CHANGES ANNOUNCED TO DUTCH ENTITY CLASSIFICATION RULES AND TAX REGIMES FOR FUNDS

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Tags
A.T.A.D.
Closed C.V.
F.B.I.
F.G.R.
Open C.V.
V.B.I.

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INTRODUCTION

In the Netherlands, traditionally the third Tuesday in September, which is known as Princes' Day, marks the opening of the new parliamentary year. At this occasion, the budget for the next year is also presented to parliament, including a "Tax Plan" (*Belastingplan*) containing fiscal measures.

The 2024 Tax Plan was presented on September 19, 2023, by the sitting Dutch government, which is merely a caretaker cabinet, which remains in office until a new coalition has been formed after the November general elections. Nonetheless, the Tax Plan comprises a number of legislative proposals that, if adopted by parliament, will have a significant impact on businesses and financial institutions, particularly in relation to Dutch investment institutions. The general consensus is that the legislative process should continue, since most of the proposals were subject to public consultation previously and some are long overdue.

The latter applies particularly to the measures concerning fundamental changes to Dutch entity classification rules, notably those applicable to a Dutch limited partnership (*commanditaire vennootschap* commonly referred to as a "C.V.") or a foreign partnership, as well as a Dutch fund for joint account (*fonds voor gemene rekening* or "F.G.R.").

Since existing Dutch entity classification rules substantially deviate from those applied in most other jurisdictions, the rationale for introducing entirely new rules is to reduce the number of hybrid mismatches. Following the implementation of the second iteration of the E.U. Anti-Tax Avoidance Directive ("A.T.A.D'.), such mismatches typically cause undesirable complexity. Therefore, the Dutch tax authorities are now prepared to abandon the entity classification rules that traditionally applied in the Netherlands.

Initially, the intention was to change Dutch entity classification rules that were in effect from January 1, 2022, which coincides with the implementation of A.T.A.D.2. However, due to severe criticism received from market parties during the public consultation at the time, the process was delayed. Most of the criticism came from Dutch financial institutions, claiming they would be adversely impacted by the originally proposed changes to the classification rules for a Dutch F.G.R. Although this is reflected in the current proposed legislation, these rules are removed from the new rules for classifying a Dutch C.V., and laid down in a separate legislative proposal.

The 2024 Tax Plan includes a proposal to amend the two specific Dutch tax regimes for funds, *i.e.*, the criteria to qualify as an exempt investment institution (*vrijgestelde beleggingsinstelling*) or a fiscal investment institution (*fiscale beleggingsinstelling*). In order to allow taxpayers sufficient time to adapt their structures accordingly, it is proposed that all of these measures will enter into force as of January 1, 2025.

In this article, the main contours of the above legislative proposals and their implications for investment in or via the Netherlands are discussed.

PARTNERSHIPS

General Partnership

In the Netherlands a general partnership is fiscally transparent by default. Obviously such classification is not affected by the 2024 Tax Plan. However, at present, an exception to this rule still applies to a Dutch partnership with a capital divided into shares (*personenvennootschap waarvan het kapitaal geheel of gedeeltelijk in aandelen is verdeeld*). While that type of partnership currently is treated as opaque for Dutch tax purposes, under the new rules it will also become fiscally transparent.

C.V.

In comparison to a general partnership, a limited partnership such as a Dutch C.V. has two different types of partners: a general partner with unlimited liability and one or more limited partners, each having liability capped at the amount of capital contributed. Due to the combination of limited liability and legal flexibility, the legal form of a limited partnership is often used for structuring investment funds, particularly real estate ventures and private equity funds.

However, the existing Dutch entity classification rules are rather complex for a C.V., since a Dutch limited partnership or a comparable foreign limited partnership may either qualify as opaque – meaning it is subject to Dutch corporate income tax for its own account – or fiscally transparent. The former is known as an open C.V./L.P., while the latter is commonly referred to as a closed C.V./L.P.

Under current law, fiscal transparency based on closed C.V. status requires a limited partnership to meet certain stringent restrictions regarding the admission of new partners, as well as the transfer of a limited partnership interest. In a nutshell, both require the written prior approval of all partners. Although this principle stems from the notion that forming a partnership has a personal character, that approach has become rather obsolete, particularly within the context of an investment fund. Moreover, applying these restrictions is generally perceived to have an adverse commercial effect.

For this reason, as well as to align Dutch entity classification rules with common international standards, the proposed new entity classification rules completely abandon the criterion of consent, which represents a significant shift in the Dutch fiscal framework. Instead, the proposed new rules entail that, going forward, all Dutch and foreign limited partnerships will be treated as fiscally transparent, *i.e.*, regardless of any further criteria and without exception.

Foreign Entity Without a Dutch Equivalent

In addition to partnerships, certain entities exist under foreign law in a legal form which does not have an equivalent under Dutch law. Where such entity is a non-resident taxpayer, it is proposed that going forward the Netherlands will simply follow the fiscal classification in the relevant foreign jurisdiction. This rule would apply in case such foreign entity must recognize taxable income in the Netherlands (*e.g.*, from real estate or a permanent establishment), holds an interest in a Dutch entity, or vice versa.

By contrast, where such noncomparable foreign entity is considered to be a tax resident in the Netherlands, it will be treated as a taxable entity in the Netherlands, and thus opaque for Dutch tax purposes, regardless of its fiscal qualification in the jurisdiction under which laws it exists.

Transitional Law

Since all limited partnerships will be treated as fiscally transparent going forward, the phenomenon of the taxable open C.V. will cease to exist once the new rules enter into force. As a result, an open limited partnership will be deemed to transfer its assets and liabilities in return for fair market value consideration immediately prior to that moment, which may lead to recognition of unrealized taxable profits such as goodwill and hidden reserves. Concomitantly, the limited partners in an open C.V. will be deemed to acquire their *pro rata* share in the partnership's assets and liabilities, meaning they will be entitled to a corresponding step-up in base.

To mitigate the effects of gain recognition without the receipt of cash consideration, transitional legislation has been proposed. Although the wording of such legislation might suggest that its scope is restricted to an open C.V. and its participants, the explanatory notes seem to indicate that it extends to any foreign limited partnership that is subject to tax in the Netherlands under current law.

In any case, the relevant transitional law stipulates that, provided certain conditions are met, a limited partner may contribute its limited partnership interest into another Dutch taxable entity in a tax neutral way, *i.e.*, through a share-for-share merger. Should the assets of the partnership comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply in such case.

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In addition, the proposed transitional legislation facilitates rollover relief for latent capital gains on interests held in a limited partnership, which might otherwise need to be recognized at the moment the new rules enter into force.

As a last resort, corporate taxpayers may request payment deferral over a period of up to ten years in relation to any Dutch tax due as a result of the disappearance of the open C.V.

FUND FOR JOINT ACCOUNT

Unlike a C.V., which has its specific legal basis in the Dutch Civil Code, the legal form of an F.G.R. is purely a contractual arrangement. As such, in the Netherlands an F.G.R. is commonly used for collective investment. Although in principle an F.G.R. may be used for a wide range of asset classes, including private equity and real estate, in practice it is mostly used for structuring hedge funds and collective investments in transferable securities.

As is the case for a C.V. or comparable foreign limited partnership, the entity classification rules that currently apply in the Netherlands to a Dutch F.G.R. or a comparable mutual fund established under foreign law are quite complex. They may be classified either as opaque, and for that reason, subject to Dutch corporate income tax or fiscally transparent. Similar to a C.V., the former is known as an open F.G.R. and the latter is commonly referred to as a closed F.G.R.

Under current law, in order to create fiscal transparency, participations in the F.G.R. may not be considered as freely tradable. That result is commonly achieved in one of two ways. The first is to apply the same restrictions to a transfer of participations in the F.G.R. that apply in case of a closed C.V. Consequently, this implies that a transfer of participations in a closed F.G.R requires written prior approval from all other participants. The second is to provide restrictions in the constituent documents that participations can be transferred only to the F.G.R,. itself. This is commonly known as the redemption model. Any other form of transfer is null and void. Either way, the participations in the fund are not considered to be freely tradable.

Going forward, the requirement of consent will no longer play a role in determining whether an F.G.R. or a comparable fund under foreign law should be treated as a partnership. By contrast, restricting free transferability of participations through mandatory use of the redemption model will largely survive the changes to Dutch entity classification rules.

Under the 2024 Tax Plan, any F.G.R. that is not regulated by definition qualifies as a closed F.G.R. Only a U.C.I.T.S. (*instelling voor collectieve belegging in effecten*) or other investment institution (*belegginginstelling*) as defined in the Financial Supervision Act (*Wet op het financieel toezicht*) may qualify as an open F.G.R. This implies that going forward, family funds and other relatively small ventures will be treated as fiscally transparent, unless they change the structure to fall within the definition of a U.C.I.T.S. or other investment institution and thus to accept regulation.

Typically, regulated funds are eligible for the two special Dutch tax regimes for investment institutions, meaning that fiscal transparency may not be desired in all cases. However, during the public consultation it became clear that many regulated investment institutions in the Netherlands still prefer fiscal transparency over application of either of the two special regimes. For this reason, following the consultation an exception was added to the Tax Plan, which essentially means that the redemption model remains in existence. On that basis, as before, a regulated F.G.R. can still qualify as fiscally transparent by virtue of the fact that its participations are not considered freely tradable.

Transitional Law

Since any F.G.R. that is not regulated will be treated as fiscally transparent under the new rules, an existing open F.G.R. which is not in scope of the Financial Supervision Act will cease to be a taxable entity once these rules enter into force. Consequently, an open F.G.R. will be deemed to transfer its assets in return for fair market value consideration immediately prior to becoming fiscally transparent, thereby triggering recognition of all unrealized capital gains for Dutch tax purposes. At the same time, participants in an open F.G.R. will be deemed to acquire their *pro rata* shares in the fund's assets at fair market value, meaning that in principle they will be entitled to a corresponding step-up in basis.

To mitigate the effects of the above, transitional legislation is proposed for an open F.G.R. First, to the extent the investors in the F.G.R. are subject to Dutch corporate income tax, an election for rollover relief can be made, meaning that such investors continue the fiscal book value of their *pro rata* share in the fund's assets. In that case, the investors forego a step-up in basis and the F.G.R. does not recognize any unrealized capital gains.

Another possibility is to defer payment of the corporate income tax due on capital gains recognized upon the deemed asset transfer. Gain would be recognized over 10 years.

Finally, the transitional law offers a participant the possibility to contribute its participation into another Dutch taxable entity in a tax neutral way by participating in a share-for-share merger, provided certain conditions are met. Should the fund's assets comprise real estate situated in the Netherlands, an exemption from real estate transfer tax may apply, as well.

EXEMPT INVESTMENT INSTITUTION ("V.B.I.") REGIME

As discussed above, under the proposed new entity classification rules, a regulated F.G.R., other than one that applies the redemption model to achieve fiscal transparency, qualifies as an open F.G.R., which implies that it is subject to Dutch corporate income tax. However, this does not necessarily imply that the F.G.R. actually pays tax in the Netherlands, since it may well be eligible for one of the two special Dutch tax regimes for investment institutions.

One of these regimes is the exempt investment institution regime (*vrijgestelde beleggingsinstelling*, commonly referred to as a "V.B.I. regime"). In a nutshell, the V.B.I. regime entails that the investment institution is exempt from Dutch corporate income tax and not obliged to withhold Dutch dividend tax on its profit distributions. To qualify for the V.B.I. regime, the investment institution must meet several criteria, notably that it invests only in financial instruments as defined in the Financial Supervision Act and within that context applies a policy of diversification in assets as a means of risk spreading.

The V.B.I. regime aims to facilitate collective investment in financial instruments by retail and institutional investors in the Netherlands. In line with this purpose, only a public limited liability company (N.V.) or an open F.G.R. can avail itself of the V.B.I. regime. Nonetheless, the V.B.I. regime is frequently used by nonregulated entities.

The proposed new entity classification rules already prevent such unintended use in the case of an F.G.R. in that, if not regulated, an F.G.R. is fiscally transparent by default, and hence not eligible for the V.B.I. regime. However, without further measures, an N.V. could still benefit from the V.B.I. regime, despite being unregulated. Therefore, it is proposed that the V.B.I. regime will be amended in such a way that, going forward, it will only be available to U.C.I.T.S. and investment institutions as defined in the Financial Supervision Act, meaning that unregulated structures will be entirely excluded.

DUTCH FISCAL INVESTMENT INSTITUTION REGIME

In addition to the V.B.I. regime, a public limited liability company in the form of a Dutch N.V. or an open F.G.R. may also seek to apply the other special Dutch tax regime for investment institutions, known as the fiscal investment institution (*fiscale beleggingsinstelling* or "F.B.I." In principle, the F.B.I. regime may also be applied by a private limited liability company such as a Dutch B.V.

As with the V.B.I. regime, the *raison d'être* of the F.B.I. regime is to facilitate collective investment in such a way that the tax burden does not exceed the level that would exist for an individual investment. In a nutshell, the F.B.I. regime entails that the relevant investment institution is subject to Dutch corporate income tax at a 0% statutory rate, which technically is not an exemption, although the tax results are economically the same. However, the F.B.I. regime does entail an obligation to withhold Dutch dividend tax at the statutory rate of 15% on annual profit distributions. Other criteria include detailed anti-concentration provisions, as well as a restriction on the use of leverage.

In comparison to the V.B.I. regime, application of the F.B.I. regime is not restricted to financial instruments as defined in the Financial Supervision Act or any other specific asset category. Instead, a qualifying investment can be any asset that is held as a passive portfolio investment. Consequently, the F.B.I. regime currently is often used for investments in real estate. This will change on a go-forward basis. The 2024 Tax Plan introduces a new restriction, pursuant to which the F.B.I. regime no longer applies to direct investments in real estate situated in the Netherlands. This is already the case for the V.B.I. regime, for which real estate does not qualify as a financial instrument.

Those investment institutions that currently invest in Dutch real estate may benefit from proposed transitional measures, including exemptions from Dutch real estate transfer tax that would be due upon a restructuring.