Dutch Ministry of Finance publishes new transfer pricing decree

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In brief

The Dutch Ministry of Finance on July 1 published a transfer pricing decree replacing the prior version from 2018, but also retracting the prior guidance on the use of a spread for financial services companies, so-called financial intermediaries ('Dienstverleningslichamen' or DVLs), in a questions and answers decree from 2014.

This new decree provides further guidance on the application of the arm's-length principle and the Dutch Ministry of Finance's view where the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD guidelines) leaves room for interpretation but also reflects a fundamental change to the way transfer pricing is dealt with for financial intermediaries.

Takeaway: The new decree is a narrower interpretation of the arm's-length principle and emphasizes the importance of both control over risks and the financial capacity to bear such risks. This is expected to result in more discussions between the Dutch tax authorities and taxpayers in practice, especially as to intercompany financial transactions, and could possibly lead to double taxation. It is therefore critical that companies revisit their policies for financial transactions in general and more specifically the transfer pricing of financial intermediaries and any guarantees provided for third-party debt across the group.

In detail

Background

The prior transfer pricing decree was published in 2018 to reflect the outcomes of the OECD's base erosion and profit shifting (BEPS) project. Since then, the OECD also published its transfer pricing guidance on financial transactions in 2020, and there also has been increasing pressure on shell companies and the use of related parties in low-tax jurisdictions (e.g., ATAD III).

These developments are reflected in the new transfer pricing decree, in addition to some changes in the wording on other parts of the decree that have been tweaked or streamlined. The most significant changes in comparison with the revoked decree include:

- Further clarification on the application of the arm's-length principle and the impact of government policies such as the support measures introduced during the COVID pandemic;

- Amendments to the guidance on intra-group services and cost contribution agreements; and
- Further details on the transfer pricing of financial transactions, such as loans, cash pooling, and guarantees, to reflect the guidance included in Chapter X of the OECD guidelines but also on the remuneration for financial intermediaries, which replaces the prior guidance included in a separate decree until now.

The biggest changes to the decree are reflected in the section on financial transactions and especially the inclusion of new guidance on the transfer pricing of financial intermediaries. The changes to the financial transactions section of the new decree are therefore discussed first, followed by the other important changes to the decree.

Financial transactions

The biggest changes to the decree are included in the section on financial transactions, including the reflection of the OECD's guidance on financial transactions in Chapter X of the OECD guidelines. Overall, there is a significant emphasis on control over risks and having sufficient financial capacity, especially for financial intermediaries.

Loans

The decree now includes new guidance on implicit support, the methods for the determination of arm's-length interest (i.e., CUP, cost of funds, and a markup on expenses are mentioned), and risk-adjusted/risk free rate.

Similar to the previous decree, the new decree emphasizes that for loans to a non-investment grade rated borrower, it must be substantiated that the loan was concluded under arm's-length conditions, predominantly when the intercompany lender lacks diversification. This requirement is not included in the OECD guidelines.

Furthermore, the decree explicitly states that a borrower is entitled to the deduction of an arm's-length interest rate, even if the lender is only entitled to a risk-free return if it lacks control over risks or financial capacity. The risk premium, in such cases, is allocable to the party that controls the risks. ***Observation:*** This statement should help in discussions on the deductibility of the interest when the lender lacks control over risks or financial capacity, although discussions on where the interest income belongs still would be expected to be complex.

Financial intermediaries

The new decree includes specific guidance on financial intermediaries, which previously had been covered in a stand-alone decree (now partly revoked). This new guidance is a departure from the prior guidance and no longer states that comparable independent parties are remunerated based on the underlying transaction amounts, which was the basis for the typical 'spread' approach between the receivable and payable for financial intermediaries in the past.

A distinction now is being made between three kinds of financial intermediaries based on their level of control over the underlying risks and their financial capacity to bear these risks (e.g., their level of equity): full control, no control, and the financial intermediary shares control with the rest of the group. Each situation is dealt with differently:

- If the intermediary has *full control* over the risks and has the financial capacity, then the requirement is to price each inter-company transaction on its own merits. This part cautions that if the financial intermediaries' borrowings would not have been possible without a corporate guarantee, then these borrowings would be recharacterized as a capital contribution. The decree recognizes a tension between the OECD guidelines and Dutch jurisprudence here and indicates that the OECD guidelines are leading in cases where a taxpayer seeks advance certainty to ensure that this position also can be defended internationally.
- When the financial intermediary has *no control* over the risks and/or lacks the financial capacity to bear the risks, then the financial intermediary is only entitled to a fee based on its own operational expenses. Although not explicitly stated, as a consequence this scenario likely also could result in the financial

intermediary not being considered the beneficial owner of the underlying income streams. ***Observation:*** It is unclear from the decree if in these situations the Netherlands will spontaneously exchange information with the other countries involved (as was the case in the past if the operational substance requirements were not met).

- In case of *shared control* over risks, the decree indicates that any risks that may materialize also should be shared. Also, it is suggested that it is not common in practice to contractually limit the risks for the financial intermediary (as typically was done in the past, e.g., to the minimum thresholds of 1% or EUR 2 million), and situations with shared control also are only rarely expected to occur.

Observation: The partly revoked decree on financial intermediaries had provided details on the preferred way of pricing the underlying transactions, but this is much more limited in the new decree. The new decree lacks specific guidance on factors to consider when pricing the transactions, but also is silent on possible ways that it can be determined that a financial intermediary has sufficient capital to have the financial capacity required for a transaction or what substance is required to be fully in control as a financial intermediary.

Observation: Overall, the new guidance suggests a fundamental change without providing detailed clarity and without clear guidance on the transition from past practices. For example, if the spread previously applied no longer is considered appropriate and is replaced by a lower remuneration based on a cost plus, then the taxable income of the financial intermediary would be subject to a downward adjustment, but this still would be taxed under new rules aimed to combat informal capital in case no corresponding upward adjustment is made there where control over risks is considered to be located. The decree also does not include any grandfathering provisions for existing financial intermediaries.

Cash pooling

The new decree now includes some high-level guidance on the transfer pricing related to cash pooling. This guidance seems somewhat limited for such a complicated topic but generally is aligned with Chapter X of the OECD guidelines. This includes confirmation that cross guarantees provided by cash pool participants generally are driven by shareholder motives and that this would not be expected to be reflected in the profits of the participants (i.e., no guarantee fee but also no costs related to any costs arising due to the guarantee — such as a default of another participants — also would not be deductible).

Key points addressed are the possible recharacterization of cash pool balances from short-term to long-term, but also the assertion that the functionality of a notional cash pool leader is more limited with less value creation by such a cash pool leader compared to that for zero balancing cash pool, which would be expected to also be reflected in the remuneration for this function.

Guarantees

Elements of what is now reflected for guarantees in Chapter X of the OECD guidelines already were included in the revoked decree. Nonetheless, the new decree has been substantially revised, with the biggest changes being the statement that implicit support should be reflected in any guarantee fee analysis but also the possibility for the Dutch tax authorities to delineate a part (or whole) of a third-party loan with a corporate guarantee as a loan to the guarantor followed by a capital contribution in the borrower, when the guarantee allows for increased borrowing capacity.

Observation: The new decree recognizes that such a (partial) recharacterization is not fully aligned with Dutch jurisprudence and as such can create uncertainty for taxpayers in the Netherlands, and emphasizes the importance of a debt capacity analysis when external borrowings are covered by a corporate guarantee. Furthermore, when it is appropriate that an intercompany guarantee fee is charged but no specific guarantee fee can be determined, the Dutch tax authorities deem it acceptable that a guarantee fee is equal to half of the benefit that the guarantee provides the borrower.

Captive insurers

More details now are also included on captive insurance companies in the new decree, although the Dutch tax authorities remain skeptical of the value that a captive adds within a multinational enterprise. The changes are mainly an increased focus on the commercial rationale for the use of a captive and emphasizing the importance of the control over risks, e.g., is there a risk mitigation and underwriting function within the captive entity, and the financial capacity in view of the level of diversification of the insured risks. In addition to passive pooling and insurance as a by-product, the decree now also includes details on insurance fronting with the assertion that any high profits due to the time and place of the sale would not be attributable to the captive.

Application of the arm's-length principle

The structure on the application of the arm's-length principle remains the same with some additions, such as the requirement to attribute an entity's overall profit to the counterparties when a transfer pricing method is used that aggregates transactions to ensure avoidance of double (non-) taxation. This is needed for recent Dutch legislation introduced to prevent mismatches when applying the arm's-length principle. There also is some further clarification when statistical methods can be appropriate to improve the reliability of the full range of observation when comparability differences cannot be qualified and/or quantified.

The impact of subsidies, tax incentives, and nondeductible costs on transfer pricing was covered as a separate section in the revoked decree, but now is included within the section on government policies as part of the application of the arm's-length principle. This section therefore has been expanded and now also includes guidance on the impact of support measures, such as COVID. ***Observation:*** The decree is not conclusive on the impact as it refers to the way third parties deal with such subsidies should be considered.

Intra-group services

The changes to the section on intra-group services are more subtle. The potentially most impactful change is that a benchmark now is also required for transactions of taxpayers that do not fall under the Master/Local File requirements, whereas the revoked decree indicated that the lack of a benchmark for so-called 8b documentation would not result in the reversal of the burden of proof. Another important change is that the new decree asserts that the Dutch tax authorities have discretionary authority when services can be charged without a markup (based on OECD guidelines' par. 7.37 and that charging costs without a markup also would require that all financing costs also are charged out). A more positive move, in line with general business developments, is that costs related to reporting on ESG policies no longer are necessarily considered to be shareholder activities.

The section of services in the new decree now adds contract manufacturing to the part on contract research, emphasizing the importance that the beneficiary of the services has control over the underlying risks but also has the financial capacity to bear these risks.

Observations

As indicated, the new decree does not provide for any grandfathering of past practices such as those for financial intermediaries. This is a concern because of the changes already mentioned but also because the decree no longer includes any guidance on the interaction between the OECD guidelines and Dutch tax law, whereas the prior version stated that the OECD guidelines had a direct application in Dutch tax law.

Certain explicit statements also have been removed, which may create uncertainty:

- The revoked decree explicitly stated that the simplified approach for low value adding services applied for all services of that nature, regardless whether the entity conducted other activities or acted as a shared service center. This clarification has now been removed.

- The section on cost contribution agreements no longer includes a statement that costs can be used as a measure of participants' added value as long as it can be demonstrated that costs are broadly similar to the value add of each participant. The example where this was illustrated also is removed in the new decree.

In contrast to the omissions above, the decree now also includes a summary of the documentation requirements in the Netherlands. These require certain larger taxpayers to prepare Master/Local File documentation for cross-border transactions and include a more open norm for other domestic and cross-border intercompany transactions. The decree now offers the ability for taxpayers to obtain certainty from the tax inspector whether the documentation requirement according to the open norm is met, but also indicates that Master/Local File documentation is sufficient to meet the open norm for domestic and cross-border transactions.

Let's talk

For a deeper discussion of how the new transfer pricing decree might affect your business, please contact:

Transfer Pricing

Michel van der Breggen, *Amsterdam*
+31 (0)62 096 08 97
michel.van.der.breggen@pwc.com

Jeroen Peerbooms, *Amsterdam*
+31 (0)65 133 46 77
jeroen.peerbooms@pwc.com

Neil Schaatsbergen, *Amsterdam*
+31 (0)61 856 58 63
neil.schaatsbergen@pwc.com

Transfer Pricing Global and US Leaders

Horacio Peña, *New York*
Global Transfer Pricing Leader
+1 917 478 5817
horacio.pena@pwc.com

Paige Hill, *New York*
US Transfer Pricing Leader
+1 917 923 841
paige.hill@pwc.com