NEW LEGISLATION ON THE TREATMENT OF PARTNERSHIPS IN THE NETHERLANDS AND LUXEMBOURG

From 1 January 2022 the reverse hybrid rule entered into force in the EU Member States, mainly impacting tax transparent partnerships that are resident in a Member State. In this newsletter we describe the implementation of the reverse hybrid rule in the Netherlands and Luxembourg. Furthermore, we briefly discuss the Dutch legislative proposal on the tax treatment of limited partnerships.

BACKGROUND

Following the implementation of EU Anti-Tax Avoidance Directive 2 (ATAD 2), the Netherlands and Luxembourg implemented the prescribed anti-hybrid mismatch rules into Dutch legislation with effect from 1 January 2020. The anti-hybrid mismatches rules of ATAD 2 are countering the effect of hybrid mismatches which result in a (double) deductible payment that is not taxed at the level of the recipient, by applying so-called deduction/non-inclusion rules (D/NI-rules). In addition to the D/NI-rules, ATAD 2 introduced the **reverse-hybrid rule** that is targeting so-called reverse hybrid mismatches. However, the ultimate implementation date of the reverse-hybrid rule differed from the D/NI rules, being 1 January 2022. Therefore, the Netherlands and Luxembourg (and the other Member States) implemented the reverse-hybrid rule into their national legislation.

1. THE REVERSE-HYBRID RULE

General

While the regular anti-hybrid rules (i.e. the D/NI rules) counter the effect of the hybrid mismatch, the reverse-hybrid rule combats the hybrid mismatch at the source by treating the hybrid entity as a taxable (i.e. opaque) entity to the extent of the hybrid mismatch. A typical example of a structure that made use of a reverse hybrid entity was the so-called CV/ BV structure in which a Dutch BV made payments to a Dutch partnership (a CV) that was considered transparent for Dutch tax purposes, while the interest in the partnership was held by US investors who checked the CV as opaque. Due to the D-NI rules such CV/BV structures are already rarely used since 1 January 2020.

Under the reverse hybrid rule a partnership qualifies as a reverse hybrid entity if it is formed, entered into or incorporated under Dutch/Luxembourg (or another MS) corporate law, or if it is residing in the Netherlands/Luxembourg (or another MS) and is considered transparent for Dutch/Luxembourg (the MS where it is resident) tax purposes. In addition, to qualify as a reverse hybrid entity, **at least 50%** of the voting rights, capital interests or profit rights in the partnership should be directly or indirectly held by related participants that are resident in a jurisdiction that qualifies the Dutch/Luxembourg partnership as opaque. If the reverse hybrid rule applies, the transparent entity becomes a taxable entity in the Netherlands/Luxembourg.

Netherlands

Corporate income tax

Reverse hybrid entities are fully subject to Dutch corporate income tax (CIT). However, the taxable profit of the reverse hybrid entity (most commonly the so-called Dutch closed CV) is reduced for the part of the taxable profit that is allocable to participants that are resident in a jurisdiction that considers the partnership as tax transparent, i.e. the participants pick up the income directly. Please note, for this reduction to apply the income should be included in the taxable profit base of the participant. For the definition of "included in the taxable profit base" the explanatory memorandum refers to the Parliamentary discussions of the implementation of ATAD 2. During the Parliamentary discussions it was stated that income should be considered to be "included in the taxable profit base" as long as the income is included within a "reasonable period of time". Based on the Parliamentary discussions, income shall be treated as being included within a reasonable period of time where:

- the payment is included by the jurisdiction of the participant in a tax period that commences within 12 months of the end of the payer's tax period (a "safe harbour" period); or
- It is reasonable to expect that the income will be included by the jurisdiction of the participant in a future period.

Thus, when a timing difference exceeds the safe harbour period, taxpayers should be prepared to evidence the inclusion of the income in the taxable profit base in the jurisdiction of the participant.

Please note, that a reverse hybrid entity in principle can be considered a tax resident for tax treaty purposes (contrary to a partnership).

Related entity

The definition of 'related entity' is consistent with the definition of related entity as included in the Dutch Controlled Foreign Company legislation. Accordingly, a participant is considered to be related to the Dutch partnership if it holds an interest of at least 25%, or if it is part of a so-called cooperating group that holds an interest of at least 25% in the Dutch partnership.

Withholding tax

In addition, distributions or other payments made by a reverse hybrid entity may under circumstances be subject to Dutch dividend withholding (DWT) tax or conditional withholding tax (CWHT). However, payments are not subject to DWT/CWHT if these are made to participants that are resident in a jurisdiction that qualifies the Dutch partnership as tax transparent.

Furthermore, dividend distributions from Dutch entities to a Dutch reverse hybrid entity may qualify for the Dutch domestic dividend withholding tax exemption (DWT exemption). However, participants in the Dutch reverse hybrid entity that are not entitled to the DWT exemption under the current rules are not entitled to the DWT exemption. The DWT exemption generally applies in case of corporate participants with an interest of at least 5% in the Dutch entity and resident in EU/EEA country or a country with which the Netherlands concluded a tax treaty.

Exception

An exception for the reverse hybrid rule is included for certain collective investment vehicles under the Netherlands Authority for the Financial Markets or fiscal investment institutions (*fiscale beleggingsinstellingen*).

Luxembourg

Corporate Income Tax

Reverse hybrid entities are fully subject to Luxembourg corporate income tax (CIT). However, the taxable profit of the reverse hybrid entity is reduced for the part of the taxable profit that is allocable to participants that are resident in a jurisdiction that considers the partnership as tax transparent, i.e. the participants pick up the income directly. The tax liability of the reverse hybrid entity is limited to CIT and does not extend to dividend withholding tax (DWT), municipal business tax (MBT) nor to net wealth tax (NWT).

Associated enterprise

The definition of 'associated enterprise' for the application of the reverse hybrid entity rule is an entity which holds directly or indirectly an interest of 50% or more in the Luxembourg taxpayer.

Furthermore, similar to the cooperating group in the Dutch legislation, under the Luxembourg implementation entities and/or individuals may be considered as acting together. Accordingly, in case any investors in a Luxembourg partnership (the SCS or SCSp) are considered to act together and as such will hold more than 50% of the interest in the partnership, the reverse hybrid rule does not apply (despite none of the investors individually is considered related).

The Luxembourg implementation contains a very important exception in this respect. Given that in an investment fund context, the different investors generally do not have any effective control over the investments of the fund, the Luxembourg implementation contains a provision under which investors in a fund which hold, directly or indirectly, less than 10% of the capital interest and are entitled to less than 10% of the profits, are considered not to be acting together with other investors in the fund (i.e., the so-called de minimis rule). This means that any such "less than 10%" investor should not be considered to be associated with the fund vehicle, and as a consequence should also not be associated with the entities which the fund vehicle controls a person who, directly or indirectly, owns less than 10% of an investment fund and is entitled to less than 10% of the profits of such investment fund are not considered “acting together” with another person participating in the Luxembourg fund. This so-called de minimis rule is consistent with the implementation of the "acting together" concept in the ATAD 2 legislation as implemented in Luxembourg law since 1 January 2020.

Exception

The reverse hybrid rule does not apply to so-called collective investment vehicles. A collective investment vehicle means an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject regulation.

- Undertakings for collective investment as defined under Luxembourg law of 17 December 2010;
- Specialized Investment Funds (SIFs) as defined under Luxembourg law of 13 February 2007;
- Reserved Alternative Investment Funds (RAIFs) as defined under Luxembourg law of 23 July 2016; and
- Alternative investment funds as defined under law of 12 July 2013 on alternative investment fund managers provided they are widely held, hold a diversified portfolio of securities and are regulated.

Retroactive amendment

On 23 December 2022, the Luxembourg reverse hybrid rule was amended. The amendment clarifies the scope of the reverse hybrid entity rule with an additional condition for a Luxembourg tax transparent entity to be considered as a reverse hybrid entity.

The rule now requires that the double non-taxation outcome resulting from the reverse entity must only be due to the *mismatch classification* of such entity. In other words, the absence of taxation on the profits of the Luxembourg tax transparent entity must be due to its tax opaque classification under the laws of the jurisdiction of its participants. Consequently, tax-exempt participants (benefiting from a local tax exemption), as well as participants located in tax neutral jurisdictions should not be taken into consideration for the rule to be triggered.

The amendment applies with retroactive effect as of 1 January 2022, i.e. as from the original date of the reverse hybrid entity's rule entering into force in Luxembourg.

Impact on Dutch/Luxembourg investment structures

The reverse hybrid rule as implemented in Dutch and Luxembourg law may have significant impact on Dutch/Luxembourg investment structures that make use of a partnership vehicle. Investment structures that solely make use of a Dutch or Luxembourg tax transparent partnership (CV or SCS/SCSp) for example for commercial reasons and without any tax impact in the Netherlands/Luxembourg, potentially fall within the scope.

For Dutch partnerships it remains unclear what the impact is if participants of a Dutch partnership are resident in a jurisdiction that does not levy (corporate) income tax and consequently does not have a view on the qualification of the partnership.

2. LEGISLATIVE PROPOSAL ON DUTCH PARTNERSHIPS

On 29 March 2021 the legislative proposal amending the tax treatment of Dutch partnerships was published. The proposal was heavily debated and on 8 May 2023 the State Secretary announced that the envisaged date of entry into force will be 1 January 2025.

Based on the legislative proposal that was published in 2021, a Dutch limited partnership would be deemed to be always transparent for Dutch tax purposes (both a so-called "open CV" and a "closed CV"). Regardless of what the limited partnership agreement stipulates about the admission and replacement of partners. The distinction between the open limited partnership and (opaque and therefore subject to tax) the closed (tax transparent) partnership will be eliminated.

Transitional law

Since the open CV as a legal form does not cease to exist when its corporate income tax liability is terminated, the proposed transitional law provides (by way of fiction) that - for tax purposes - an existing open CV will be deemed to have transferred all of its assets to its partners against fair market value at the time immediately preceding the termination of the tax liability of the open CV. In addition, the open CV is deemed to have ceased to earn taxable profits in the Netherlands. The consequence is that the open CV is subject to a mandatory final corporate income tax settlement of all hidden reserves, tax reserves and goodwill present in its company.

Impact

From an international structuring perspective, the Dutch consent requirement in limited partnership agreements, in order to qualify as 'closed', is often experienced as restrictive. As under the proposed legislation this requirement will no longer need to be taken into account, it is expected that the proposed legislation will contribute to the legal certainty when it comes to the tax treatment of Dutch partnerships.

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