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The Newly Updated Dutch Transfer Pricing Guidance, Part 1: Basics and Treatment of Subsidies and Stimulus Measures

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INTRODUCTION

On July 1, 2022, a new Dutch Transfer Pricing Decree No. 2022-0000139020 dated June 14, 2022 (hereinafter "new TP Decree"),[1] was published in the Gazette.[2] Effective the day after the date of publication, the new TP Decree updates the previous one, from April 2018. In addition to explaining how the arm's-length principle will be applied and how accurate delineation is conducted, it addresses several current transfer pricing topics that can broadly be categorized under the five following headings:

1. Treatment of subsidies and stimulus measures;
2. Treatment of intercompany financial transactions;
3. Treatment of intangibles;
4. Treatment of intra-group services; and
5. Treatment of financial service entities.

The discussion of this new TP Decree and analysis of changes presented is divided in five separate parts, following the above broad categories. In this first part, the transfer pricing treatment of subsidies and stimulus measures together with the force and effect of the new TP Decree is discussed, as well as how the arm's-length principle will be applied according to the new guidance.

BASICS OF THE NEW DUTCH TP DECREE AND TREATMENT OF SUBSIDIES AND STIMULUS MEASURES

The Dutch Tax Authorities (DTA) consider the OECD Transfer Pricing Guidelines (OECD TPG)[3] as clarification of Article 8b of the Dutch Corporate Income Tax Act (CITA)[4] which references the arm's-length principle. Furthermore, they apply a dynamic interpretation to the OECD TPG. This means that changes to the OECD TPG will be considered applicable retroactively to years in which these changes were not published yet, to the extent they can be considered as "further clarifications" of the application of the arm's-length principle.

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[1] https://zoek.officielebekendmakingen.nl/stcrt-2022-16685.html.

[2] *See Netherlands Gazettes Decree Clarifying OECD Guidelines on Arm's Length Principle, Transfer Pricing for Multinational Enterprises*, Daily Tax Report Int'l (July 6, 2022). https://www.bloomberglaw.com/product/tax/bloombergtaxnews/daily-tax-report/X4LEFLDS000000.

[3] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022. https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_0e655865-en#page348.

[4] *See* The Netherlands Transfer Pricing Country Profile https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profile-netherlands.pdf; https://wetten.overheid.nl/BWBR0002672/2016-01-01.

The new TP Decree is binding on the DTA and sets out the DTA interpretation of the arm's-length principle, particularly of aspects where the OECD TPG leave room for interpretation or where there is ambiguity. Taxpayers are not legally bound by the new TP Decree, however, and may take different TP positions, but can expect to be challenged by the DTA if they do.

Noteworthily, the new TP Decree explicitly provides that when the application of the OECD TPG or the interpretation thereof would lead to a transfer pricing adjustment within an internationally operating group leading in turn to part of the group profit not being subject to a corporate income tax, the Dutch DTA considers itself authorized to deviate from the arm's-length principle as described in the new TP Decree. In other words, the DTA will consider non-arm's-length pricing appropriate if it serves to avoid the result of revenue being tax exempt (elsewhere). This approach is consistent with new rules that were recently introduced in Dutch law and disallow downward transfer pricing adjustments in the Netherlands in case there is no evidence of a matching foreign (taxable) income inclusion.

RESTATEMENT OF HOW THE ARM'S-LENGTH PRINCIPLE IS TO BE APPLIED

The new TP Decree restates how the arm's-length principle is to be applied. Each transfer pricing analysis should be based on a proper analysis of the role of each multinational enterprise (MNE) group member, the commercial and financial relations between the respective group members, and the transactions through which those relations are expressed. Characterization of transactions takes place by way of delineation of the actual transactions, consistent with paragraph 1.36 of the OECD TPG. The starting point of the analysis will be the transaction as presented by the taxpayer and the relevant intercompany agreements, as further explained by an analysis of other economically relevant characteristics so that there is a clear view of the actual conduct of the relevant involved parties. To the extent actual conduct deviates from the contractual relationship, however, conduct will be considered as governing for the characterization of the transaction. Functions and relevant risks related to the transactions are to be determined consistent with paragraph 1.60 of the OECD TPG. The economically relevant characteristics mentioned in the OECD TPG will be part of the comparability analysis that is used to determine the appropriate transfer price.

If next to the party that contractually assumes the risk there is another party that exercises control over the risk and has the financial capacity to assume the risk, the contractual allocation of risk will be respected, but the transactional profit split method may be considered appropriate in order to remunerate the other party for its functions.

As regards the comparability analysis, the new TP Decree emphasizes that the price determined based on such analysis is just one of the factors to consider. The so-called Options Realistically Available (ORA) mentioned in paragraph 1.38 of the OECD TPG are relevant as well, as is the fact that the transaction must be considered from the perspective of all parties involved with the transaction. If based on a comparability analysis the intercompany price deviates from the price that would have been applied at arm's length, a price adjustment can be made for tax purposes. However, when adjusting the price or other conditions of an individual transaction or specific group of transactions, an analysis is required to determine whether an arm's-length result remains for a related entity, considering its functions, assets used and risks incurred. It may very well be that the price or conditions of other transactions with other group entities need to be adjusted as well if those have not been determined consistent with the new TP Decree. While not explicitly mentioned, the above elaboration may serve to address situations where a foreign initiated transfer pricing adjustment regarding an associated distributor would lead to a reduction in profitability for a Dutch entity operating as a mere cost-plus intermediary service provider between the foreign associated distributor and a foreign associated manufacturer, and as such, pushing the Dutch entity below the arm's-length cost-plus margin if a corresponding adjustment were to be made. The wording indicates that in such a scenario, the Dutch entity's (related-party) cost base would need to be reduced commensurately, to allow the Dutch entity to continue to earn an arm's-length cost-plus margin.

Consistent with the OECD TPG (paragraphs 1.122–1.124), the new TP Decree references when a transaction can be disregarded (this can only be when the transaction as characterized in totality differs from what unrelated parties acting commercially rationally would have agreed to in similar circumstances, as a result of which it is not possible to establish an acceptable price for all parties). Here the ORAs for each of the parties need to be considered as well. In the event a transaction is disregarded, the consequences of such a transaction will need to be ignored for determining the taxable profit. A transaction may itself also be revisited. This may serve to avoid the result that the arm's-length principle cannot be applied. To the extent possible and appropriate, the transaction may be replaced with an alternative transaction for the purposes of determining taxable profit. The alternative transaction should, however, be based as much as possible on the observed facts and circumstances of the

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transaction at issue. That said, the new TP Decree references the OECD TPG which acknowledge that related parties may engage in transactions that unrelated parties would not enter into. This does not mean the transaction is not at arm's length, but it requires identification of conditions that commercially rational acting independent parties would have accepted under similar circumstances to enter into the transaction. If those can be determined, the transaction should be respected.

The new TP Decree reiterates (as did the previous decree) that while the OECD TPG tend to determine the arm's-length price on a per-transaction basis, aggregation of transactions may be required. It adds, however, that if transactions are entered into with several entities and the (one) transfer pricing method used does not directly match with a given transaction, that transaction will need to be assessed as to what entity and what part of the total profit earned it relates to. Only in such a scenario can the arm's-length price as determined by the transfer pricing method be considered reliable. This is considered important in preventing double taxation and double non-taxation.

The new TP Decree addresses the use of the arm's-length range and clarifies when the interquartile range is required to be used. In essence, that depends on whether the data used for comparison include comparables that can be considered highly reliable or contain comparability flaws that cannot be qualified and/or quantified. In the former case, the arm's-length range consists of the full range of prices/margins earned by all the comparables. In the latter case, a statistical method, such as the interquartile range, is to be used to improve the reliability of the comparable data. In the previous TP Decree, the full range could be used in case the data used consisted of ''good'' comparables. It is unclear whether the change in wording to ''highly reliable'' means that the full range will be available less often in the view of the DTA and that using the interquartile range will be the norm. In case a taxpayer wants to report a margin that falls outside the interquartile range, it should be prepared to submit robust evidence and substantiation therefor.

If the price of the relevant reviewed transactions falls within the appropriate range, no adjustment will be required. In case the price of the relevant reviewed transactions falls outside of the appropriate range, and the taxpayer cannot sufficiently substantiate the deviation, an adjustment will be required. In case the full range can be used, the adjustment can be made to each point within the full range or a specific point within the full range that best fits the conditions of the transaction. However, the adjustment will be to the median of the range in case the comparables cannot be considered highly reliable, to limit the risk of mistakes resulting from unknown comparability flaws or unquantifiable flaws. This is more strict as compared to the previous TP Decree pursuant to which it was possible to make the adjustment to a specific point within the range that best fits the conditions of the intercompany transaction. In case this specific point cannot be designated, the previous decree provided that adjustment is made to the median. Because the interquartile range is used in most cases in practice, this stricter position of the DTA is notable.

Use of a multiple-year analysis is allowed, but to avoid the use of hindsight, such should only include the year in issue and previous years. The approach prescribed is that it should first be determined if the transfer price of the transaction in issue falls within the range determined for the relevant year. No adjustment is required if such is the case. If, however, the transfer price falls outside of that range, the next approach is to consider whether the transfer price falls within a range determined by a rolling average of a couple of years. The number of years to be considered will depend on the length of the life cycle of the product or service in issue. If the transfer price would (still) fall outside of that (rolling average) range, an adjustment will be applied to the median or the specific points as determined through the approach set out in the preceding paragraph, based on the level of comparability of the comparables.

CHOICE OF TRANSFER PRICING METHODS

The DTA will commence a transfer pricing audit considering the transfer pricing method that was applied by the taxpayer at the time of the transaction. The taxpayer is free to choose any method that leads to an arm's-length result for the specific transaction at issue.

However, for certain situations one method will be more appropriate than another. Although a taxpayer can be expected to consider the reliability of a method for a particular situation, consideration of all five transfer pricing methods is not required. In certain situations, a combination of methods may be used. Taxpayers are required only to be able to substantiate their choices.

The new TP Decree observes that the CUP (comparable uncontrolled price) method is difficult to apply in practice due to a lack of comparable uncontrolled transactions, with the exception for financial transactions, for which comparable uncontrolled transactions are generally available. According to the new TP Decree, the transactional net margin method (TNMM) is often used. Where a method compares the results of a related-party (the tested party) transaction with those of an unrelated comparables-based transaction, the related party that has the least complex functions is to

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be used, as per paragraph 3.18 of the OECD TPG. This in general will not be the party that, considering its functions, assets and risks, is entitled to the return related to the intangibles used.

For methods that are cost based, the new TP Decree lists a few observations. While prices are generally determined considering budgeted costs, if the actual cost exceeds the budgeted costs, such determination and any adjustment will depend on the reason for the excessive costs. Excessive costs attributable to inefficiencies in a contracting party's performance will remain with that party, as solely that party can influence those costs. An unrelated buyer would not accept a price adjustment based on such excessive costs. To the extent transfer prices are based on budgets, such budgets will need to be prepared prudently.

Paragraph 2.98 of the OECD TPG indicates that using a transfer price based on cost is appropriate only where the cost can serve as relevant indicator for the value add of the functions performed, assets used, and risks incurred. This means costs that are not a relevant indicator for such value add should not be included the cost base when determining profit. While paragraph 2.99 of the OECD TPG provides that integral costs are to be considered when applying the TNMM, the possibility remains to exclude certain costs from the cost base if an unrelated party with a similar transaction would be willing to forgo making a profit as regards those costs. Reference is made to paragraph 7.34 of the OECD TPG where it is concluded that an (associated) agent or intermediary in the provision of services is only entitled to a mark-up on the costs of the agency function and is not entitled to include the cost of the services themselves in the cost base. Similarly, pass-through costs remain outside of the cost base on which a mark-up is applied and cost of raw materials that are processed by a manufacturer without having any control related to the raw material risks can generally remain outside of the cost base because in those circumstances only the operational costs of the manufacturer will serve as a relevant indicator of the value add resulting from the functions performed, assets used, and risks incurred. This applies regardless of how the raw material costs administratively are handled.

In case a group entity sells goods through a related Dutch intermediary entity that does not conduct relevant sales activities, in practice the intermediary entity mainly provides administrative services for the benefit of a sales transaction. The resulting sales revenue may nevertheless be recorded in the profit and loss statement of the intermediary entity in such cases. Paragraph 2.9 of the OECD TPG provides in relevant part that the intermediary who economically does not perform a function that increases the value of the products sold or does not incur any risk related to the sales transaction should not receive any part of the related profit. In an unrelated-party setting, the intermediary would not have received such a profit but would only be rewarded based on a mark-up on its own operational costs, including the costs related to its administrative services, and not receive a margin based on turnover.

Valuation methods such as the discounted cash flow method may be applied as part of the five transfer pricing methods to determine the arm's-length price in case of transfers of intangibles by taxpayers and the DTA. Paragraph 6.157 of the OECD TPG prescribes that the valuation needs to take place from the perspective of all parties involved in order to get to an arm's-length determination. The arm's-length price of the intangible will be somewhere between the values seen from the perspective of the seller and of the buyer (unless the former is higher than the latter). The value resulting from the application of a valuation method is not necessarily the same as the arm's-length price. The possible tax consequences of a transfer need to be considered as well. The seller of an intangible may be subject to tax on the gain resulting from the transfer of the (intangible) asset. The seller will generally want to be compensated for this. The buyer will need to consider the possible tax consequences of a depreciation of an acquired (intangible) asset, as per paragraph 6.178 of the OECD TPG and Example 29 of Chapter VI of the OECD TPG.

The new TP Decree concludes that in the situation where the seller's perceived value is higher than the buyer's, a transaction is not likely to take place. Both parties would appear to have a better alternative: not entering into the transaction at all. Mention is also made that for the discount factor used for determining the current value of a future income stream, such as the weighted average cost of capital, the risk profile of the parties involved, the asset to be valued, and the activity to be valued need to be considered.

UPDATED GUIDANCE FOR SUBSIDIES, FISCAL STIMULUS MEASURES AND (LIMITEDLY) DEDUCTIBLE EXPENSES

The new TP Decree elaborates on how subsidies and fiscal stimulus measures are to be considered for transfer pricing purposes. As a result of the Covid-19 pandemic and related government aid and subsidies, a lot of questions arose in this particular field. The Dutch policy is that a subsidy can serve to reduce a taxpayer's cost base if there is a direct relationship between the subsidy and the provision of services or products and when the subsidy is granted by way of a discount or a contribution toward the costs. An example would be aid for the purpose of using more ex-

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pensive yet more environmentally friendly raw materials, such as a subsidy for an acquisition of energy-efficient machinery or a contribution on the basis of an investment premium scheme. The same applies for reduced withholding obligations for wage taxes and social security premiums (based on Article 3 of the Act on reduction of payment of wage taxes). These contributions would also result in a lower cost base. The opposite also applies: extra levies such as those for the use of environmentally harmful raw materials will lead to an increase of the cost base.

Subsidies and tax breaks that are awarded to an entity as such and have no causal relationship with the activity for which a cost-based remuneration is applied, will not serve to reduce the cost base applied. Those are to be included in the profit and loss statement. In the event that a tax break is made available by way of a deduction against taxable income, such as investment premiums, those will also not reduce the cost base applied. In such a case, taxable income is determined based on the allocated costs and subsequently the contribution is separately applied by way of a reduction of the taxable income.

Certain cost categories are only limitedly deductible by operation of (tax) law. The new TP Decree references certain specific Dutch CITA articles in this respect. While those costs do belong to the cost base that is used for determining profit, the limitation in deduction is effectuated by way of adding the non-deductible part of the cost back to taxable profit.

The new TP Decree includes a paragraph that focuses in particular on government aid available in certain events, such as a credit crisis and the Covid-19 pandemic, and how such aid is to be considered in a related-party setting, for example, in case a cost-plus-based remuneration is agreed between associated enterprises. While it may be very difficult to collect such information, according to the new TP Decree this will depend on whether comparable unrelated parties that receive such support will include such government aid in the equation when considering the conditions (including the price) of their transactions. The new TP Decree mentions, it is plausible that a significant reduction of turnover and/or the temporarily halt of production as a result of a risk that cannot be controlled leads unrelated parties to renegotiate their conditions (including price). The consequences of such risk will be allocated to the most appropriate party/parties, according to the new TP Decree. During these renegotiations the parties may consider a possible grant of government aid received by either one of them. If that is the case, the same will apply for associated enterprises, according to the new TP Decree. If an associated enterprise wishes to adjust the conditions (including the price) because of government aid (to be) received, the taxpayer needs to substantiate that it is plausible that unrelated parties in comparable circumstances would have agreed to similar adjustments. The adjustment ought to be for business reasons and for obtaining a reduction in turnover that would lead to a qualification for government aid. In practice it may be difficult to obtain information on how comparable independent enterprises consider government aid in the conditions of their transactions.

SUMMARY FINDINGS

The new TP Decree updates the previous 2018 decree and elaborates on how the DTA want the arm's-length principle to be applied.

While the use of an arm's-length range is described, no specific mention is made of how taxpayers could best handle benchmarking challenges for the pandemic years or how pandemic-related losses are to be allocated — such guidance would have been welcome. While the OECD did publish guidance on the transfer pricing implications of the Covid-19 pandemic (OECD Covid Guidance), this guidance is not copied or not even referenced in the new TP Decree.

In forthcoming Part 2, the newly included transfer pricing guidance for financial transactions will be discussed in detail.

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