duties that are collected by EU Member States have to be sent to Brussels as the EU's "Own Resources", forming part as they do of the EU's budget income line called "Customs and Sugar Levies".

The figure in the EU's own budget against income from Customs and Sugar Levies is strangely low compared to the volume of imports into the EU: this cannot just be because of the EU's free trade agreements. The EU's Budget is made up of an agreed spending budget – 0.97% of the EU's combined Gross National Income as the Cash spending budget, and 0.26% of GNI as guarantees that the EU can issue. The 0.97%-of-GNI cash resources are met from:

- VAT Receipts = EU's "Own Resources"
- Customs and Sugar Levies = EU's "Own Resources"
- Cash contributions from EU Member States

Any shortfall on the EU's "Own Resources" is made up by increasing the cash contributions from EU member states, *the largest member states paying the most.*

The StarTurn supply chain involves StarTurn B.V. Neuchatel branch owning the coffee, having bought it directly from the growers in Kenya, Brazil and Indonesia, or through an intermediary, and at the world market price. The coffee itself never passes physically through Switzerland: it is shipped to Rotterdam or Amsterdam, and distributed by barge, lorry or container to the EU subsidiaries like StarTurn UK Ltd.

StarTurn B.V. Neuchatel branch pays out the world market price but then charges out with a Transfer Pricing mark-up to its sister companies of as much as USD 30-per-pound.

StarTurn B.V. Neuchatel branch pays the growers straight away but ensures through its agents in Kenya, Brazil and Indonesia that the shipping documents state the name StarTurn B.V. on shipments to the EU.

Note the absence of "Neuchatel branch" in the wording on the shipping documents.

StarTurn B.V. need enter into no transactions and make/receive no payments with StarTurn B.V. Neuchatel branch because *they are the same legal person.*

Upon arrival in Rotterdam the shipping documents are presented to Dutch customs and they stamp them as the property of a Dutch resident:

- not as an import from outside the EU/EEA country such as Kenya, Brazil or Indonesia;
- not as an import from Switzerland i.e. from the Neuchatel branch of StarTurn to the Dutch legal person of whom it is a branch;
- therefore no customs duties are payable - the goods have been presented under a "false flag".

The goods can be transhipped in Rotterdam to the rest of the EU, with transportation documents showing the goods as already being the property of an EU-domiciled natural person i.e. it is an intra-EU supply and not subject to import duties.

This is an example of a Dutch/Swiss sandwich operating in two ways:

1. StarTurn B.V. makes a USD 30+-per-bag turn on the coffee beans, and the tax on that profit is about 2% because each of Switzerland and the Netherlands exempt 80% of the profits from tax;
2. The tag "Neuchatel branch" is inserted into or deleted from documents *as the need arises*, in order to present coffee coming from Jakarta, Mombasa or Santos as already belonging to an EU legal person, but then to book the profits on the trade in the Swiss branch.

The losers are:

- The EU Member States where the coffee is used, because the taxable profits there are sucked out via the Transfer Pricing; and,
- The EU Member States who make large net cash contributions into the EU as these increase as a proportion of the EU cash budget when its Customs & Sugar Levies decrease.

Bank Mendes Gans – dressing intercompany loans up as bank loans and padding out the rates

Finally we have a genuine Dutch bank – Bank Mendes Gans – an independent subsidiary of the Netherland's largest bank, ING – operating in a way that no other bank believes is acceptable by recycling corporate cash deposits out as bank loans to corporates, without recording the deposits or the loans in its own balance sheet. The main effect is to make the loan interest deductible against tax for the borrowing subsidiaries, even if it exceeds the customary limitations on deductibility when a company is borrowing from its own sister companies.

Mendes Gans inserts itself into this relationship between two sister companies for show, to help the borrower characterise the interest paid as "Bank interest" and not "Intercompany interest", without making any pretence that all its loans are not 100% refinanced with deposits from sister companies of the borrower.

Here we draw upon the bank's 2014 Annual Report, approved at the general meeting of shareholders on April 13, 2015 at 15:00 CET at the offices of Bank Mendes Gans, Herengracht 619, Amsterdam. This shows a small bank:

Assets (in EUR millions)		Liabilities (in EUR millions)	
Cash	31	Amounts owed at banks	58
Bank balances at other banks	9,124	Funds entrusted	9,187
Derivatives	38	Derivatives	48
Loans to customers	173	Other liabilities	25
Investment securities	255	Accrued interest and expenses	77
Property and equipment	11	Total liabilities	9,397
Prepayments/accrued income	97	Equity and reserves	332
Total assets	9,729	Total equity, reserves & liabilities	9,729

This is a really small balance sheet that is known to be acting as a lead bank to multinational customers – because its main business line need not be recorded, in the view of the bank itself and its advisers.

Mendes Gans' "Cash Pool"

The bank acts as a lead Cash Management Bank to multinational customers, through its Cash Pool service: "Cash Pool enables you to take control of decentralized cash without inter-company loans and to improve interest results at the same time. You can easily bridge liquidity gaps between regions, currencies and banks. Subsidiaries will no longer have to borrow from their local bank or leave cash idle. This will improve interest earnings and reduce interest expense".

"Cash Pool" is invisible in the published figures. Mendes Gans is taking in credit balances from some parts of multinational groups, and lending them out as overdrafts to other parts of the same groups, in very large amounts. The essence is that the loans taken by one set of subsidiaries are secured on the account balances deposited by other subsidiaries of the same multinational groups. But neither appear in the Mendes Gans balance sheet, because the depositing subsidiaries are dependent upon the borrowing subsidiaries for getting their money back, not supposedly on Mendes Gans. That is the same risk as making an intercompany loan i.e. direct from one sister company to another without Mendes Gans in the way.

"Cash Pool" is made invisible in Mendes Gans' own figures

Mendes Gans' balance sheet and Profit & Loss account show it has no risk on this business i.e. that the business is really being conducted amongst the sister companies:

- No “Cash Pool” loans or deposits in its Balance Sheet;
- No capital held in respect of the risk of default on the loans;
- The interest it credits to the customer deposits as “Interest paid” does not pass through its own Profit & Loss account;
- Nor does the interest it debits to the customer overdrafts as “Interest Received”.

But the Pool participants show a completely different accounting treatment

Notwithstanding that nothing appears in Mendes Gans’ own figures, Mendes Gans issues each subsidiary participating in the “Cash Pool” with the necessary statements to justify an accounting and tax treatment on their side that they are dealing with a bank:

- A borrower:
    - o Balance Sheet - Loan from bank
    - o P & L account - Bank interest paid
- A depositor:
    - o Balance Sheet - Cash in bank
    - o P & L account - Bank interest received

Mendes Gans’ interest enables circumvention of Thin Capitalisation rules

The subsidiaries can show the interest charged on their overdraft by Mendes Gans to their tax inspector, as interest charged by a bank on arm’s-length terms i.e. unsecured and based on the subsidiary’s own creditworthiness:

- The interest is deductible against the corporation tax bill of the borrower;
- Since it is “Bank Interest”, it does not touch the computations that limit the amount of interest that a subsidiary can deduct from its corporation tax bill when the lender is a sister company of the borrower;
- These rules are called Thin Capitalisation and normally state that:
    - o Intercompany loans cannot be more than 100-150% of the subsidiary’s equity before the loan interest cannot be deducted against corporation tax;
    - o The intercompany loan terms must reflect the creditworthiness of the subsidiary in maturity, amount, and security;

- A Mendes Gans loan bypasses those tests because it is a bank loan, even though Mendes Gans makes no customer loans that are not secured on cash deposits from other parts of the same customer.

Opinions are divided as to whether Mendes Gans' stance is defensible on a number of bank technical issues regarding this service, which is known as "Cross-currency notional pooling":

- Mendes Gans and its advisers believe it is;
- Every other bank and banker who has anything to do with notional pooling thinks it isn't.

Mendes Gans' advisers? Dutch-resident professional services suppliers.

What is the damage done to the UK by this?

The key point here, as regards the damage being done to the UK, is what is the amount of money that is invisible in the Mendes Gans Balance Sheet, how much of it is being lent into the UK, and at what interest rate?

These are intercompany loans in substance and the issue is that these will in many cases exceed the permitted amount under Thin Capitalisation Rules where interest ceases to be tax-deductible.

We have to make assumptions about the UK financing volume going through Mendes Gans, what is the excess of this financing amount over the Thin Capitalisation threshold, and what is the rate of interest being applied: interest which should not be tax-deductible.

Let us say that Mendes Gans has 100 multinational customers and each one is holding, on any one day, £400 million on both sides of the coin, loans and deposits. That makes a fictive total of loans of £40 billion, of which we can assume that £4 billion are being lent into the UK, and that this is double the Thin Capitalisation threshold that should apply – meaning that the deduction of interest against tax would be disallowed on £2 billion if these loans were openly contracted as intercompany loans, and not as disguised ones.

Bank Mendes Gans has been under investigation by the European Central Bank for two years about its accounting treatment and capital adequacy, but its customers gained assurance about the correctness of scheme at the recent Eurofinance International Cash and Treasury Management conference in Vienna, where Mendes Gans' advisers made a determined defence: that is Ernst & Young Accountants LLP, Cross Towers, Antonio Vivaldistraat 150, 1083 HP Amsterdam.

How much money is leaking out of the UK due to these techniques?

The leakage is at the margins compared to business models like IT giants booking their UK sales out of European bases in Ireland and Luxembourg, but we can make some conservative estimates:

Dutch finance B.V.

Cause of leakage	UK subsidiaries of multinationals paying ½% more on their financing through the B.V. than they would pay if they borrowed direct, and increasing their interest deducted against tax
Volume leakage is ocurring on	GBP 20 billion of loan outstandings from B.V. companies into the UK
Calculation of leakage	GBP 20 billion x ½% x 19% lost corporation tax
Leakage amount	**GBP 12 million** per annum in lost corporation tax

Dutch/Swiss sandwich - finance

Same as the Dutch finance B.V. in principle but:

- Bigger amounts – x 10
- Not such a large interest margin lost – 3/8% instead of ½%
- Meaning **GBP 89 million** per annum in lost corporation tax

Dutch/Swiss sandwich – coffee – high Transfer Pricing

Cause of leakage	UK subsidiaries of companies like StarTurn paying USD 34 per-pound on their Arabica coffee rather than the USD 4 per-lb world market price; this reduces their corporation tax
Volume leakage is ocurring on	30,000 tons of coffee per annum to supply the entire UK, meaning 67.2 million lb
Calculation of leakage	67.2 million lb x USD 30 / 1.22 x 19% lost corporation tax
Leakage amount	**GBP 314 million** per annum in lost corporation tax

Dutch/Swiss sandwich – coffee – avoidance of Import Duties

Cause of leakage	UK EU Member State cash contributions rise by 16% of the import duties avoided, the UK's GNI being 16% of EU GNI
Volume leakage is ocurring on	187,500 tons of coffee per annum to supply the entire EU, meaning 420 million lb
Calculation of leakage	420 million lb x USD 30 x 5% avoided duties = total rise needed in EU Member State cash contributions in EUR
Leakage amount	EUR 630 million rise needed in EU Member State cash contributions X 16% = EUR 100 million rise needed in UK Member State cash contribution, which approximates to **GBP 100 million**

Bank Mendes Gans – deductibility of interest against UK corporation tax

Cause of leakage	UK subsidiaries of multinationals can deduct, on supposed Bank Debt, amounts of interest that would be disallowed for deduction against corporation tax if the loans were made by sister companies
Volume leakage is ocurring on	GBP 2 billion – half of the assumed UK loan book of Bank Mendes Gans, because this is the excess over the restriction on Thin Capitalisation
Calculation of leakage	GBP 2 billion x all-in interest rate of 4% x 19% lost corporation tax. NB: this one does not just apply to the loan margin, but the whole interest coupon
Leakage amount	**GBP 152 million** per annum in lost corporation tax

Conclusion

Pulling together the figures in the above section, we come to an estimated annual leakage of just over GBP660 million per annum:

Technique	Leakage in GBP millions p.a.
Dutch finance B.V.	12
Dutch/Swiss sandwich – finance	89
Dutch/Swiss sandwich – coffee – high Transfer Pricing	314
Dutch/Swiss sandwich – coffee – avoidance of Import Duties	100
Bank Mendes Gans – deductibility of interest against UK corporation tax beyond Thin Capitalisation limits	152
Total	667

The categories that could be much higher are both through the Dutch/Swiss sandwich, because the estimates above are for the coffee business *only* – and the Dutch/Swiss sandwich is used across *many* industries, meaning:

- further losses on Transfer Pricing; and,
- an even greater rise of UK's EU Member State cash contribution due to the connivance of Switzerland and the Netherlands to avoid EU Import Duties.

It is therefore justifiable to expect that the lost revenues in total amount to a figure in the low billions. This total amount of leakage does not come into the same category as that from business models like IT giants booking their UK sales out of European bases in Ireland and Luxembourg (estimated at £10bn) – or our annual net EU member state cash contribution of £10bn.

What we have to remember, though, is that these techniques represent an institutionalised, industrial-scale work effort by one – and indeed not an isolated one – EU Member to chip away at the tax base of one of its European "partners", and to accumulate professional services work and income to itself, with a little bit of tax as the icing on the cake.

Ironically, it is rather like a Dutch Auction in corporation tax where the original tax that might be due is bid down until the moment someone offers to pay *something*.

The other EU Member State “partners” involved have been happy to work both with one another – and with EEA Member States like Switzerland – to share out the benefits, where they are big enough to support two or three lots of pigs living in clover.

This is another strong reason for our leaving the Single Market and imposing proper terms for our external relationship with other countries, and for taking control of setting the terms upon which foreign multinationals can have access to the UK market.

Bob Lyddon 8 December 2016

Summary of
The Single Market's Dutch Auction

How the EU's Single Market fosters corporate tax avoidance schemes that costs the UK billions

- The Netherlands has built up an industry out of becoming the focus of international financing structures – promoting its own revenues to the detriment of EU "partners" like the UK;
- These Dutch practices are estimated to be costing the UK over £650 million per annum in lost corporation tax;
- The Dutch B.V. company style and the Netherlands' wide network of beneficial Double Taxation Treaties are the bedrock of their approach;
- It is supplemented by a mantra of "I'd rather have 2% of something than 100% of nothing" applied on a grand scale, and includes the following specifics:
- Issuing Tax Rulings for fixed, annual amounts of tax payable by a B.V., even when the assumptions used to calculate the amount were implausible and when they differ from the B.V.'s actual profits; and
- Fostering a regime where Dutch lawyers and trust companies stretch credibility in the practices used to prove that management control of the B.V. is being exercised from the Netherlands; and
- Co-operating with other countries – initially Belgium but now principally Switzerland – to allow the largest multinationals to almost eliminate any corporation tax as long as they agree to a certain level of spending in the Netherlands and Switzerland; and
- Enabling the corporation's taxable profits from the larger EU Member States to be conduited into Switzerland via high Transfer Pricing and via intercompany loans with high interest margins added to them; and
- Enabling imports of goods from non-EU countries to be documented as the property of a Dutch B.V. when they arrive in a port like Rotterdam, circumventing EU customs duties, and causing EU Member State cash contributions to rise – and to rise most for the largest counties, like the UK; and finally
- Enabling a small bank to operate out of the Netherlands whose speciality is to dress up Intercompany Loans as Bank Loans, thereby circumventing controls on deductibility of intercompany loan interest against tax, and reducing the UK's corporation tax-take;
- All of this has the effect of reducing the UK's corporation tax receipts,

other than the one where our EU Member State cash contribution is made to increase;

- The Netherlands has trained an army of professional services staff to operate these practices;
- The Netherlands has been happy to work both with other EU Member States and with EEA Member States like Switzerland to share out the benefits, where they are big enough to keep two or three lots of pigs in clover;
- This is another strong reason for the UK leaving the Single Market and imposing proper terms for our external relationship with other countries, and for taking control of setting the terms upon which foreign multinationals can have access to the UK market.

About the author...

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Bob Lyddon is an experienced management consultant both privately and with PwC. Recent engagements include running an international banking alliance, advising small payment providers how to access UK payment systems, and advising a major player in global payments as to the opportunities and threats arising from the establishment the UK's Payment Systems Regulator.

With PwC Bob managed several Euro implementation programmes. Prior to that, he had a diverse 17-year career in international banking, encompassing Transaction Banking, syndicated loans, export finance and derivatives.

Bob holds a First Class degree in Modern Languages from the University of Cambridge.

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