DOUBLE DUTCH: A UNIQUE APPROACH IN THE NETHERLANDS TO U.S. L.L.C.'S OWNED BY TRUSTS

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INTRODUCTION

Trusts play a crucial role in U.S. estate planning. However, the use of a U.S. trust in an international context can create a multitude of challenges. As illustrated in this article, the Dutch tax system's approach to the taxation of trusts poses a number of concerns for trust beneficiaries residing in the Netherlands.

This article addresses Mrs. X, a U.S. citizen who lives in the Netherlands. Mrs. X is a beneficiary of a U.S. trust created by her mother, a U.S. resident. Due to a mismatch in the U.S. and Dutch tax treatment of the trust, Mrs. X is subject to tax in the Netherlands and in the U.S. without there being an appropriate solution to double taxation short of competent authority relief under the Netherlands-U.S. Income Tax Treaty ("the Treaty). Had the mother obtained proper planning at the time Mrs. X first became a Dutch resident, a costly and time-consuming mutual agreement procedure could have been avoided.

BACKGROUND

While Mrs. X was in university in the U.S., she elected to study abroad for one semester of her junior year.[1] She chose to study in the Netherlands where she met Mr. X, a Dutch national and resident. Soon after graduation, Mr. and Mrs. X were married, at which time Mrs. X relocated to the Netherlands.

Mrs. X is the sole beneficiary of a U.S. trust, that was established by her mother when Mrs. X was a child. Throughout her life, the mother was a U.S. citizen and a U.S. resident. At the death of the mother, a professional trustee was engaged to oversee the activities of the trust.

At all times relevant, the trust held, and continues to hold the following assets:

- A 50% interest in U.S. L.L.C. 1.The principal source of income of U.S. L.L.C. 1 is rental property located in the U.S. The L.L.C. is classified as a partnership for U.S. income tax purposes.
- A minority interest in U.S. L.P. 2. U.S. L.P. 2 owns U.S. real property which is leased to third parties and other passive assets. The principal source of U.S. L.P. 2's income is rental income from property located in the U.S.

U.S. L.L.C. 1 and U.S. L.P. 2 are profitable, and both entities make annual profit distributions to the trust. The terms of the trust deed require all income to be distributed

[1] At U.S. universities, the third year of a four-year program to obtain a bachelor's degree is referred to as the junior year.

annually. Mrs. X does not have any income other than the annual distributions she receives from the trust.

DUTCH TAX TREATMENT

Taxation of Trusts

Trusts do not exist under Dutch civil law. However, because the Netherlands is a party to the Hague Trust Convention,[2] Dutch civil law recognizes trusts created under the laws of foreign countries.

The Dutch tax treatment of a trust will generally depend on whether the trust is considered discretionary or nondiscretionary ("fixed"). For discretionary trusts, the trust is likely to be classified as separate private property, known in Dutch as *Afgezonderd Particulier Vermogen*. As a consequence, for Dutch income tax purposes, the trust's assets, liabilities, income, and expenses are attributed to the settlor of the trust.[3] After the settlor dies, the trust's assts, liabilities, income, and expenses are generally attributed to the settlor's heirs. The same attribution rules will apply for purposes of Dutch gift and inheritance tax.[4]

If a trust is classified as separate private property, the Dutch tax classification of the entities owned entirely or partially by the trust is critical to determining the Dutch tax position of the settlor during his or her lifetime, and thereafter, the tax position of the heirs.

Tax Classification Rules for Foreign Entities

The Dutch tax authority issued new rules to be used in determining the Dutch tax classification of foreign entities as of January 1, 2025. Minimizing hybrid mismatches was a specific goal of the new rules. The tax classification rules are premised on the assumption that the most appropriate method available to determine the Dutch tax classification of a foreign entity is to compare the foreign entity to a Dutch entity. This is commonly referred to as the comparison method. The Dutch authorities prefer the comparison method as it aligns with principles of Dutch taxation and is in accordance with existing European Union case law.[5]

The comparison method focuses on the following two characteristics of the foreign entity, (i) the entity's nature and (ii) the entity's design.[6] The nature of the foreign entity is determined based on the function and intent of the entity as viewed under the legal regime of its formation. The design of the foreign entity is based on the entity's individual attributes.

The Dutch tax authority issued a decree (the "Decree") on the comparison of foreign legal forms that explains when the characteristics of a foreign entity are sufficiently comparable to those of a Dutch entity so as to allow the comparison method to be

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[2] Convention on the Law Applicable to Trusts and on Their Recognition (Concluded 1 July 1985).

[3] Article 2.14a Personal Income Tax Act of 2001.

[4] Article 16 and 17 Succession Act of 1956.

[5] Parliamentary documents II 2023/24, 36425, no. 3, p. 4.

[6] *Besluit Vergelijking Buitenlandse Rechtsvormen*, art. 2 (Nov. 9, 2024).

applied.[7] The Decree presents the essential characteristics of certain Dutch legal entities which serve as points of comparison. For a Dutch corporation such as a *Naamloze Vennootschap* ("an N.V.") or a *Besloten Vennootschap* ("a B.V."), the essential characteristics include (i) capital divided into freely transferable shares, (ii) legal personality, (iii) limited liability for shareholders, and (iv) the ability to make profit distributions.[8] For a Dutch limited partnership commonly known as a *Commanditaire Vennootschap* ("a C.V."), the essential characteristics include (a) capital divided into shares, (b) a business purpose with contributions from all members and the motive of generating profits that are divided among the members, (c) at least one managing general partner that bears unlimited liability, and (d) at least one limited partner that benefits from limited liability.[9]

Where a foreign entity is not sufficiently comparable to a Dutch entity, the comparison method is inapplicable. In these situations, the classification method will depend on the tax residence of the foreign entity. If the foreign entity is a Dutch tax resident, the foreign entity will be considered nontransparent for Dutch tax purposes. This is referred to as the "fixed method." On the other hand, if the foreign entity is not a Dutch tax resident, the foreign entity's classification for Dutch tax purposes will mirror the tax classification of the jurisdiction in which the foreign entity is a tax resident. This is referred to as the "symmetrical method."

The Dutch tax authority utilizes the comparison method to determine the Dutch tax classification of certain commonly encountered foreign entities. While the Dutch tax authority's classification of a foreign entity can be challenged by a taxpayer, there is a rebuttable presumption that the tax classification adopted by the Dutch tax authority is correct. To overcome the presumption of correctness, a taxpayer must demonstrate that the characteristics of the foreign entity are sufficiently different in order for a different tax classification to be accepted.

Relevant for this article is the Dutch tax classification of U.S. L.L.C. 1 and U.S. L.P. 2. The Dutch tax authority has determined that a U.S. L.L.C. is comparable to a Dutch corporation while a U.S. L.P. is comparable to a Dutch limited partnership. This means that, for Dutch tax purposes, a U.S. L.L.C. is a nontransparent entity while a U.S. L.P. is generally a transparent entity.

Dutch Tax Position of Mrs. X

Mrs. X, as a Dutch tax resident, is subject to Dutch income tax on her worldwide income. Determining Mrs. X's Dutch income tax exposure requires application of the tax rules in relation to the classification of trusts and foreign entities. Mrs. X's interest in the trust qualifies as separate private property. Because the settlor of the trust no longer is alive, Mrs. X is considered to directly own the trust's assets and liabilities, and directly receive the trust's income and expenses, for Dutch tax purposes. She is considered to be a shareholder of U.S. L.L.C. 1 and a partner of the U.S. L.P. 2.

Accordingly, Mrs. X is deemed to receive the following income for Dutch tax purposes:

7 *Id.*

8 *Id.*, art. 3 (Nov. 9, 2024).

9 *Id.*, art. 11 (Nov. 9, 2024).

- Profit distributions from a foreign corporation, of which she is a 50% shareholder
- Rental income from U.S. real property held via a foreign partnership

U.S. TAX TREATMENT

The trust is subject to U.S. income tax on income that is accumulated, rather than distributed to beneficiaries.[10] On the other hand, the trust is allowed a deduction against its U.S. income for the income distributed to Mrs. X.[11] The trust distributes all of its net income annually to its sole beneficiary, Mrs. X. Consequently, the trust effectively does not pay U.S. income tax on its rental income derived from U.S. L.L.C. 1 and U.S. L.L.P 2.

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Mrs. X is a U.S. citizen and subject to U.S. income tax on her worldwide income. Mrs. X receives annual distributions from the trust which consist primarily of rental income. The rental income received by Mrs. X was generated from U.S. real property and for U.S. tax purposes is U.S. source income. Therefore, Mrs. X is not entitled to a foreign tax credit against her U.S. income tax for the income tax paid in the Netherlands.

THE TREATY

Asymmetrical Treatment of L.L.C.'s

Mrs. X is subject to income tax in both the Netherlands and the U.S. However, the rationale for being taxed is quite different in the two countries.

- In the U.S., both U.S. L.L.C. 1 and U.S. L.P 2 are deemed to be transparent. Income flows up to the trust automatically. Under rules applicable to the taxation of nongrantor trusts, Mrs. X recognizes income only to the extent the trust distributes proceeds to her during the year or within the first 65 days of the following year and is specially designated by the trust as a distribution of the prior year's income. Where those facts exist, all of the income that that is recognized by Mrs. X is properly characterized by reference to the character in the hands of U.S. L.L.C. 1 and U.S. L.P. 2.
- In the Netherlands, U.S. L.L.C. 1 is characterized as the equivalent of a B.V. which is taxed as a corporation. Only U.S. L.P. 2 is viewed to be tax transparent. Consequently, only the revenue of U.S. L.P. 2 is considered to be immediately recognized by the Trust when and as generated by U.S. L.P. 2. Only that income is treated as rental income by the trust. Because U.S. L.L.C. 1 is treated as an opaque entity for income tax purposes, meaning that it is not transparent, the trust recognizes income only when it receives an actual distribution from U.S. L.L.C. 1. Finally, the trust's income is attributed to Mrs. X for personal income tax purposes.

While one aim of the Treaty is to prevent double taxation, the Treaty does not effectively achieve that goal in the situation of Mrs. X. Unfavorable treatment arises

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[10] Code §641(a).

[11] Code §651(a) in the fact pattern presented. Also see Code §661 in other circumstances.

from the saving clause of the Treaty and the scope of the withholding tax provision for dividends.

As with all income tax treaties entered into by the U.S., the Treaty contains a savings clause that allows the U.S. to tax a U.S. citizen as if the Treaty had not come into effect.[12] As a result, reductions in U.S. tax for income items such as dividends, interest, and royalties are not enjoyed by a U.S. citizen who is a tax resident of the Netherlands. Instead, a form of relief is provided in Article 25 (Methods of Elimination of Double Taxation).[13]

Where the saving clause applies to a U.S. citizen residing in the Netherlands who receives a dividend from a U.S. corporation, the Netherlands is required to allow a reduced tax credit for U.S. taxes paid on U.S. source dividend income. The credit is capped at the applicable rate of withholding tax provided by the Treaty, 15% for individuals. In turn, the U.S. is required to allow a foreign tax credit for the residual Dutch tax paid in excess of the 15% deemed withholding tax and will treat the income as if it were derived from foreign sources. However, a profit distribution by an L.L.C. to a resident of the Netherlands is generally not treated as a dividend. In discussing the scope of Article 10 (Dividends), the Technical Explanation of the 2004 Protocol to the Treaty prepared by the Treasury Department states the following:

> [A] distribution by a limited liability company is not characterized by the United States as a dividend and, therefore, is not a dividend for purposes of Article 10, provided the limited liability company is not taxable as a corporation under U.S. law.

The same problem does not exist with regard to U.S. L.P. 2, which as mentioned above, is treated as a tax transparent entity in the U.S. and the Netherlands. Also as mentioned above, both U.S. L.P. 2 and the trust are treated as transparent for Dutch tax purposes. In the U.S., similar treatment is provided to U.S. L.P. 2, and the trust is treated as a conduit to Mrs. X to the extent that the proceeds of income recognized by the trust are distributed to Mrs. X in the year income is recognized or deemed distributed in that year under the 65-day rule discussed above.

DUTCH VIEW OF ECONOMIC DOUBLE TAXATION

In 2010, when the regime for the taxation of separate private property was introduced in the Netherlands, the risk of double taxation as a result of the attribution rules was recognized by Dutch lawmakers, as illustrated by the following quote from the discussion of the new regime in the Dutch Second Chamber (the Dutch "House of Representatives"). An unofficial, but accurate, translation of the quote is as follows:

> In principle, a tax treaty does not limit the Netherlands to determine, due to a change in the law, that its residents will be deemed to receive income from the APV and subject this income to personal income tax, while another country taxes the same income at the level of a different person with personal income tax. Then, the result is economic double taxation in the sense that the same income is

[12] Paragraph 1 of Article 24 (Basis of Taxation).

[13] Paragraph 6 of Article 25 (Methods of Elimination of Double Taxation).

taxed at the level of more than one taxpayer. There is no legal double taxation in the sense that the same income is taxed twice at the level of the same taxpayer. In principle, the purpose of a tax treaty is not to prevent economic double taxation and as such does not protect against this.[14]

POTENTIAL SOLUTION

In the scenario that an applicable tax treaty does not provide a solution for double taxation issues, and neither country provides a unilateral solution, double taxation may be solved by competent authority proceedings under Article 29 of the Treaty.

In 2019, the competent authorities of the Netherlands and Germany reached a competent authority agreement in a case that is somewhat similar to that of Mrs. X.[15] In that case, a Dutch tax resident held an interest in a German *Kommanditgesellschaft* ("KG"). From a Dutch tax perspective, the KG was a non-transparent entity. From a German perspective the KG was a transparent entity. As a consequence, the German tax authority considered the Dutch Tax Resident to have a permanent establishment in Germany. At the same time, the Dutch tax authority considered the taxpayer to hold the shares in a German corporation. As such, the taxpayer was subject to Dutch income tax on profits received from the corporation. The applicable tax treaty did not provide for a solution for double taxation in this scenario.

The competent authorities agreed to relieve the double taxation by treating the KG as an opaque entity under German law. As a result, the Netherlands decreased its taxable income with a notional deduction of 30% to allow for a fictitious German income tax on the profits of the permanent establishment. In addition, the Netherlands allowed for a 15% foreign tax credit, to simulate the tax credit on dividends received by a Dutch taxpayer from a German company.

If, in the case of Mrs. X, a similar approach is applied, the distributions from U.S. L.L.C. 1 that are included in the Dutch taxable income of Mrs. X could be decreased by 21%, the U.S. Federal corporate income tax rate. In principle, the remaining 79% would be taxable in the Netherlands at a rate in the range of 31%, depending on various factors. On this fictitious profit distribution, Mrs. X should be allowed to claim a 15% foreign withholding tax credit. As a result, Mrs. X would pay 24.5% Dutch personal income tax on the income she receives from the trust insofar this income is allocable to U.S. L.L.C. 1. In principle, the U.S. should allow Mrs. X to claim a foreign tax credit for the residual Dutch personal income tax she incurs and to treat most of the income as foreign source income for foreign tax credit purposes.

Alternatively, the competent authorities may simply determine that an approach similar to that which appears in Paragraph 6 of Article 25 (Methods of Elimination of Double Taxation).

If self-help is required to address the issue, U.S. L.L.C. 1 may consider converting itself to a limited partnership under relevant state law. Because U.S. L.L.C.1 is currently classified as a partnership for U.S. income tax purposes, this would not require the admittance of an additional partner. Under U.S. tax law, a conversion of

[14] Parliamentary documents II 2009/10, 31930, no. 18, p.2.

[15] Decree of 14 December 2020, no. 63177.

a partnership from L.L.C. form to L.P. form is generally treated as a continuation, which is a nonrecognition event in the U.S.[16] It is likely, however, that such a conversion would result in capital gain recognition for Dutch tax purposes, assuming that the interest in U.S. L.L.C. 1 has increased in value when measured in terms of euros.[17]

CONCLUSION

It is often thought that the use of U.S. trusts can be disastrous for Dutch taxpayers. This article illustrates that, while the tax treatment of a structure involving a trust and an L.L.C. can result in very high taxation, with proper planning and restructuring it is possible to obtain a favorable outcome. If it is too late for tax planning, as was the case for Mrs. X, a solution can be sought via the competent authorities of the Netherlands and the U.S.

"It is often thought that the use of U.S. trusts can be disastrous for Dutch taxpayers."

[16] Code §708.

[17] Article 4.16(1)(g) Personal Income Tax Act of 2001. Also see the publication of the Knowledge Group of the Dutch tax authority of July 18, 2023, KG:003:2023:3, holding that the conversion of an opaque Dutch partnership into a transparent Dutch partnership results in a capital gain.