

New Decree on Transfer Pricing

On 26 November 2013, the Dutch State Secretary of Finance published a new Decree (IFZ 2013/184M) on transfer pricing, the arm's length principle and the latest update of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010). The new Decree will replace two former Decrees dated 30 March 2001 (IFZ2001/295M) and 21 August 2004 (IFZ2004/680M). With the new Decree, the State Secretary of Finance wishes to clarify the policy of the Dutch tax administration on transfer pricing.

In this Tax News Bulletin ("TNB"), we will discuss new subjects and amendments in relation to the former Decrees. After a short summary, we will discuss the important subjects in more detail.

Summary

The new Decree provides:

- A more detailed description of the applicability of the arm's length principle;
- Amendments following changes in Dutch legislation and case law;
- Amendments following an update of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010) ("OECD TP Guidelines");
- A more limited explanation of the use of Transfer Pricing ("TP") methods;
- A clarification regarding shareholders activities, which is in line with the "Guidelines on low value adding services" as published by the EU Joint Transfer Pricing Forum ("EJTPF");
- A clarification indicating that corporate governance costs may also be mixed costs (part shareholder costs and part group costs);
- A replacement of the text regarding financial/treasury activities (in line with Dutch case law).

Furthermore, the new Decree pays special attention to transactions which can not be considered at arm's length and involve:

- Intangible Property ("IP");
- Intragroup procurement activities;
- Intragroup (re)insurance (captive insurance) activities.

Finally, attention is paid to:

- The relation with the EJTPF;
- Guarantees in relation to loan agreements;
- Documentation requirements;
- Advance discussions with the tax authorities (pre-clearance).

Please note that the following subjects are no longer included in the new Decree:

- Administrative approaches regarding the avoidance of double taxation (now included in Decree IFZ 2008/248);
- Attribution of profits to permanent establishment (now included in Decree IFZ 2010/457);
- A possibility to request for a mutual agreement procedure regarding withholding taxes on fees for intra-group services and payments under a Cost-Contribution Agreement (CCA) which are levied in contravention of a tax treaty;

Detailed discussion of most important subjects

General

In line with the OECD TP Guidelines, the new Decree starts by stating that TP is not an exact science. The Guidelines encourages Tax Administrations to be flexible in their approach and not demand from taxpayers in their TP a precision that is unrealistic under all the facts and circumstances. In the new Decree, it is confirmed that the Dutch tax administration will respect these principles.

Arm's length principle

In line with paragraph 1.65 of the OECD TP Guidelines, the Dutch Tax Authorities are entitled to investigate an abusive transaction which is not found between independent parties. At first instance, the Dutch Tax Authorities should investigate whether the transaction could be requalified to a transaction which can be found between independent parties (in other words: a transaction for which arm's length conditions can be found). If this is not the case, in the end, the transaction could be disregarded entirely.

TP method used

As before, the new Decree confirms that taxpayers are obliged to explain the rationale for using a certain TP method. However, taxpayers are not obliged to use the best method available.

Intra-group services for which a fee should be charged

In the case of intra-group services for which a fee should be charged, the OECD TP Guidelines present a clear preference for a direct TP method (Paragraph 7.20). In practice, it appears that most taxpayers prefer an indirect method, because application of the direct method often causes important practical issues. In case of such important practical issues, in principle, the Dutch Tax Administration will allow the indirect method chosen by the taxpayer. However, it is also noted that the results under the method used should be consistent with the arm's length principle.

Furthermore, the Decree notes that (in most circumstances) a profit-based formula for calculating fees for intra-group services is not in line with the arm's length principle. A formula based on turnover, number of employees or employee costs could be more appropriate.

We note that the new Decree contains an (unchanged) list regarding shareholder activities for which no fee should be charged.

Shareholder activities for which no fee should be charged

In line with the Guidelines, the Decree notes that the taxpayer should not charge other group members a fee for shareholder activities. A non-exhaustive list of shareholders activities is included in the new Decree (no amendments were made to the list itself compared to the former Decrees).

Mixed activities

'Mixed activities' are activities which are performed by a division or a group of persons and which can partially be characterized as intra-group services and partially as shareholder activities (i.e. consolidation activities and activities regarding mergers and acquisitions).

The new Decree still offers the possibility for a taxpayer to request certainty upfront regarding the qualification of mixed activities.

IP

According to the new Decree, a transfer of IP is not at arm's length if the transferee does not add any value to the transferred IP (i.e. because the functions required to manage and control the relevant risks are not present at the level of the transferee). The new Decree specifically mentions the case in which the transferee is located in a low tax jurisdiction.

According to the new Decree, and in line with the OECD TP Guidelines, a sole legal owner, which only performs low and/or non value adding services is only entitled to a relatively small share of the total IP-profit.

Procurement activities

Centralized procurement activities are generally remunerated with a cost plus (CP). The new Decree confirms that the Dutch Tax Authorities will allow this TP method. However, if the activities of the tested party can be considered routine activities, the cost base (PLI) should only contain the operational costs of the tested party (i.e. the purchase price of the goods should not be included).

A discount resulting from economies of scale should be attributed to the group companies which are responsible for the increased procurement. However, please note that under the arm's length principle (a part of) the discount which is caused by specific knowledge and skills of the employees of the central procurement company may be allocated to this company.

Guarantees in relation to loan agreements

In the new Decree, it is noted that a taxpayer is not obliged to pay a remuneration to a group company for a guarantee in case the lender would not be willing to provide the loan without the guarantee of the group company. In that case, it is assumed that the group company was only willing to provide the guarantee in his capacity as a shareholder. Furthermore, it is noted that, on 1 March 2013, the Supreme Court of the Netherlands ruled that losses incurred under such a guarantee agreement are not deductible for Dutch CIT purposes.

It is also possible that the lender would be willing to provide the loan without a guarantee of a group company, but that the guarantee would result in more favorable conditions (i.e. lower interest percentage). In line with the OECD TP Guidelines, it is noted that no remuneration should be paid to a group company for an implicit guarantee. However, an arm's length remuneration should be paid for an explicit guarantee. In the example presented in the new Decree, the arm's length remuneration for an explicit guarantee is equal to the difference between the interest percentage under an explicit guarantee (based on the credit rating of the group) and the interest percentage under an implicit guarantee (based on the credit rating of the borrower taking into account that it is part of a group). It is expected this approach will confront taxpayers with a difficult documentation burden, as the impact of being part of a group on the credit rating of a borrower is often difficult to determine.

Reinsurance

In the new Decree, it is noted that, if a group insurance company only performs limited (i.e. administrative) functions, it is not entitled to a substantial remuneration. Two specific situations are mentioned:

1. Pooling

If group companies share, by means of pooling, their (insurance) risks, the resulting discounts on premiums paid to external insurers should not be allocated to the passive pooling company but to the group companies itself (compare with procurement activities discussed above).

2. Insurance premiums as a subordinate product

Some retailers offer (additional) insurance services when selling their products. The premium paid is often allocated to an off shore reinsurance company. However, in case the reinsurance company only performs limited (administrative) functions, the new Decree argues that a substantial part of the premiums should be allocated to the retailer.

Finance transactions (instead of financial services)

The new Decree determines that group companies who lend money to other group companies with a rating below BBB- have to explain that the interest percentage is at arm's length. This is because, according to the State Secretary of Finance, third party financial institutions would normally not be willing to lend money to companies with a rating below BBB-.

Furthermore, the new Decree confirms that losses incurred on a loan to a group company may not be deducted if the circumstances of entering into the loan were not at arm's length (please refer to the ruling of the Supreme Court of the Netherlands dated 25 November 2011).

Documentation obligations

The new Decree refers to the case law to determine the documentation obligations:

1. Explain chosen method (appropriate method rule);
2. Explain conditions used;
3. Explain prices used.

It is noted that the documentation obligations may not lead to severe administrative tasks.