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Rulings Hold Dividends on Stock Held Through Hybrid Entities are Eligible for Zero Withholding Tax Benefit Under U.K. and Dutch Income Tax Treaties

I.R.S. Priv. Ltr. Rul. 200522006 (Mar. 4, 2005); Decree of the Government of the Netherlands Interpreting U.S.-Netherlands Income Tax Treaty (July 6, 2005).

Overview

In separate rulings, the two tax authorities hold that dividends on stock owned through foreign entities that made check-the-box elections were eligible for the zero withholding tax on dividends, as if the owners of the entities directly owned the 80% subsidiaries paying the dividends, under the U.S. income tax treaties with the U.K. and the Netherlands, respectively. These rulings are significant because they give effect to the U.S. check-the-box regime in the context of income tax treaties.

P.L.R. 200522006

Under the U.S.-United Kingdom Income Tax Treaty (the "U.K. Treaty"), a U.K. corporation is not subject to U.S. withholding tax on dividends received from a U.S. corporation if the U.K. corporation has owned at least 80% of the voting power of the shares in the U.S. corporation for the 12-month period ending on the dividend declaration date. The Treasury Department Technical Explanation states that the shares in the dividend paying corporation must be "owned directly" by a company that is eligible for benefits under the treaty.

In P.L.R. 200522006, the taxpayer, a U.K corporation, owned 100% of the stock of a U.S. subsidiary. The taxpayer acquired the shares of the U.S. subsidiary from two wholly-owned entities formed by the taxpayer under the laws of a third country. Both of the third country entities elected to be a disregarded entity for U.S. income tax purposes under the check-the-box regime. Less than 12 months after the date the taxpayer acquired the shares of the U.S. subsidiary, the U.S. subsidiary redeemed some of its stock from the taxpayer in a transaction that was treated as a dividend for U.S. income tax purposes.

The IRS considered the taxpayer the direct owner of the shares of the U.S. subsidiary under the U.K. Treaty during the period the shares were held by the disregarded entities even though the disregarded entities were formed under the laws of third countries. The ruling reasoned that while the Technical Explanation required "direct" ownership of the requisite number of shares, there was no discussion of the types of ownership that would constitute direct ownership. The general interpretative provisions of U.K. Treaty provide that, unless the context otherwise requires, a term that is not defined in the treaty has the meaning it has under the law of the country that is applying the treaty provision. Therefore, under U.S. law, the owner of a disregarded entity is treated as owning shares owned by the disregarded entity. The ruling further holds that attribution of stock held by a disregarded entity to its U.K. owner is consistent with the policy behind the one year holding period for the 80% stake in the dividend paying company to prevent short-term shifting of ownership in order to claim the benefit of the zero rate of withholding. The ruling observes that this policy is distinct from the general issue addressed in the treaty's limitation on benefits provision.

Decree under the U.S.-Netherlands Income Tax Treaty

On December 28, 2004, the Protocol amending the U.S.-Netherlands Income Tax Treaty (the "Dutch Treaty") took effect, subject to a grandfather provision that allows taxpayers to elect to delay the effective date of the Protocol for one year. The most significant provisions in the Protocol are the elimination of withholding tax on certain dividends paid to 80% corporate shareholders and a much needed rewrite of the limitations on benefits provision in the treaty ("LOB"). The Protocol also added a hybrid entity clause to Article 24 of the Dutch Treaty

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to combat abusive structures involving hybrid entities. The provision provides that income received by a hybrid entity is only eligible for the benefits of the treaty if it is treated as income of a resident of a treaty country under the law of both the Netherlands and the U.S.

Prior to the Protocol, the Dutch Treaty did not contain a specific provision on hybrid entity structures and many U.S. companies invested in the Netherlands through the so-called CV/BV structure. Under this structure a U.S. company is the sole limited partner in a Dutch limited partnership (or a "CV") and the CV is the owner of the shares of a Dutch limited liability company (or "BV"). The CV is a fiscally transparent entity for Dutch income tax purposes; however, for U.S. income tax purposes, it is treated as a corporation pursuant to a check-the-box election. The BV is a corporation for both Dutch and U.S. income tax purposes.

For Dutch purposes, a dividend paid by the BV to the CV is treated as if it were paid to the limited partner in the CV – a U.S. taxpayer. Prior to implementation of the Protocol, the dividend was eligible for reduced withholding tax under the Dutch Treaty even though under U.S. law the dividend was not taxed because the CV is a foreign corporation with no U.S. presence. Under the Protocol, however, the Dutch Treaty no longer applies to reduce the withholding tax on a dividend paid to the CV because the dividend is not considered income of a U.S. resident under U.S. law (or of a Dutch resident under Dutch law). This result has generated significant criticism because it could force U.S. companies with a substantial business presence in the Netherlands to undertake costly restructurings (and possibly leave the Netherlands or reduce their presence there). People have also questioned whether the result is consistent with the policy behind the zero withholding tax for dividends from 80% subsidiaries, at least in the case of U.S. companies with a substantial business presence in the Netherlands.

On July 6, 2005, in response, Joop Wijn, the State Secretary of Finance in the Netherlands, issued a Decree that provides that the hybrid entity provision in the Protocol will not apply to a dividend paid to a fiscally transparent entity under Dutch law that is treated as a corporation under U.S. law provided the Dutch company that pays the dividend is engaged in "real" activities in the Netherlands. A company will be considered to be engaged in real activities in the Netherlands if (i) it has directors who are residents of the Netherlands, they make their decisions in the Netherlands and they have sufficient professional qualifications; (ii) it maintains accounts in the Netherlands including its main bank account; and (iii) it has sufficient equity and it is engaged in reasonable economic activity. The Dutch authorities will issue rulings under their advance tax ruling program (ATR) on whether the activities of a Dutch company satisfy this standard.

The Decree is effective for dividends paid by Dutch companies on or after January 1, 2006. For 2005, taxpayers may invoke the Protocol's grandfather rule to apply the provisions of the Dutch Treaty prior to amendment by the Protocol.

Planning Considerations

Both P.L.R. 200522006 and the Decree are welcome pro-taxpayer applications of the check-the-box regime in the income tax treaty context. We will be watching to see if this trend continues. More specifically, U.S. companies that have invested in the Netherlands through a CV/BV structure will need to analyze the Decree to determine whether they are eligible for relief and, if they are, they must elect the grandfather rule in the Protocol to avoid withholding tax on any dividends received during 2005. Similarly, in light of P.L.R. 200522006, U.K. companies with U.S. subsidiaries should consider potential benefits in structuring their U.S. subsidiaries through hybrid entities in third countries that are disregarded for U.S. income tax purposes.

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