

The Use of Hybrid Legal Entities in International Tax Reduction Strategies, Part III



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In WCR December 2009 we have shown how a Dutch “Cooperative Association” might be used in a hybrid form to a foreign tax payer’s advantage via international tax planning and in WCR March 2010 a similar article was devoted to the potentially hybrid Dutch limited liability companies NV, BV and SE. This month’s contribution deals with hybrid Limited Liability Partnerships (LLP’s)

Dutch LLP’s: Dutch corporation tax act allows tax payers to freely choose between a “tax entity” or a “tax transparent limited partnership”

Article 2 of the Dutch Corporation Tax Act contains a definition of which Dutch legal or contractual entities are subject to Dutch corporate income tax. As far as Dutch LLP’s are concerned, this article subjects to tax the so-called “open limited partnerships”. In doing so the law apparently distinguishes between open limited partnerships and closed limited partnerships. The latter category is not subject to Dutch corporate income tax.

A Dutch LLP is known in the Netherlands by its abbreviation in the Dutch language: CV (*Commanditaire Vennootschap*). This is the notion we will use below for such Dutch entities.

A CV has at least one general partner and one limited partner. Limited partners are liable only for the debts of the CV up to the amount of their partnership contribution. General partners are fully liable for the debts of the CV and are therefore usually limited liability companies, also in other jurisdictions.

The question whether a CV is “open” or “closed” has been dealt with in legislative history and case law. An “open CV” is any CV which is not considered “closed”. A “closed CV” is a Dutch limited partnership which has quite severe limitations to the access of new partners and the voluntary transfer of a partnership share from one partner to another partner. Only in case such accessions and transfers are subject to the express approval of ALL partners, is the CV a Closed CV and transparent for Dutch corporate income tax purposes. In such a case the partners are subject to corporate income tax in the Netherlands themselves if they are Dutch residents and if they are foreign residents, in case they operate a Dutch permanent establishment or own Dutch real estate.

By playing with the CV’s “articles of establishment”, tax payers are therefore entirely free to choose whether to set up a CV which is taxable for Dutch CIT by itself or to create a CV which is transparent for Dutch CIT purposes. All will depend on the founding documents, especially those concerning admission of new partners and transfer of partnership interests between existing partners.

The foreign tax denomination of a Dutch CV will invariably be dependent on foreign tax rules (foreign entity tax classification rules), so a tax mismatch (good or bad) can rather easily occur: a Closed CV may well count as a Dutch tax entity abroad even if it is not subject to Dutch corporate income tax and an Open CV may well be seen as a tax transparent partnership abroad even if it is subject to Dutch CIT itself. CV’s are therefore “tricky” entities to work with, from an international tax perspective. One may run into double taxation before one knows it, but the opposite (no taxation at all) is also possible. This implies, as always, that one cannot really ignore the tax rules because if one does, things may go terribly wrong, with double taxation as a result.

Foreign LLP’s under Dutch corporate income tax principles

The Netherlands, like any other country, uses its own criteria to determine if foreign LLP’s must be considered taxable entities in which case they are seen as “participations” which qualify for the participation exemption, or as transparent entities in which case they should be seen as a foreign branch office of the Dutch participant/

limited partner, subject to the Dutch foreign branch income exemption. It should be noted that the two Dutch tax exemptions, one for income from and capital gains realised with participations and the other one for branch income, differ markedly from each other so changing the one exemption for the other may make considerable financial difference. The foreign tax criteria (like the question “is the LLP subject to tax itself under foreign tax law?”) play no role in the Dutch entity tax classification process either.

The Dutch Ministry of Finance offers tax payers guidance in the “Dutch tax classification of foreign entities” process via a so-called Resolution, dated 18/12/2004, which contains the following criteria:

- 1) Can the foreign joint venture, under its own legal system, own the assets with which the joint venture is conducted?
- 2) Is there at least one participant in the joint venture who is liable for the debts of the joint venture without limitation?
- 3) Does the joint venture have a capital dividend into shares?
- 4) Can new participants access the joint venture or can participant transfer their share in the joint venture to other participants without the unanimous acceptance by all participants?

The answers to the above four questions will basically determine whether from a Dutch corporate income tax viewpoint the foreign joint venture qualifies as a tax entity or as a tax partnership. In case the foreign joint venture is legally comparable to a Dutch CV (which is the case if questions 1) and 2) above have been answered affirmatively, the foreign LLP is a “CV lookalike” in which case criterion 3) loses its significance and criterion 4) needs to be looked at in detail, in which case a set of additional Dutch rules apply, as follows:

- a) the foreign joint venture conducts an enterprise in its own name;
- b) there is at least one general partner and one limited partner;
- c) the general partners are liable for the debts of the joint venture without limitation (although they might be LLC’s themselves);
- d) the limited partner is only liable up to the amount of his capital contribution;
- e) the limited partner does not act towards third parties as representing the joint venture.

These Dutch criteria are not part of any foreign entity tax classification rules, so a mismatch between the Dutch and the foreign tax take of a foreign LLP can also very easily occur. A good example of this would be the German KG: This entity very much resembles a Dutch CV (the words even mean the same in the two languages), so from a Dutch corporate income tax viewpoint, German KG structures where a German limited liability company acts as the general partner (“GmbH & Co KG” structures) are “CV lookalikes”. It will then depend on the internal rules in the KG as concerns the access of new partners and the transfer of partnership shares between partners, whether the German KG is seen as a tax entity (“Open KG” from a Dutch tax viewpoint) or as a tax transparent entity (“Closed KG”). Regardless of the fact that under German law a KG is always tax transparent!

The Dutch distinction between Open CV’s and Closed CV’s, in use to distinguish foreign LLP interests in “foreign participations” and “foreign branch offices”, based on the internal LLP rules concerning their

accessibility to new partners and to the transferability of partnership interests between partners, is a rather unpractical one. Obtaining consent from all other participants for each and every change in the partnership composition is in fact unworkable in partnerships with more than just a few partners. However, this implies that foreign LLP's which resemble their Dutch CV counterparts will usually be regarded as "Open LLP's" in which case they are treated as "participations" of the Dutch limited partner who participates in such a joint venture even though abroad they are treated as tax transparent. A mismatch between the Dutch and the foreign tax treatment of LLP's is therefore often unavoidable.

Examples

- In case a foreign LLP is considered a "participation" (ie. a "subsidiary") from a Dutch corporate income tax viewpoint whilst the foreign jurisdiction, considers it tax transparent, like in a KG situation, the following might happen:

a) The Netherlands will normally exempt any and all income from such a foreign LLP from Dutch corporation tax under its "participation exemption" (eg. interest payments);

b) The foreign tax authorities may equally exempt the Dutch share in what they see as a tax transparent LLP from local profits tax; this would especially be true in case the LLP share does not constitute a permanent establishment of the Dutch limited partner in the foreign country under foreign tax law;

c) Even if the foreign tax authorities would consider the Dutch limited partner taxable in their country, eg. for operating a permanent establishment there or for owning real estate, they may allow for tax deductions for a variety of expenses (especially under a tax treaty with the Netherlands which resembles the OECD Model Tax Treaty's article 7-3, which is true for 99% of the Dutch tax treaties). However, such foreign tax deductible items may not be picked up in the Netherlands as income (by reducing exempt foreign branch income), as a result of which a "double dip" in expense deduction may easily occur: certain expenses incurred by the Dutch "partner" for the KG will be tax deductible in both countries;

d) It may even become possible for the tax payer to create a tax deduction in the KG without income pick-up elsewhere in the group for internal expenses in the Dutch group which owns the KG interest. For instance, for mortgage interest which the Dutch participant in the KG must pay to its Dutch parent company that finances the mortgage loan from equity. The above KG example also works for many other countries;

- In case a Dutch LLP is considered a taxable entity in the Netherlands ("Open CV") whilst abroad it is seen as a tax transparent partnership, and the foreign jurisdiction is where the "parent" of the Dutch CV is, the following might happen:

a) Upon a transfer of intangibles against book value from the foreign parent to the Dutch CV, depending on the "foreign entity tax classification rules" to which the parent company is subject,

which will likely deviate from the Dutch rules, there might not be a gain recognition abroad; after all, the parent transfers intangibles to itself (ie. its foreign branch office). However, the Netherlands may consider the CV as a taxable entity (Open CV) and will, upon the tax payer's request and based on a transfer pricing report, recognize a transfer against fair market value and the intangibles may then be shown for their fair market value in the tax balance sheet of the CV and be depreciated over their useful lifetime (with a five year minimum depreciation period). This will create sometimes very substantial tax deductions, within a multinational group without pick-up elsewhere in the group.

Conclusions

Like Dutch NV's, BV's, SE's and Cooperative Associations, Dutch LLP's are open to so-called hybridization, in which case they are treated differently under Dutch corporate income tax law than under foreign corporate income tax law of their parent company. The same is true for LLP's in which a Dutch tax payer participates. This may easily lead to double taxation (for which a tax treaty may not offer any solution). However, the opposite is possible as well: LLP's, both Dutch and foreign, may give rise to double non-taxation, or to "double dipping" or to the tax deductibility of expenses in one country without income pick-up elsewhere in the group in another country.

Tax authorities show little or no interest in aligning their tax rules ("entity tax classification rules") with those of other countries. They will therefore – albeit unintentionally – continue to subject tax payers to double taxation and in such cases, tax treaties offer no help at all. Is it then strange if tax advisers do the opposite and advise their clients to deliberately enter into certain hybrid entity structures whereby double taxation does not only disappear, but even turns into double non-taxation because part or even all of their corporate income disappears from the tax radar screen? The one comes with the other, in my view.

Working with foreign joint venture formats is never easy from a tax perspective, in any country. Still, this is the way in which business deals unavoidably develop. Tax payers doing business abroad usually have no choice than to work with a foreign joint venture format. Tax payers are therefore well advised to take a thorough look at their home country tax definitions of any foreign joint venture and to take nothing for granted, to avoid nasty surprises. But it is good to know that often, with some more tax planning, a possibility might exist to turn these tax risks into tax benefits. This can be achieved by deliberately opting for a foreign joint venture format which causes a mismatch between the home country and the investment country's tax systems, so part of corporate income may fall "between the ship and the shore" or certain business expenses might become tax deductible in both tax jurisdictions.

Next time we will take a closer look at "hybrid financing" where one country sees a loan for tax proposes whilst the other country defines the financing arrangement as the provision of equity. ■