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Update on Dutch Entity Classification and Anti-Base-Erosion Rules

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In this installment of In Step With Stibbe, Peeters and Molenaars examine a recent EU's Court of Justice tax ruling regarding the Dutch anti-base-erosion rule and the Dutch Ministry of Finance decree on the classification rules for foreign entities.

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In May, we discussed developments regarding the rules aimed at preventing artificial erosion of the Dutch tax base by creating interest charges within a group of affiliated taxpayers.[1] One of those developments was an opinion of Advocate General Nicholas Emiliou[2] of the EU's Court of Justice on these rules. On October 4 the Court issued its preliminary ruling in this case.[3] In this article, we recap the relevant anti-base-erosion rule and Emiliou's opinion and then discuss the Court's ruling and the possible effect on taxpayers.

Further, on November 13, the Dutch Ministry of Finance issued a decree on the comparison of foreign entities, which provides a framework for the tax classification of foreign entities.[4] The decree will enter into force on January 1, 2025. Below, we discuss the decree, the list of presumed classifications of foreign entities annexed to it, and its effect.

Dutch Anti-Base-Erosion Rules

Recap Course of Events

In short, the Dutch anti-base-erosion rules prohibit interest deductions on loans to affiliated companies used to finance dividend payments, capital repayments, capital contributions, or to acquire an interest in a company that qualifies as an affiliated company of the taxpayer after acquisition (these transactions are also known as tainted transactions).[5] However, if the taxpayer proves that both the transaction and its financing are predominantly based on business motives, an escape applies and the interest is deductible.

[1] *See* Ashley Peeters and Michael Molenaars, "Recent Dutch Tax Developments in M&A Transactions," *Tax Notes Int'l*, May 6, 2024, p. 831.

[2] Opinion of Advocate General Emiliou in *X BV v. Staatssecretaris van Financiën*, C-585/22, ECLI:EU:C:2024:238 (Mar. 14, 2024).

[3] *X BV v. Staatssecretaris van Financiën*, C-585/22 (2024). Please note that national courts may submit questions to the Court about the interpretation or validity of a provision of EU law. The questions raised by such a national court are answered through a preliminary decision. Consequently, the national court in question must take the answers in the preliminary ruling into account when assessing the case.

[4] Decree of the Dutch Underminister of Finance, Stb. 2024, 339 (Nov. 13, 2024).

[5] A company is deemed an affiliated party for the anti-base-erosion rules if (i) the taxpayer has at least a one-third interest in the company, (ii) the company has at least a one-third interest in the taxpayer, (iii) both the taxpayer and the company are held by a third party that holds at least a one-third interest in the taxpayer and the company, or (iv) the parties are part of the same fiscal unity for Dutch tax purposes.

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In the Court's ruling, the focus was on the escape rule and an earlier decision regarding Lexel.[6] The Dutch Supreme Court petitioned the EU's Court of Justice for a preliminary ruling.[7] The question boiled down to whether loans based on arm's-length terms should not be considered wholly artificial and therefore should not be deemed abusive in light of the escape rule of the Dutch anti-base-erosion rules.

Emiliou's opinion held that whether an intercompany loan was concluded on arm's-length terms is irrelevant when deciding whether a loan was intended for genuine business reasons. In short, the advocate general concluded that the decisive consideration is whether the entry into the loan is overall devoid of economic or commercial justification and whether the main purpose of the loan is to generate deductible interest payments at the borrowing company. As a result, Emiliou was of the opinion that an intercompany loan concluded on arm's-length terms could still be considered artificial based on the parties' overall intention.

The question that remained for the Court to answer was to what extent the Dutch anti-base-erosion rules were compatible with EU law and whether the Court would follow the advocate general.

The Ruling

The ruling first clarifies that the question of whether a loan is at arm's length relates not only to the terms of the loan, more specifically the interest rate, but also to the economic sense of the loan and related legal transactions. It should be examined whether such transactions would still have taken place absent a special relationship between the relevant parties.

The Court refers to the so-called *BMW Bank* ruling that was published after *Lexel*.[8] It follows from that ruling that a general EU principle applies according to which EU law cannot be relied on for abusive or fraudulent ends and that member states must reject such situations. In short, an examination of the formal conditions of the transactions alone is insufficient to assess the economic reality of a given transaction. The Court also notes that the Swedish tax system in *Lexel* differs from the Dutch tax system, which results in different practical consequences. Further, whether the loan at issue in *Lexel* made economic sense had not been challenged before nor examined by the Court, and therefore it did not take a position on how economic reality should be taken into account when determining whether a loan is genuine.

As a result, the Court clearly does not agree that loans based on arm's-length terms cannot be considered wholly artificial and that the *Lexel* ruling was interpreted too narrowly regarding the escape rule by the Dutch Supreme Court in their request for a preliminary ruling.

With reference to Emiliou's opinion, the Court states that the principle of proportionality must be considered. The principle requires the deduction of interest to be limited to the non-arm's-length interest that exceeds the arm's-length market rate when the artificial nature of the loan stems from an exceptionally high interest rate for a loan that reflects economic reality. Otherwise, according to the Court, if the full interest amount were not deductible, the anti-abuse rules would go beyond the objective of combatting artificial arrangements. However, if the loan itself is devoid of economic justification and would never have been entered into but for the special relationship between the parties and the economic advantage of being able to deduct interest, all interest deduction may be limited based on the principle of proportionality. In conclusion, the Dutch anti-base-erosion rules and, more specifically, the escape rule are not in breach of EU law.

Effect for Taxpayers

A taxpayer entering into a loan with a related party should not only look at the arm's-length terms of that loan but also consider the economic sense of the loan, the related legal transactions, and the reason why the parties are entering into that loan. This means that the rules have become a bit more abstract because it is not yet clear which reasons could be deemed genuine for entering

[6] *Lexel AB v. Sweden*, C-484/19 (2021).

[7] Request for a preliminary ruling from the Netherlands in *X BV v. Staatssecretaris van Financiën*, C-585/22 (Sept. 7, 2022).

[8] *BMW Bank and Others*, joined cases C-38/21, C-47/21, and C-232/21 (2023).

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into a loan and when there might be an abusive character.

The Dutch Supreme Court must interpret the ruling, apply it to the situation at hand, and further develop the concept of genuine loans apart from arm's-length interest rates and other terms.

Decree on the Comparison of Foreign Entities

As part of the 2025 Tax Package (*Pakket Belastingplan*), new tax classification rules for foreign entities, Dutch limited partnerships (*commanditaire vennootschap*, or CV), and funds for joint account (*fonds voor gemene rekening*, or FGR) will enter into force as of January 1, 2025.

Introducing new classification rules for foreign entities was important because the current system looks at four criteria for determining tax transparency that could easily lead to hybrid mismatches: nontransparent from a Dutch perspective or transparent in the foreign jurisdiction. The four criteria are (1) whether the entity can legally own assets, (2) whether the participants can be held liable for claims against the entity, (3) whether the capital can be divided into shares, and (4) whether participants can be admitted to the entity or can transfer their participation without the consent of all participants. The last criterion is especially relevant for the qualification of foreign limited partnership and often leads to the conclusion that the foreign limited partnership is nontransparent from a Dutch tax perspective, while the limited partnership is transparent in the foreign jurisdiction (thus a hybrid entity).

As of January 1, 2025, all Dutch CVs will become tax transparent. The tax classification rules for the Dutch FGR will also change as of that date. An FGR does not require a certain legal form and is usually based on a contract that is entered between parties. Starting January 1, 2025, an FGR can be either transparent or nontransparent for Dutch corporate income tax purposes.[9] An FGR will maintain its nontransparent status only if (i) it is an investment fund or UCITS (Undertaking for Collective Investment in Transferable Securities) regulated by the Dutch Financial Supervision Act and (ii) the participations in the FGR are tradeable.

As of January 1, 2025, it must be determined whether a foreign entity is sufficiently similar to a Dutch entity (the similarity approach). If so, the tax classification of the entity's Dutch equivalent will be applied. If this is not the case, two additional methods to classify foreign entities have been introduced:

- foreign entities without a clear Dutch equivalent that are resident in the Netherlands are deemed to be nontransparent (the fixed method); and
- foreign entities resident outside the Netherlands will generally follow the classification for foreign tax purposes for Dutch tax purposes (the symmetrical method).

On November 13 administrative guidance was published in the form of a decree intended to function as a framework to apply the similarity approach. The decree discusses the legal fundamental characteristics of the Dutch entities, such as the public limited liability company (*naamloze vennootschap*), private limited liability company (*besloten vennootschap* or BV), cooperative (*coöperatie*), limited partnership (CV), and professional partnership (*maatschap*).

Apart from the legal fundamental characteristics, it is also relevant for the similarity approach to consider a variety of features that might be similar to the fundamental characteristics of Dutch entities. The following features are for Dutch BVs: the relationship between the entity and its participants, whether the participants can be held liable for claims against the entity, the relationship between the

[9] Under the current rules, whether an FGR is transparent or nontransparent depends on whether the participations are freely transferable. Participations are freely transferable — and the FGR is treated as nontransparent — when the participations can be transferred without the consent of all participants. If the participations can only be transferred back to the fund itself, the participations are not freely transferable. If the participations are not freely transferable, the FGR will be qualified tax transparent.

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participants themselves, whether the entity can legally own assets, the management structure of the entity, and the conditions for incorporating such legal entity, for example regarding its objects. The question of whether a foreign entity is comparable to a Dutch BV can be answered by going through the different features and deciding which ones are decisive to conclude that the foreign entity is similar to a Dutch BV and therefore nontransparent. For other legal forms, other features apply.

The decree also notes that if a foreign entity meets the definition of a nontransparent FGR, no other classifications apply. The foreign entity is then treated as nontransparent for Dutch tax purposes. The comparability to an FGR would thus also prevail for U.S. limited partnerships if the limited partnership is comparable to a Dutch CV but also meets the requirements of an FGR.

An annex to the decree is published with presumptions regarding the comparability of certain foreign entities. The list contains a number of foreign entities and their (presumed) Dutch equivalent, as well as foreign entities that (presumably) cannot be compared to any Dutch legal form. Examples of foreign entities included in the list are:

- the U.S. Corp/Inc and U.S. LLC, which are presumed to be comparable to a Dutch public LLC or BV and therefore nontransparent from a Dutch tax perspective;
- the U.S. LLP, U.S. limited liability limited partnership, U.S. nonprofit nonstock corporation, U.S. trust, Canadian unlimited liability partnership, U.K. ULC, and Luxembourg partnership limited by shares (SCA), which are presumed to be noncomparable to a Dutch entity or partnership;
- the U.S. LP and Luxembourg special limited partnership (SCSp), which are presumed to be comparable to a CV and will therefore be tax transparent as of January 1, 2025, from a Dutch tax perspective (unless it also qualifies as an FGR); and
- the U.S. general partnership, which is presumed to be comparable to a professional partnership and therefore transparent from a Dutch tax perspective.

Effect of the Decree

Even though this decree gives more clarity in the form of the presumed classifications in the list of foreign entities, it is still unclear when an entity is actually comparable based on the fundamental characteristics. The explanatory notes state that all fundamental characteristics listed in the decree are equally important, but in assessing the classification of a foreign entity, more or less significance may be given to certain characteristics depending on the case. However, no clear rule of thumb is given for which, for example, a foreign entity would be deemed similar to a Dutch entity if eight out of 10 characteristics of the BV are met. Lastly, it is included that the Legislature's intent should be taken into account when determining whether a foreign entity is similar to a Dutch entity.

There seem to be three main uncertainties for taxpayers when determining whether a foreign entity is comparable to a Dutch legal entity.

First, even though the fundamental legal characteristics of the different Dutch legal entities are listed, it is uncertain how many characteristics would need to be met to be deemed similar to such entity and how to weigh the various characteristics. One also must take the intent of the legislator into account when making the comparison to Dutch entities, which may not be easy for the taxpayer to determine.

Second, according to the explanatory notes, the list of foreign entities and their presumed classification provides only an indicative classification. These indicative classifications could change after amendments in the foreign law of the relevant entity. It is also still possible that the indicative classification is set aside if the fundamental characteristics and their assessment lead to a different outcome. This means that even though more clarity is provided on the qualification of certain foreign entities, this can still be challenged based on the fundamental characteristics. The burden of proof that the presumption of comparability included in the list is incorrect rests on the party that challenges the presumed classification.

Third, as mentioned, the FGR prevails over any other classification. If a foreign entity meets the definition of an FGR, no other classification applies and it will be considered nontransparent

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for Dutch tax purposes, even though it might be tax transparent in the relevant foreign jurisdiction. This could mean that a foreign limited partnership, which is comparable to a Dutch CV (tax transparent for Dutch tax purposes in line with the tax treatment in the foreign jurisdiction), could also meet the definition of an FGR and thus be treated as nontransparent for Dutch tax purposes (as the FGR classification prevails over the CV classification). There would therefore still be a hybrid mismatch, even though the purpose of the new rules was to prevent hybrid mismatches.

Conclusion

The ruling, on the one hand, has clarified that the Dutch escape rule under the anti-base-erosion rules is not in breach of EU law; but on the other hand, it may make it somewhat more difficult to determine when a loan is deemed genuine. The loan being at arm's length is a first step, but the economic sense and the reason why the parties entered into a loan should also be considered. The Dutch Supreme Court may give further guidance when interpreting the ruling.

Even though the new rules and the decree provide more guidance on how to qualify foreign entities, there is still some uncertainty regarding foreign entity classification, especially because the rule that FGR classification has priority over other classifications may still result in hybrid mismatches. ■

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