

The New Dutch Conditional Withholding Tax And Hybrid Entities

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In this installment of In Step With Stibbe, Tolman and Molenaars explain the Netherlands' conditional withholding tax regime, which applies to interest and royalty payments to low-tax jurisdictions and aims to curtail profit shifting, and its implications for hybrid entities.

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As of January 1 the Netherlands levies a conditional withholding tax (CWHT) on interest and royalty payments to low-tax jurisdictions (LTJs). The CWHT may also apply for indirect payments to LTJs and if the recipient is a hybrid entity in a non-LTJ. In addition to the CWHT on interest and royalty payments, a legislative proposal is pending to extend the CWHT to dividends. On September 30 the Lower House adopted it, and if adopted by the Upper House, the CWHT on dividends is expected to become effective January 1, 2024. The CWHT rate equals

the highest Dutch corporate income tax rate, which is 25 percent but may slightly increase in 2022.

The CWHT Act 2021 (Wet bronbelasting 2021) contains two provisions on interest and royalty payments to hybrid entities. Because of the broad scope of these hybrid entity provisions, CWHT may be due even if no LTJ is involved in the structure. The CWHT Act contains escape rules for hybrid entities, but they lacked clarity until a welcome clarification was announced on Budget Day.¹ This article focuses on the CWHT, in particular in hybrid entity situations, and the clarification.

CWHT on Interest and Royalty Payments

In essence, the aim of the CWHT is to discourage the use of the Netherlands to channel interest and royalty payments to LTJs and to discourage the shift of taxable income to LTJs. For the CWHT Act, a jurisdiction is an LTJ if it:

- does not levy a tax on profits or has a statutory profit tax rate of less than 9 percent; or
- is included on the EU list of noncooperative jurisdictions.²

The CWHT can also be triggered if the payments are made for genuine business

¹ Budget Day in the Netherlands was on September 21.

² Decree on low-tax and noncooperative jurisdictions for tax purposes (DB 2018/216528). To the extent an LTJ is a jurisdiction with which the Netherlands has concluded a double tax treaty, it will be deemed a non-LTJ until three calendar years after the date the jurisdiction was first included in the list of LTJs. The three-year period aims to give both tax treaty partners sufficient time to renegotiate the double tax treaty. The following jurisdictions will qualify as an LTJ based on the EU list of noncooperative jurisdictions: American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, U.S. Virgin Islands, and Vanuatu (as of October 5).

purposes or if the beneficiary of the payment performs genuine economic activities in an LTJ.

The CWHT applies only to interest and royalty payments between related entities.

Entities are related if:

- the recipient has a qualifying interest in the interest or royalty-paying entity;
- the interest or royalty-paying entity has a qualifying interest in the recipient entity; or
- a third entity has a qualifying interest in both the recipient and the interest or royalty-paying entity.

An interest is considered a “qualifying interest” if it represents enough influence in the decision-making process of an entity that the entity’s activities can be determined. For example, this is the case if the interest represents more than 50 percent of the statutory voting rights in an entity (that is, controlling rights). Even if an entity does not have a qualifying interest on its own, it can still be considered to hold one if it holds enough interest together with other entities as part of a cooperating group. Whether a group of entities qualify as a cooperating group should be determined on an all facts and circumstances test.

The CWHT Act also contains an antiabuse provision to prevent the avoidance of CWHT by interposing an entity (conduit company) in a non-LTJ. The antiabuse provision is triggered in cases in which:

- the related entity in a non-LTJ is entitled to the interest or royalty payment with the main purpose, or one of the main purposes, of avoiding CWHT in the hands of an entity in an LTJ (the subjective test); and
- there is an artificial arrangement or transaction, or a series of artificial arrangements or transactions (the objective test).

An arrangement or transaction, or series of arrangements or transactions, is regarded as artificial to the extent that it is not put into place for valid commercial reasons reflecting economic reality.

Provisions Aimed at Hybrid Entities

Under the hybrid entity provisions in the CWHT Act, CWHT may be triggered in cases in which payments are made to:

- an entity that is considered transparent for Dutch tax purposes and nontransparent in the state of the participants in the entity; or
- an entity that is considered nontransparent for Dutch tax purposes and transparent in the state of the participants in the entity.

Below we will address the latter situation in more detail, including the recent clarification on the escape rule.

Example

In the case of a hybrid entity that is considered nontransparent for Dutch tax purposes and transparent for the participants, the entity (for example, a U.S. limited liability company)³ is considered the recipient of the interest or royalty payment for Dutch tax purposes and accordingly in scope of the CWHT.⁴ However, under the escape rule,⁵ the hybrid entity should not be subject to CWHT if it can be substantiated that each of the participants in the hybrid entity that has a qualifying interest in it:

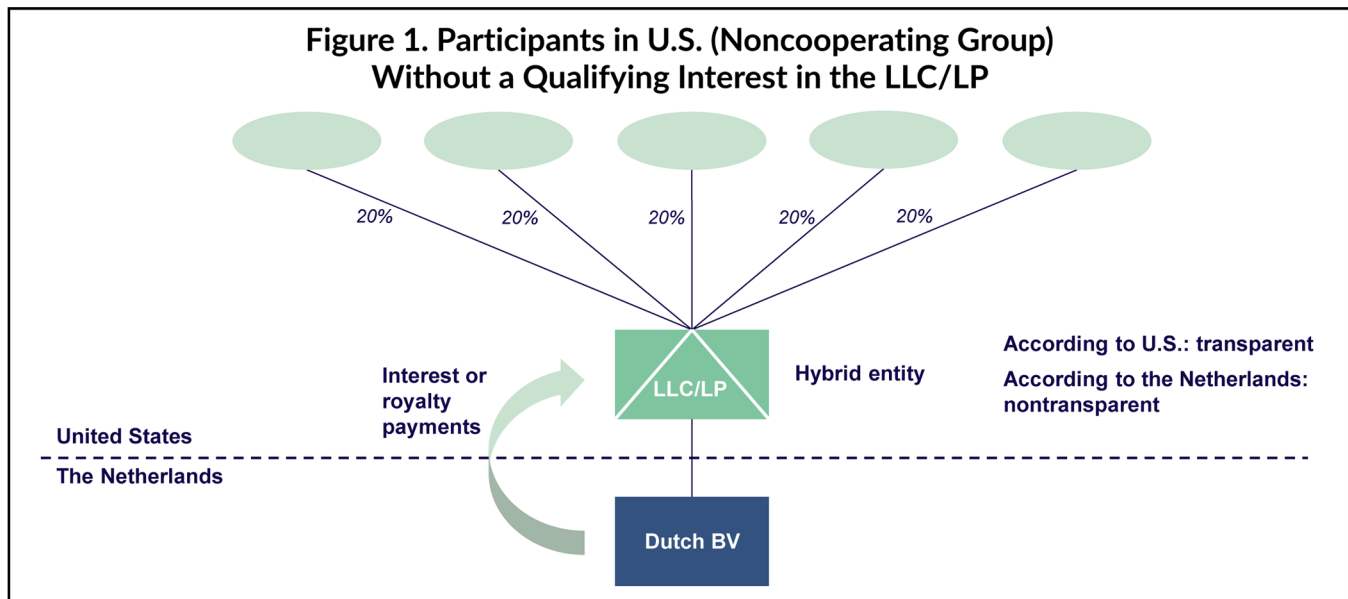
- is treated as the recipient of the payment in its jurisdiction of incorporation; and
- would not have become subject to CWHT if it received the payment directly from the Netherlands.

In practice, however, it was unclear whether the escape rule could be relied on if there were no participants with a qualifying interest (alone or as part of a cooperating group). This is illustrated in Figure 1. A U.S. LLC (or U.S. limited partnership (LP)) may have various members (or multiple partners) located in non-LTJs that are not considered to have a qualifying interest in the U.S. LLC (or U.S. LP). It was therefore unclear whether a U.S. LLC (or U.S. LP) could rely on the escape rule to avoid the scope of the CWHT.

³ A new legislative proposal dealing with the Dutch entity classification rules is expected in the winter of 2021-2022. However, under these new classification rules a U.S. LLC is unfortunately still expected to qualify as nontransparent for Dutch tax purposes.

⁴ On January 1, 2020, the Netherlands (already) implemented the second EU anti-tax-avoidance directive (ATAD 2, 2017/952/EU), amending ATAD 1 (2016/1164/EU), containing rules to neutralize the consequences of hybrid mismatches as a result of which payments to hybrid entities may not be deductible for Dutch corporate income tax.

⁵ In some circumstances, the escape rule can be relied on if there are multiple levels of hybrid entities.



Based on a literal reading of the escape rule, one could argue that in this situation, it is not possible to rely on the escape rule because at least one participant with a qualifying interest in the hybrid entity would be required. However, this view seems to conflict with the object and purpose of the CWHT Act, given that the members in the U.S. LLC (or U.S. LP) — as illustrated in Figure 1 — would not have been in scope of the CWHT if they had held their interest in the Dutch interest or royalty-paying entity directly (they should not be worse off solely by holding their interest via a hybrid entity).

A Welcome Clarification

On Budget Day, the Dutch government announced that hybrid entities (that are qualified as nontransparent for Dutch tax purposes and transparent by its participants, as illustrated in Figure 1) can rely on the escape rule (and accordingly not be in scope of CWHT) if none of the participants has a qualifying interest in the hybrid entity. The clarifying legislative amendment was published on October 5.⁶

To amend the CWHT, it is proposed to add a new subsection to the escape rule for interest or royalty payments to these types of hybrid entities, as a result of which no CWHT is due if no

participants in the hybrid entity have a qualifying interest. This outcome also matches the rationale of the CWHT Act, because the participants in Figure 1 would not have been subject to CWHT if the Dutch paying entity had paid the interest or royalties directly to the participants. Given the uncertainty addressed above, this clarification is very welcome. The amendment — if enacted⁷ — is expected to have retroactive effect to January 1, the entry into effect date of the CWHT Act.

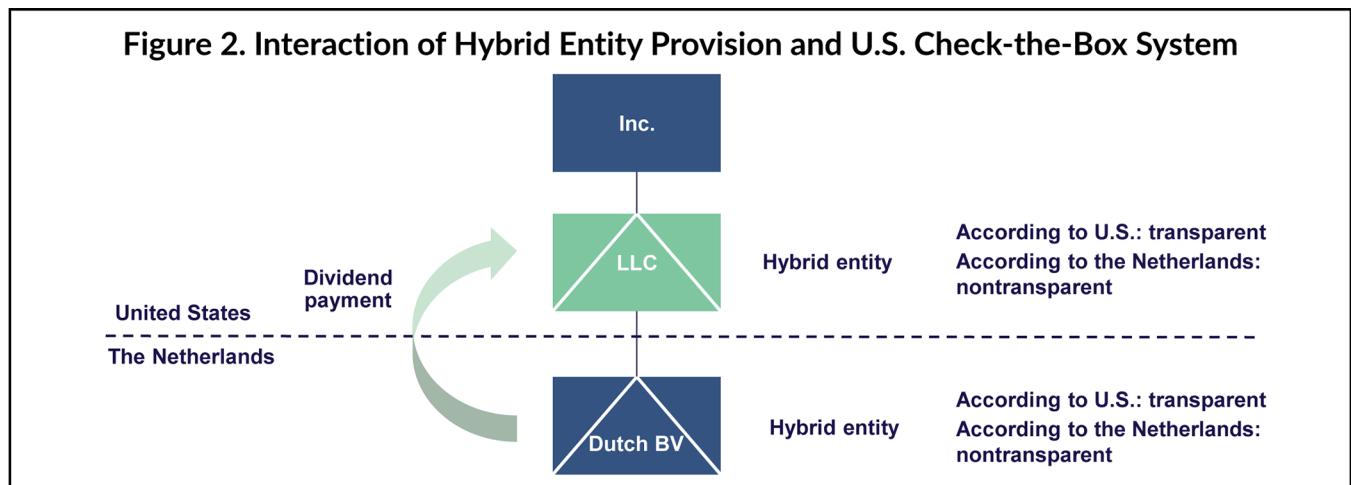
CWHT on Dividends

The CWHT on dividends will be levied under the same principles as the CWHT Act for interest and royalty payments. During the legislative debate on the introduction of the CWHT on dividends, further issues were addressed that apply to the CWHT on interest and royalty payments.

One of these is the interaction between the hybrid entity provisions in the CWHT Act and the U.S. check-the-box system. This interaction could have an undesirable outcome if, for example, a (for U.S. tax purposes) checked Dutch entity makes a dividend payment to a U.S. LLC (considered transparent from a Dutch tax perspective), which is held by a U.S. corporation

⁶ Parliamentary Papers, Upper Chamber, 35 928, no. 7, at 2, 5, and 10-12 (Oct. 5, 2021).

⁷ Because the legislative amendment is part of the Budget Plan package, enactment is expected by mid-December.



(illustrated in Figure 2).⁸ From a U.S. tax perspective, the U.S. corporation would not recognize the dividend payment, but Dutch tax rules may — based on a literal reading — require that the dividend payment be “picked up” by the U.S. corporation to rely on the escape rule introduced for hybrid entities (otherwise a CWHT of 25 percent may be withheld from dividend payments from the checked Dutch *besloten vennootschap* (BV — private limited company) to the U.S. LLC).⁹ The Dutch government is considering this situation and the possible need to amend legislation.

⁸Dutch Association of Tax Advisers (Nederlandse Orde van Belastingadviseurs), “Commentary to the Legislative Proposal CWHT on Dividends,” at 5 (May 12, 2021). This issue is also relevant in cases of interest or royalty payments from the BV to the LLC.

⁹Without taking the effects of the Netherlands-U.S. treaty into consideration.

Concluding Remarks

The Netherlands introduced the CWHT on interest and royalty payments at the start of this year. It may also apply in cases in which interest and royalty payments are made to hybrid entities in non-LTJs. Earlier this month, a legislative amendment was published, announced on Budget Day, that clarified that a hybrid entity (that qualifies as nontransparent for Dutch tax purposes) may rely on the escape rule and not be subject to CWHT if none of the participants has a qualifying interest in the hybrid entity.

Given the broad scope of the hybrid entity provisions, this is a very welcome clarification. Without it, the CWHT would arguably apply in situations in which a U.S. LLC or U.S. LP is widely held. The legislative process to introduce a CWHT on dividends starting January 1, 2024, is still pending, and hopefully this process will provide for further clarity on the interpretation of the escape rules concerning hybrid entities, for example in cases in which a U.S. tax perspective would apply the check-the-box rules. ■