NETHERLANDS: NEW LEGISTLATION TO COMBAT HYBRID MISMATCHES

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INTRODUCTION

On December 19, 2023, a legislative proposal was adopted in the Netherlands with the goal of significantly reducing the use of hybrid mismatch arrangements by companies operating internationally. The new law will take effect on January 1, 2025, although transitional rules will apply in 2024. The hybrid mismatch rules address entity classification disparities between countries that can lead to certain income being taxed twice or escaping taxation entirely.

A key aspect of the proposed *Wet fiscaal kwalificatiebeleid rechtsvormen* (Law on Fiscal Classification Policy of Legal Forms) is the elimination of the "consent requirement" for Dutch limited partnerships (*commanditaire vennootschappen*, or "C.V.'s") having a member wishing to transfer all or a portion of the investment held in the C.V.

This legislative change is expected to substantially decrease the occurrence of entity hybrid mismatches and enhance the flexibility of organizations that utilize tax transparent structures involving the Netherlands. Taxpayers with existing structures should review the effect of the new law in order to prevent adverse tax consequences in the Netherlands.

This article discusses these changes and analyzes the implications of these legislative changes as to the classification of U.S. entities for Dutch tax purposes.

BACKGROUND OF THE PROPOSAL

The proposal reflects parliamentary discussions on hybrid mismatch measures transposed into Dutch tax law following the enactment of the E.U.'s second Anti-Tax Avoidance Directive ("A.T.A.D. 2"). Those discussions culminated in recommendations to revise its existing Dutch classification policy for legal entities that deviate from international norms.

The core issue involves classification differences between tax systems involving two countries where one country classifies an entity as transparent for tax purposes, so that tax is imposed at the level of its owners, while another country classifies the same entity as taxable in its own right. Hybrid mismatches also apply to the classification of instruments, permanent establishments, and headquarters across various tax systems. These mismatches can result in economic double taxation where the same income is taxed simultaneously in different jurisdictions. They can also result in scenarios where expenses are deducted in one country by the payor, but not recognized as income in another country by the recipient.

While the hybrid mismatch regulations of A.T.A.D. 2 address the consequences of these mismatches, they do not resolve the underlying cause, which is that differences exist in the classification of entities, payments, permanent establishments, and corporate residence. In response, the Dutch government committed to examining the challenges posed by the classification policy of the Netherlands. The Ministry of Finance, the Dutch Tax Authorities, and various stakeholders engaged in discussions that led to a preliminary proposal for modifying the classification policy. Feedback from this consultation are reflected in the current legislative proposal.

Key elements of the proposal include the following:

- Codification of the Dutch classification policy for foreign legal forms using a comparative method with domestic forms, supplemented by the fixed method and the symmetric method for cases where a foreign entity's legal form lacks a Dutch equivalent.
- Eliminating the consent requirement and the open limited partnership ("Open C.V."). These changes will terminate the Open C.V.'s independent tax liability under corporate tax laws and other related tax obligations, aligning it with entities recognized as partnerships having capital divided into shares, under existing law. Transitional provisions are included to facilitate the implementation of these changes.

These legislative adjustments will impact various types of taxes where the classification of legal forms is relevant, including income tax, corporate tax, dividend tax, source tax, inheritance tax, gift tax, and transfer tax.

CURRENT CLASSIFICATION RULES

The current Dutch classification policy for tax purposes compares the civil law characteristics of an entity established under foreign law with the legal form of entities formed in the Netherlands, such as a public limited company (*naamloze vennootschap*, or "N.V."), a private limited company (*besloten vennootschap met beperkte aansprakelijkheid* or "B.V."), a cooperative (*coöperatie*), an association (*vereniging*), a foundation (stichting), a commercial or professional general partnership without legal personality (*maatschap*), a general partnership (*vennootschappn onder firma*, or "V.O.F."), and a limited partnership (*commanditaire vennootschap*, or "C.V."). A foreign entity is treated for tax purposes in the same manner as its counterpart under Dutch law.

This approach includes a mutual fund (*fonds voor gemene rekening*, or "F.G.R."), an entity that does not have a legal form requirement. The F.G.R. is included in the comparison to maintain simplicity. In recent years, criticisms have emerged around the "consent requirement" aspect of this policy. This requirement has prevented certain foreign entities from being classified as transparent for Dutch tax purposes, causing those entities to be standalone taxpayers, notwithstanding home country tax treatment as transparent entities. Hybrid mismatches can occur.

Feedback from practice has shown that maintaining the current Dutch comparison method for classifying foreign entities is preferred because it aligns with E.U. case law and effectively addresses classification issues in most situations. Nonetheless, there are instances where the classification method falls short, particularly when the legal form of a foreign entity does not match any existing Dutch legal forms. This discrepancy can lead to complex disputes or hybrid mismatches.

NEW RULES: TWO SUPPLEMENTARY METHODS

To address situations that do not properly match under the classification method, the fixed method and the symmetric method are applied. The former method applies to entities formed abroad but tax resident in the Netherlands. The latter method applies to entities that are formed abroad and tax resident abroad.

The supplementary methods are intended to result in consistent and equitable tax treatment of foreign legal entities when structural complexities of a particular type of entity formed can lead to hybrid mismatches when the comparison method is applied.

Fixed Method

Under this method, an entity formed abroad, but maintaining its tax residence in the Netherlands is never considered to be transparent for Dutch tax purposes when it fails to be comparable to any legal form of an entity formed in the Netherland. The entity is a standalone taxpayer in all circumstances.

Symmetric Method

Under this method, an entity formed abroad that maintains its tax residence outside the Netherlands is not considered to be transparent for Dutch tax purposes if it is treated as a standalone taxpayer in its country of residence for tax purposes. Where the entity is formed in one country but becomes tax resident in another country, the tax classification in the latter country controls. And if the entity moves its tax residence to a third country, the classification in the third country becomes controlling. This method is particularly relevant if the foreign entity generates income from Dutch sources.

APPLICATION

The following discussion provides a comprehensive overview of the application of the new rules, proposed legislative adjustments, and their impact across personal income tax, corporate income tax, dividend tax, and withholding tax in the Netherlands.

Personal Income Tax (*Inkomstenbelasting*)

The legislation aims to codify the existing tax treatment of transparent Dutch entities within the Dutch personal income tax framework. The goal is to ensure that the income of a transparent entity is directly included in the tax base of its participants, eliminating double nontaxation. If an entity is deemed to be a taxpayer in its own right, the imposition of income tax on its members is avoided.

Corporate Income Tax (*Vennootschapsbelasting*)

Currently, partnerships other than C.V.'s – a *maatschap*, a V.O.F., or a comparable foreign legal form such as an L.L.P. – can structured as transparent or not transparent for tax purposes. Such partnerships are taxpayers in their own right where the following facts exist:

- The partnership interests are akin to share in a corporation.[1]
- The transfer of the participations does not require the consent of all other partners.

"Once an entity resident in the Netherlands is viewed to be a taxpayer in its own right, distributions by the entity to its owners may be subject to Dutch withholding tax."

It follows that a Dutch C.V. is deemed a Dutch corporate taxpayer in its own right if the admission or replacement of partners is possible without the unanimous consent of all partners, including both managing and limited partners. This situation describes what is generally referred to as an "Open C.V."

As of January 1, 2025, all C.V.'s will be treated as fiscally transparent, thereby standardizing their classification as partnerships. Dutch corporate income tax is eliminated. This change also applies to U.S. L.P.'s.

Also as of January 1, 2025, a foreign entity that is resident in the Netherlands for Dutch tax purposes without a comparable Dutch legal form defaults to corporate status, and becomes a Dutch taxpayer in its own right.

Finally, as of January 1, 2025, a foreign entity based abroad for which no comparable Dutch legal form of entity can be identified will have its Dutch tax status controlled by its status as transparent in its country of residence. If transparent in its country of residence, it is transparent in the Netherlands. If not transparent in its country of tax residence, it is not transparent for Dutch tax purposes. A foreign entity is not transparent when its assets, liabilities, revenue, and costs are taken into account at the entity level under the tax laws of its home country.

Dividend Tax (*Dividendbelasting*)

Once an entity resident in the Netherlands is viewed to be a taxpayer in its own right, distributions by the entity to its owners may be subject to Dutch withholding tax. Briefly, dividend withholding tax is levied at the time profits are distributed to shareholders. The same standard discussed above is used to determine whether the recipient of the dividend or its members are taxable. The answer may affect the rate of withholding tax that must be collected.

Withholding Tax (*Bronbelasting*)

The Dutch Withholding Tax Act of 2021 mandates a withholding tax on specified interest, royalties, and dividend payments. The withholding tax reflects the highest corporate tax rate imposed in the Netherlands. In 2024, the highest corporate tax is 25.8%.

Withholding tax applies when a Dutch-based entity makes payments to a related entity based in a low-tax jurisdiction or under certain conditions considered to be abusive.

Related Party

A payment is deemed to be made to a related party if one entity holds a significant interest in the other or if a third party holds a significant interest in both the paying and receiving entities. An interest is considered to be significant when it exceeds 50%.

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[1] Dutch Supreme Court 2006, nr. 40919, ECLI:NL:HR:2006:AX2034, BNB 2006/288.

Low Tax Jurisdiction

The recipient of a payment is considered to be based in a low-tax jurisdiction in three fact patterns. The first is that the jurisdiction imposes no income tax. The second is that tax is imposed, but the tax rate is below 9%. The third is that the country is included in the E.U.'s list of noncooperative jurisdictions for tax purposes.

Coordination with Dividend Tax

In certain scenarios, both dividend and withholding taxes may be levied on the same dividends. In computing the amount of withholding tax, an offset is allowed for the amount of dividend tax previously withheld. The offset is allowed only if both the dividend tax and the withholding tax are payable by the same entity. In the context of potentially hybrid entities, the appropriate classification method discussed above is used to determine both the recipient of the income and the person responsible for withholding and remitting the tax.

Effect on Offshore Funds

Many fund structures currently are subject to Dutch withholding tax because they are resident in no-tax jurisdictions such as the Cayman Islands and are formed as limited partnerships that are treated as the equivalent of Open C.V.'s. When the new rules become effective in 2025 onwards, the pass-through nature of a limited partnership will allow it to be viewed as a transparent entity for Dutch tax purposes. Consequently, the focus will shift towards the (ultimate) investors, who typically are not based in tax havens.

TESTING COMPARABILITY OF FOREIGN ENTITIES

Through a general administrative order (*algemene maatregel van bestuur* ("A. Mv.B.")), frameworks have been set up to assess when a foreign entity's legal form is comparable in nature and structure to an entity established under Dutch law.

Draft Decree

On February 5, 2024, a brief consultation period for the draft Decree on the Comparison of Foreign Legal Forms began. The decree was intended to establish frameworks to evaluate how foreign entities compare to Dutch entities based on their structure and nature. It is applicable to various Dutch legal forms, as discussed above.

The consultation ended on March 18, 2024. It faced significant criticism, which focused on the following concerns:

- There is a lack of clarity in the criteria and weighting for comparing foreign entities to Dutch equivalents.
- The list of pre-classified foreign entities is too short. For example, in the U.S., only three states are covered: Delaware (in which the entities are a corporation, an L.L.C., and an L.P.), Massachusetts (in which the only entity is a G.P.), and Ohio (in which the only entity is an L.L.C.).
- A real risk exists of potential reclassification errors that could lead to hybrid mismatches and double taxation, thereby falling short of the goal of the

legislation.

IMPACT ON STRUCTURE

The table below provides an overview of common American business structures and their closest Dutch equivalents, outlining how each U.S. legal form is currently classified under Dutch tax law and the upcoming changes set for 2025. Please note that the table below is based on the expected outcome of the definitive legislation and can be subject to changes before it is implemented.

U.S. Legal Form	Dutch Legal Form	Current Dutch Fiscal Classification	New Dutch Fiscal Classification (Effective 2025)
Sole Proprietorship	*Eenmanszaak*	Transparent	Transparent
General Partnership	*Vennootschap onder Firma* (V.O.F.)	Transparent	Transparent
Limited Partnership	*Commanditaire vennootschap* (C.V.)	Nontransparent if Open C.V.; otherwise, transparent	Always transparent
Limited Liability Company (L.L.C.)	*Besloten Vennootschap* (B.V.)	Nontransparent	Nontransparent
C Corporation	*Naamloze Vennootschap* (N.V.)	Nontransparent	Nontransparent
S Corporation	Not available	Typically, it would be compared to a B.V. or N.V., nontransparent	Typically, it would be compared to a B.V. or N.V., nontransparent
B Corporation	Not available	It would be compared to a B.V. or N.V., nontransparent	It would be compared to a B.V. or N.V., nontransparent
Nonprofit Corporation	Not available	Typically nontransparent unless specific conditions are met	Typically nontransparent unless specific conditions are met
Professional Corporation	*Maatschap* (for certain professions)	Transparent	Transparent
Limited Liability Partnership (L.L.P.)	Not available	Nontransparent	Nontransparent if resident in the Netherlands; otherwise, it depends on the U.S. tax classification

On a very general note, all of the entities listed above should not be affected by these new rules, except for L.P.'s and L.L.P.'s that are transparent from a U.S. tax perspective. Those entities will be considered to be transparent for Dutch tax purposes, while pre-2025, these entities would almost always be considered to be nontransparent.

DUTCH TAX CONSEQUENCES FOR CHANGES IN TRANSPARENCY

For Dutch C.V.'s and comparable foreign entities currently treated as nontransparent for Dutch corporate tax purposes, transitioning to fiscal transparency means they are deemed to have transferred their assets and liabilities to their participants, who may be subject to tax in the Netherlands on the change of status. Generally, the deemed transfer of assets and liabilities results in a tax charge deriving from hidden reserves, fiscal reserves, and goodwill sitting in the entity.

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To prevent immediate taxation on these components, the legislative proposal introduces transitional measures:

- **Rollover Relief:** The fiscal claim related to the hidden and fiscal reserves along with the goodwill is transferred to the underlying limited partners.
- **Share Merger Relief:** Underlying limited partners may move the fiscal claim to a holding company. This transfer is exempt from transfer tax when real estate is involved.
- **Rollover Relief for Business Use:** When assets are utilized by the business, underlying limited partners can relocate the fiscal claim on these assets.
- **Deferred Payment Options:** Payment can be spread over a maximum of ten years.

The new law will take effect on January 1, 2025. However, taxpayers can opt to exercise transitional rights starting in 2024, providing a year to prepare and potentially benefit from these measures.

DUTCH TAX IMPLICATIONS FOR U.S. INVESTORS

The forthcoming changes in Dutch tax legislation aimed at combatting hybrid mismatches will necessitate a thorough review by U.S. entities with investments in or through Dutch structures, particularly those involving C.V.'s, L.P.'s, and L.L.C.'s. Starting January 1, 2025, the new legislation will treat these entities as fiscally transparent, altering their tax status or those of their investors and potentially the taxation of the income derived from these investments.

U.S. structures that currently benefit from or are structured around the nontransparent status of Dutch entities may face significant changes. This shift could lead to tax consequences that might not have been anticipated under the previous regulatory framework.

Entities affected by these changes should consider adopting the following action steps:

- Analyze the specific impacts of these legislative changes on the current tax positions and structures.
- Evaluate the transitional measures provided in the legislation, such as roll-over relief and deferred payment options, to mitigate immediate tax impacts.
- Prepare early by taking advantage of the transitional rights available from 2024 to align their strategies with the new tax regime effectively.

This proactive approach will help ensure compliance with the new Dutch tax laws and potentially leverage any transitional facilities to optimize tax outcomes.