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Tackling Reverse-Hybrid and Entity Classification Mismatches In the Netherlands

by Charlotte Tolman and Michael Molenaars

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In this article, the authors examine two recent Dutch proposals that target hybrid mismatches, which could have an immediate impact on Dutch and non-Dutch corporate taxpayers and existing national or international structures.

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On March 4 the Dutch government started a public internet consultation by releasing two draft bills of law and explanatory memoranda.[1] One of the proposals in the consultation documents targets so-called reverse-hybrid mismatches.[2] The proposed rule tackles the result (double deduction or deduction without inclusion) of reverse-hybrid mismatches and is the final part of the implementation of the EU anti-tax-avoidance directive (ATAD 2, or Directive (EU) 2017/952, amending Directive (EU) 2016/1164). EU member states were granted an extended implementation date for the reverse-hybrid rule until January 1, 2022. Interested parties were able to submit comments to the Dutch proposal on reverse-hybrid mismatches until April 2.

In addition to the proposed reverse-hybrid rule, on March 29 the Dutch government released another consultation document containing a draft bill of law and explanatory memorandum to amend the Dutch classification rules for specific domestic and foreign legal entities. This proposal aims to tackle the cause of hybrid entity mismatches in which the Dutch classification of domestic and foreign legal entities don't match, and the classification of those entities in other jurisdictions.[3] The proposal further aims to bring the Dutch classification rules more in line with common international classification standards. Interested parties were able to submit their comments until April 26.

The two proposals targeting hybrid mismatches could immediately affect Dutch and non-Dutch corporate taxpayers and existing national or international structures. It is expected that both legislative proposals will be sent to Parliament this year and that the proposed rules will become effective as of January 1, 2022.

I. The Proposed Reverse-Hybrid Rule

ATAD 2 provides for minimum standards to neutralize the consequences of hybrid mismatches

[1] The consultation document on the legislative proposal "Act combating mismatches as a result of the arm's-length principle" (Mar. 4, 2021) will not be further discussed in this article. For more information, see Charlotte Tolman and Michael Molenaars, "Combating Non-Arm's-Length Transfer Pricing in the Netherlands," *Tax Notes Int'l*, Mar. 29, 2021, p. 1697.

[2] Consultation document on the reverse-hybrid rule (ATAD 2) (Mar. 4, 2021).

[3] Consultation document on the legislative proposal "Act amendment of fiscal classification rules of legal entities" (Mar. 29, 2021).

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and the regular anti-hybrid rules that have been in the Netherlands since January 1, 2020. EU member states were granted an extended implementation date for the special rule that targets reverse-hybrid mismatches. The new deadline is January 1, 2022. The proposal provides for the implementation of the reverse-hybrid rule in the Dutch Corporate Income Tax Act 1969 (Wet op de vennootschapsbelasting 1969 (CITA)) and some technical changes to incorporate the effect of this rule into both the Dutch Dividend Withholding Tax Act 1965 (Wet op de dividendbelasting 1965 (DWTA)) and the Dutch Conditional Withholding Tax Act 2021 (Wet op de bronbelasting 2021 (CWTA)).

A reverse-hybrid entity (*omgekeerde hybride lichaam*) is an entity (often a partnership) that is considered transparent in its jurisdiction of incorporation or establishment (the resident jurisdiction), while the jurisdiction of a related participant of the entity (the participant's jurisdiction) considers it nontransparent. A participant is considered "related" to a reverse-hybrid entity if it holds directly or indirectly an interest of 50 percent or more of the voting rights, capital interest, or profit rights of the entity.[4] Only entities can qualify as related participants in terms of determining whether the entity qualifies as reverse-hybrid. Related individual participants are not relevant. As a result of the different treatment by the resident jurisdiction and the participant's jurisdiction, the reverse-hybrid entity may not be subject to corporate income tax, and payments could result in a deduction without inclusion or double deduction.

An example of a reverse-hybrid entity is the Dutch CV/BV structure, illustrated in Figure 1, in which a so-called closed Dutch CV (*besloten commanditaire vennootschap*, or a limited partnership)[5] is considered transparent for Dutch tax purposes, but its related participants are resident in a jurisdiction that considers the Dutch CV a nontransparent entity (for example, under the U.S. check-the-box regime). The CV/BV structure was often set up to flow royalty payments from the Dutch BV to the Dutch CV's participants without taxation in the Netherlands.

Payments received at the level of the Dutch CV (for example, deductible royalty payments derived from intellectual property rights licensed by the Dutch BV) are not subject to corporate income tax in the Netherlands because of the CV's transparent classification. The payments may also not be included at the level of the participants if the participant's jurisdiction (for example, the United States) classifies the Dutch CV as a nontransparent entity for tax purposes and does not consider the participants as recipients of the payments. As of January 1, 2020, the deduction without inclusion is already neutralized under the general ATAD 2 rules; the deduction at the level of the Dutch BV is denied under ATAD 2's primary rule.[6] Most Dutch CV/BV structures have accordingly been disassembled or restructured.

The proposed reverse-hybrid rule aims to tackle the hybrid mismatch at source by making reverse-hybrid entities incorporated or established in the Netherlands integrally subject to Dutch corporate income tax. If, and to the extent that, the income of the reverse-hybrid entity is directly allocated to related participants in jurisdictions that classify the entity as transparent, the proposed rule provides for a deduction of the income at the level of the reverse-hybrid. Effectively, part of a reverse-hybrid entity's income will only become subject to Dutch corporate income tax to the extent there is a classification mismatch between the involved jurisdictions. This assumes that in this case, the participant's income is subject to corporate income tax in the participant's jurisdiction. Should this not be the case, then the regular ATAD 2 rules would provide for a denial of the deduction at the level of the paying entity (to neutralize a deduction without inclusion).

Applying the reverse-hybrid rule to the CV/BV structure as illustrated in Figure 1 would

[4] *See* article 12ac (2) CITA.

[5] Under Dutch tax law, there is a distinction between closed CVs (*besloten commanditaire vennootschap*), which require prior unanimous consent of all partners upon a transfer, admission, or substitution of a partner, and open CVs (*open commanditaire vennootschap*), which do not require the prior unanimous consent of all partners. For Dutch tax purposes, a closed CV is considered transparent, and an open CV is treated as a taxable entity. However, this distinction seems to cease to exist as of January 1, 2022 (see Section II below).

[6] *See* article 12aa CITA.

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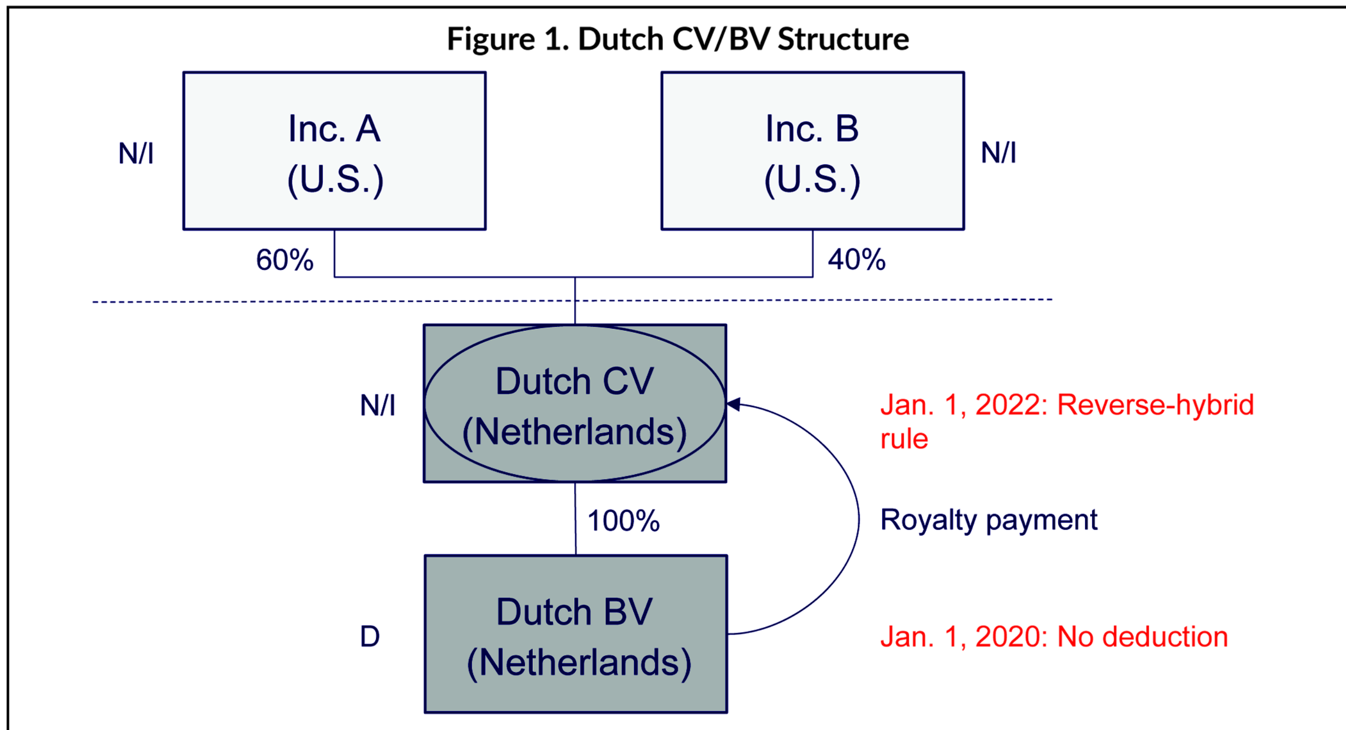
Figure 1. Dutch CV/BV Structure



result in the following outcome. Given the different classification of the Dutch CV from a resident jurisdiction (transparent) and participant's jurisdiction (nontransparent) perspective, the entity will become integrally subject to Dutch corporate income tax as of January 1, 2022. Royalty income paid by the Dutch BV to the Dutch CV will be subject to Dutch corporate income tax at the level of the Dutch CV. The reverse-hybrid rule targets the discrepancy between classifications in different jurisdictions, the cause of the mismatch. The reverse-hybrid rule renders application of the regular ATAD 2 rules obsolete in this situation.

If the reverse-hybrid entity's related participants are incorporated/established in the Netherlands, no deduction will be granted for income allocable to the Dutch resident participants. Dutch resident participants of a reverse-hybrid entity will be treated as deemed shareholders. This methodology of providing only a deduction for the income that is directly allocated to related participants in foreign jurisdictions that classify the entity as transparent could become problematic and result in discriminatory treatment of domestic and foreign participants, something noted by the Dutch Association of Tax Advisers (Nederlandse Orde van Belastingadviseurs) in its commentary to the consultation document.[7] It would be a welcome clarification if the legislature would deal with this potential discriminatory treatment in the legislative proposal.

As an exception, the reverse-hybrid rule will not apply to regulated collective investment vehicles with a diversified portfolio.

To incorporate the principle that a reverse-hybrid entity will become subject to Dutch corporate income tax through other Dutch tax laws, the proposal also provides for amendments to the DWTA and the CWTA. Distributions by a reverse-hybrid entity will only become subject to (and the reverse-hybrid entity a withholding agent of) Dutch dividend withholding tax (in case of dividends) and the new Dutch conditional withholding tax (in case of interest and royalties) to the extent that the distribution is allocated to related participants that classify the entity as nontransparent. Payments received by a reverse-hybrid entity would only become subject to withholding tax if the payment is directly allocable to the participant in a jurisdiction that considers the reverse-hybrid entity transparent

[7] Nederlandse Orde van Belastingadviseurs, Commentary to the Consultation document on the reverse-hybrid rule (ATAD 2) (Apr. 2, 2021).

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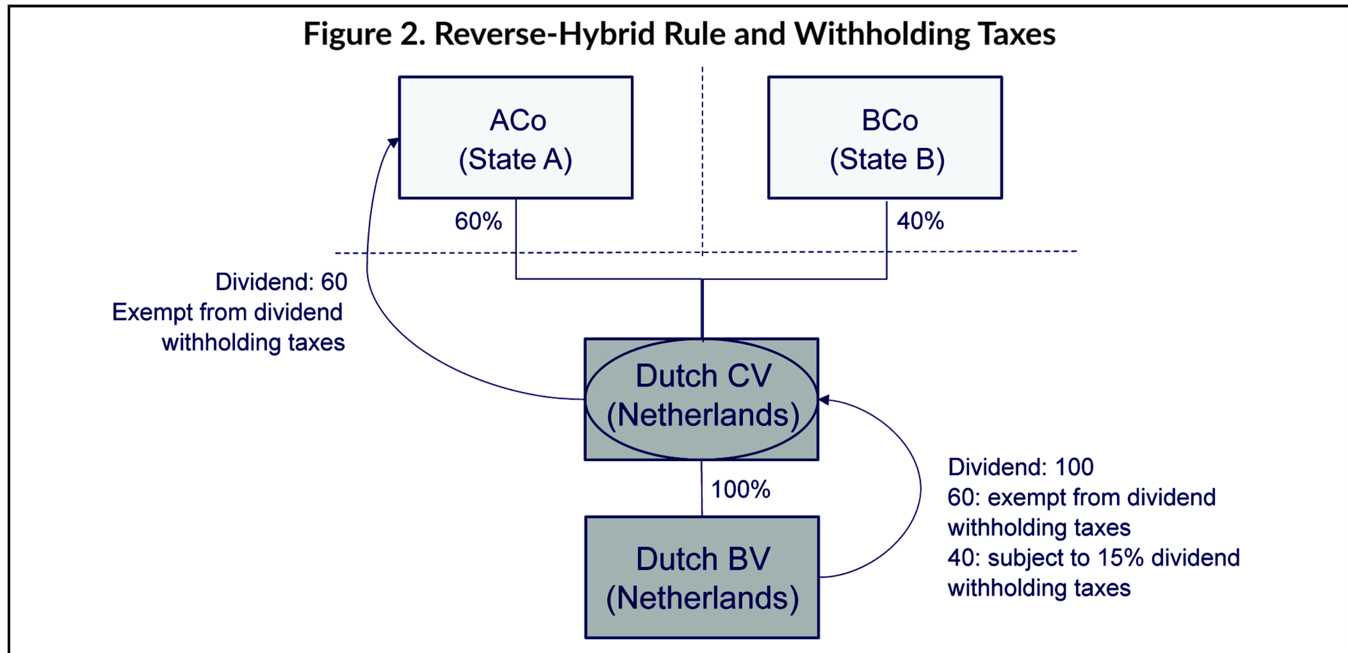

Figure 2. Reverse-Hybrid Rule and Withholding Taxes

and would without interposition of the reverse-hybrid entity also have become subject to withholding tax.

Figure 2 illustrates how the receipt and distribution of dividends will be treated when a reverse-hybrid entity is involved. The facts are as follows. Dutch CV is considered transparent from a Dutch tax perspective. State A (an EU/treaty jurisdiction) considers Dutch CV nontransparent for tax purposes and does not allocate income to Dutch CV's participant ACo. State B (a non-EU/non-treaty jurisdiction) considers Dutch CV transparent for tax purposes and allocates income directly to Dutch CV's participant BCo. Dutch CV qualifies as a reverse-hybrid entity because ACo is entitled to at least 50 percent of the profits of Dutch CV, and State A and the Netherlands classify Dutch CV differently. As of January 1, 2022, Dutch CV will become integrally subject to Dutch corporate income tax under the reverse-hybrid rule.

However, part of the income that is directly allocated to BCo, resident of a jurisdiction that also classifies Dutch CV as transparent, will be deductible from Dutch CV's corporate income tax base. A dividend distribution by Dutch BV to Dutch CV would, in principle, be exempt from Dutch corporate income tax at the level of Dutch CV under the Dutch participation exemption.

However, the distribution will be subject to Dutch dividend withholding tax if the domestic dividend withholding tax exemption would not have been available in case the participants had held their interests directly in Dutch BV without the interposition of Dutch CV. In the case at hand, a direct distribution by Dutch BV to BCo in State B (a non-EU/non-treaty jurisdiction) would have become subject to Dutch dividend withholding tax. As a result, 40 percent of the dividend distribution by Dutch BV to Dutch CV that is allocable to BCo will become subject to 15 percent Dutch dividend withholding tax. The subsequent distribution by Dutch CV to ACo will, in principle, be subject to Dutch dividend withholding tax, unless the domestic dividend withholding tax exemption can be applied.

We assume that the domestic dividend withholding tax exemption would apply in the case at hand given that State A is an EU/treaty jurisdiction (and other requirements of the dividend withholding tax exemption will be met). There is no subsequent dividend distribution recognized by Dutch CV to BCo given that State B considers Dutch CV transparent for tax purposes and allocates income directly to Dutch CV's participant BCo. As such, BCo is not deemed to receive a dividend from deemed shareholding in Dutch CV.

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II. Proposed Changes to Classification Rules

ATAD 2's minimum standards to neutralize the consequences of hybrid mismatches still do not eliminate the cause of hybrid entity mismatches. The proposed amendments to the Dutch classification rules for domestic and foreign legal entities aim to avoid hybrid entity mismatches arising because Dutch classification rules deviate from the classification rules in other jurisdictions.

The consultation document proposes the following three amendments to the Dutch classification rules:

- existing Dutch open CVs (*open commanditaire vennootschap*) that are considered nontransparent will become transparent;
- the definition of a Dutch fund for joint account (*fonds voor gemene rekening* (FGR)) that is considered a taxable entity will be amended; and
- two supplementary methods for classifying foreign legal entities will be introduced.

A. Open CVs Will No Longer Be Taxable

Under Dutch tax law, there is a distinction between closed CVs, which require prior unanimous consent of all partners upon a transfer, admission, or substitution of a limited partner, and open CVs, which do not require prior unanimous consent. A closed CV is considered transparent for Dutch tax purposes, while an open CV is treated as a taxable entity for Dutch tax purposes.

It is now proposed to abolish the unanimous consent requirement for the classification of a closed CV and to treat all CVs as transparent for Dutch tax purposes (subject to the reverse-hybrid rules as described above). If the proposal is adopted, all existing open CVs will become transparent for Dutch corporate income tax effective January 1, 2022. Also, open CVs will no longer be obliged to pay Dutch dividend withholding tax or Dutch conditional withholding tax on interest and royalties.

The classification of a CV as transparent should not affect the tax position of the CV's general partner. A general partner will continue to be subject to tax in proportion to its interest in the CV.

The proposal provides for transitional rules on the Dutch tax implications resulting from the conversion from a taxable entity into a tax-transparent entity. These transitional rules stipulate (by a fiction) that immediately before the conversion moment, open CVs will be deemed to have transferred their assets and liabilities at fair market value to their participants (both general partners and limited partners) and ceased to derive taxable profits in the Netherlands. This will leave open CVs potentially subject to Dutch corporate income tax on hidden reserves, tax reserves, and goodwill. The limited partners of an open CV will be deemed to have transferred their interests at FMV, as a result of which they may be subject to Dutch tax on any capital gains or deemed capital gains.

Because this may result in taxes being triggered without actual profits being made, the transitional rules also provide for several facilities:

- a rollover facility;
- a share-for-share merger facility; and
- a deferred payment obligation (spread out over 10 equal annual installments).

B. Amendment of FGR Definition

An FGR is commonly used in the Netherlands for structuring investment funds. An FGR is a contractual agreement among a fund manager (*beheerder*), depositary (*bewaarder*), and the participants/investors. Depending on the requirements for the admission and substitution of participations, an FGR may qualify as a tax-transparent closed FGR or a taxable open FGR for Dutch corporate income tax and dividend withholding tax purposes.

To avoid FGR hybrid entity mismatches, it is proposed to abolish the consent requirement for classifying an FGR as a taxable (open FGR) or transparent entity (closed FGR). Instead, a new definition for an open FGR is proposed: An open FGR raises capital for collective investment purposes and either:

- the participations are traded on a regulated stock exchange within the meaning of article 1:1 of the Financial Supervision Act (Wet op het financieel toezicht) or a comparable trading platform; or

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- based on its fund terms and conditions, the FGR is required upon request by the participants to redeem its outstanding participations, and this is regularly exercised.

Based on the new definition, an FGR — with the exception of "family funds" for which different rules will apply — can choose its tax treatment by amending its corporate structuring. It is expected that this freedom of choice in setting up the fund terms and conditions of an FGR will result in simplicity and clarity for both taxpayers and Dutch tax authorities.

C. Other Ways to Classify Foreign Legal Entities

Based on Dutch policy,[8] the classification of foreign legal entities as transparent or nontransparent is based on a comparison of corporate characteristics of the foreign legal entity and Dutch legal entities (legal entity comparison method), such as a public limited company (*naamloze vennootschap*), a private company with limited liability (*besloten vennootschap*), or a limited partnership (*commanditaire vennootschap*). For Dutch tax purposes, a foreign legal entity is, in principle, treated the same as a comparable Dutch legal entity.

Under the legal entity comparison method, if three of the following four questions are answered "yes," the foreign legal entity is classified as a taxable entity (nontransparent) for Dutch taxation. If not, the foreign legal entity qualifies as transparent for Dutch tax purposes. The four questions are:

1. Can the foreign legal entity hold the legal ownership of assets?
2. Is the liability of the participants limited?
3. Does the foreign legal entity have a capital divided into shares?
4. Can admission or substitution of participants take place without the consent of all participants?

Because of the proposed abolishment of the unanimous consent requirement for open CVs (see above), it is expected that most foreign limited partnerships will qualify as transparent for Dutch tax purposes because all Dutch CVs will, in principle as of January 1, 2022, be treated as transparent entities. The fourth question seems less relevant under the proposed rules, and it would be helpful if the legislature clarified the application of the comparison method.

In situations in which no Dutch equivalent of a foreign legal entity exists, the legal entity comparison method is not helpful, and a hybrid entity mismatch may occur.[9] Two supplementary classification methods for this situation are therefore proposed:

- *Symmetrical method*: This method can be used in situations in which either the legal entity is incorporated or established under foreign law, resident outside of the Netherlands, and holds an interest in a Dutch corporate income taxpayer (Dutch inbound structure); or a Dutch corporate income taxpayer holds an interest in a legal entity incorporated or established under foreign law (Dutch outbound structure). According to this method, the Netherlands will follow the classification of the foreign legal entity for profit tax purposes of its jurisdiction of incorporation or establishment. If the foreign legal entity is considered transparent or nontransparent in its jurisdiction of incorporation or establishment, the foreign legal entity will also be classified as transparent or nontransparent for Dutch tax purposes.
- *Fixed method*: This method can be used for legal entities incorporated/established under foreign law that are resident in the Netherlands. Under this method, the foreign legal entities are considered a taxable entity for Dutch tax purposes.

Although the supplementary classification methods are a welcome clarification, it should be noted that they will only apply to foreign legal

[8] Decree from the Dutch Under Minister for Finance, nr. CPP2009/519M (Dec. 11, 2009) (hereinafter, the "entity classification decree"). In addition to the decree, an indicative (nonbinding) list of the classification of commonly used foreign legal entities for Dutch tax purposes is regularly published.

[9] The following examples are mentioned in the consultation document as non-comparable to Dutch entities: the limited liability partnership established under U.K. law, the unlimited company (ULC) established under Irish law, and the *Kommanditgesellschaft auf Aktien* (KGaA) established under German law (although the ULC and KGaA are classified as nontransparent in the nonbinding indicative list of the entity classification decree).

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entities that have no Dutch equivalent. The existing legal entity comparison method will always have to be applied first. For example, the proposal unfortunately has not clarified that all U.S. limited liability companies would per se fall within the ambit of the symmetrical method and follow the U.S. classification.

According to the proposal, the comparison method based on corporate law characteristics would remain the starting point. It should therefore probably be determined case by case based on the LLC agreement whether the LLC is comparable to, for example, a Dutch limited company that is treated as nontransparent.[10] If the LLC cannot be compared to a Dutch company based on its corporate characteristics, the symmetrical method would be a way out, and the U.S. classification would be followed. It would be a welcome clarification if the legislature would provide an updated list of entities that are comparable to Dutch companies.

[10]The Dutch Supreme Court ruled, for example, in 2006 (BNB 2006/288) that a Delaware LLC is comparable to a Dutch limited company based on, among other things, a specific type of letter participations issued by the LLC.

III. Concluding Remarks

Both consultation documents contain yet another proposal to target reverse-hybrid mismatches and mismatches caused by classification differences.

Surprisingly, the proposals do not refer to each other, and the exact overlap is therefore not yet clear. If both proposals are adopted and become effective as of January 1, 2022, all Dutch open and closed CVs will be considered transparent by default. Only if a CV qualifies as a reserve-hybrid entity will it be subject to Dutch corporate income taxation (subject to a deduction for income that is directly allocated to related participants). However, if the proposed amendments are not adopted, in some situations a CV may be considered both an open CV and a reverse-hybrid entity.

Another undesirable situation arises if a taxable open CV from January 1, 2022, is treated by default as a transparent entity for tax purposes but also qualifies as a reverse-hybrid entity from that date (and thus would be treated as a taxable entity). Based on the proposal, the conversion could automatically result in taxation for the open CV and its participants (final settlement of hidden reserves and so forth), even if the CV is considered a reverse-hybrid entity going forward and is therefore treated as a taxable entity. A clarification on the interplay of the two proposals would be welcome. ■

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