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New Dutch Transfer Pricing Decree

A new Dutch transfer pricing decree was published on July 1, 2022. The new decree incorporates chapter 10 of the OECD transfer pricing guidelines into Dutch rules and addresses other updates included in the OECD transfer pricing guidelines, in particular those applicable to financial and other service entities in the Netherlands. Furthermore, clarification is provided on how to treat government subsidies and stimulus measures for transfer pricing purposes.

Following we provide a summary overview of the relevant changes that particularly relate to financial transactions and financial service entities. The rules are effective as of the month of July 2022, and may be applied retroactively. Tax inspectors are highly likely to audit taxpayers and apply the new rules.

For **intra-group loans**, the following guidance is provided:

1. The determination of whether an intercompany transaction presented as a loan will also be characterized as such for tax purposes will depend on explicitly described aspects that are part of the accurate delineation analysis.

2. The existence of control and financial capacity in relation to risks related to the loan will be closely reviewed and considered, including whether the related remuneration is allocated to the relevant party/parties that in reality control the relevant risks and have adequate financial capacity.

3. If and to the extent the transaction cannot be transformed into an arm's length arrangement this may result in disregarding or requalification of the entire loan or part thereof.

4. A two-sided analysis is required when analysing an intercompany loan. This requires consideration of the options realistically available to both parties and includes consideration of whether the credit rating of the debtor is investment grade after receipt of the loan and whether the loan and interest can be (re)paid by the debtor considering its income flow. One likely question will be whether it would not have been preferable for the debtor to attract financing by way of an equity contribution considering the relevant indicators.

5. Implicit support will be considered relevant when analysing the credit rating of a debtor. It results in a derived credit rating for the debtor. The position of the debtor within the Group will be relevant in this respect, and essential group companies will be deemed to have a credit rating that is equal to or close to the group credit rating.

6. The arm's length interest rate can be determined through application of the comparable uncontrolled price method, considering available information for comparable transactions with borrowers with a similar credit rating. In addition, the cost of funds method may be used, for which the cost of the creditor to attract the funding necessary for the intercompany loan is considered with a markup for costs, risk premium and remuneration for the required capital to be maintained by the creditor to support the loan. It is noted that if the creditor of record is a mere intermediary entity or an agent, the appropriate remuneration for that creditor of record will solely be a markup on its own (operational) costs.

7. Remuneration for an intercompany loan is essentially a risk-adjusted rate of return. This rate of return consist of a risk-free rate of return and a premium fee for the risk allocation to the creditor. A party that does not control relevant risk related to the intercompany loan will not be entitled to more than a risk-free rate of return, which is usually found by way of looking at government bonds.

8. The borrower may very well be entitled to deduct the full interest paid to the creditor that at arm's length solely earns a risk free rate of return. The difference between these two rates should be allocated to the party that controls the risk related to the intercompany loan, assuming that this remuneration will also be subject to corporate income tax.

9. The new decree references the existence of Dutch jurisprudence regarding not-at-arm's length loans or "non-business" loans (i.e. profit-sharing loans), but also provides that for purposes of determining an arm's length interest rate for intercompany loans, the principles included in the new decree and the OECD transfer pricing guidelines ought to be considered determinative.

For **financial guarantees**, the decree clarifies that an analysis is required to what extent the financial guarantees are provided at arm's length. The following aspects will be considered:

1. The arm's length nature of the guarantee needs to be considered using a two-sided analysis. Considering the presence of implicit support, would a guarantee be required?

2. A benefit resulting from a guarantee can be that the debtor obtains funding under better terms. If this means that the cost of the funding is reduced, the debtor may be willing to pay a guarantee fee. To that extent the cost of the funding with a guarantee should be compared with the cost of funding without a guarantee but including implicit support.

3. Another benefit resulting from a guarantee can be that the debtor can obtain more funding than without the guarantee. The surplus funding available as a result of the guarantee should be deemed as a loan obtained by the guarantor, followed by a capital contribution of that amount by the guarantor to the party that benefits from the guarantee. The (intercompany) arm's length guarantee fee will solely relate to that part of the funding that corresponds with the loan to the party benefitting from the guarantee and does not include the surplus amount that is considered as a capital contribution.

4. If and to the extent a guarantee is provided for funding of an entity that stand-alone would not have qualified for funding, the guarantee will be treated as granted through the shareholder relationship. No guarantee fee applies in that case. If the creditor calls on the guarantor as a result of the guarantee, it will be considered to relate to the part of the loan that could not have been obtained stand-alone and as such not result in a tax deductible charge.

5. If the guarantee can be considered a service, the guarantee fee cannot exceed the benefit obtained by the party benefitting from the guarantee.

6. If the CUP method cannot be applied, there is a preference for the yield approach to determine an arm's length guarantee fee. If a specific arm's length guarantee fee cannot be determined, the guarantee fee can be determined based on 50% of the benefit enjoyed by the guaranteed borrower.

7. Cross-guarantees are considered to add no more value than passive association and implicit support do. No guarantee fee would be required at arm's length in that scenario.

8. To the extent that an associated entity guarantees an umbrella credit facility and takes on the principal liability for the debt of all entities that participate in that credit facility, the guarantee will be considered as resulting from the corporate relationship between that entity and the group members participating in the credit facility. No arm's length fee is expected to be available in such a scenario.

The Dutch Tax Authorities are sceptical about the arm's length nature of **captive insurance**. The following guidance is provided:

1. The decree presents six key questions that each must be addressed before it can be determined whether the captive insurance structure is legitimate/arm's length:

   a. Do the captives engage in diversification and pooling? It is noted that captives usually have a lower level of diversification than an external insurer would have which would lead to a higher premium to be able to take on the insured risk. Without that higher premium the captive would not earn sufficient income to incur the risk and realize a return on its capital at risk. Considering this higher premium, the insured entities would probably be better off externally insuring the relevant risk.

   b. Has the capital of the group entities economically improved as a result of the diversification?

   c. Is the captive a regulated entity subject to rules regarding taking on risk and related capital?

   d. Would the insured risk be available for insurance outside of the Group?

   e. Is there a real possibility that the captive incurs losses?

   f. A difference is noted between insured risk and risk related to insurance. An insured party is usually in control of the insured risk. Deciding to take on risk and insurance against that risk is part of the control over that risk. This would include the underwriting function. If no such control functions are performed, the (return on) premiums received ought to be allocated to the party that performs the control functions. If, however, there is insurance, then that is essentially a risk mitigation function that does not belong to the control function with regard to the insured risk.

2. Passive pooling of insurance risk means the risk is pooled and insured by an unrelated (re)insurer. Passive pooling is usually considered an extension of the risk management performed by the headquarter company. It does not include underwriting and diversification and often the required insurance knowledge or investment knowledge is not available either. This would be a more administrative function that warrants a modest return.

3. Benefits resulting from bundling (the need for less coverage), procurement benefits resulting from negotiations with (re)insurers and the earnings resulting from investment of the premiums should be allocated to the group entities that bundle their forces this way.

4. Insurance may also be offered as a by-product to unrelated buyers of products or services with activities outside of the insurance industry, such as by way of cancellation insurance or extensions of a guarantee period. In these situations the insurance policy will usually be issued in the name of an unrelated insurer that is a regulated entity. The premium will be paid to the re-insuring entity after deduction of the fee for the unrelated insurer. The associated re-insurer usually does not perform any underwriting functions, does not diversify and does not have the required knowledge and expertise to operate as an insurer. This entity solely performs a limited administration function which merits a modest remuneration.

5. The sale of insurance via an associated agent can lead to a higher profit for the insurer than in the case similar transactions were entered into with third parties. If an associated enterprise benefits from the fact that an associated distributor offers insurance directly to the customer at the moment of sale, the resulting profit should not be allocated to the insuring entity. The insurer should only receive an arm's length remuneration.

Furthermore, the new decree addresses the treatment of **financial service entities**. In this respect it is observed that a special form of financial services within a multinational group comprises transactions that mainly consist of the directly or indirectly receiving and payment of interest, royalties, rent or lease payments in whatever name or form. Financial service entities perform service activities where a close relation exists between incoming and outgoing financial flows. Relevant observation in this respect are as follows:

1. The arm's length remuneration for such financial service entities must reflect their functions, activities and risks.

2. For the allocation of risk to a financial service entity it is required that the entity can control the risk and has sufficient financial capacity to incur the consequences of the risk when it materializes.

3. The risks that may arise from financial transactions mainly include credit risk, market risk and operational risk. To the extent these risks are carried by the financial service entity and are closely related to the flow of funds, remuneration related to the underlying principal amount may be appropriate. The sole carrying of operational risk (resulting from the support activities of the financial service entity) will not justify an allocation of credit risk to the financial service entity.

4. If the financial service entity does not have sufficient control and or financial capacity, the related risk is to be allocated to the entity that does have sufficient control over this risk and capacity to perform the risk.

5. If the financial service entity has full control over credit risk and financial capacity, and the financial service entity is capable of attracting financing from unrelated parties, an appropriate interest rate must be determined based on a comparability analysis. The CUP method will be considered the most logical method for that purpose.

6. If the financial service entity has no control over credit risk and or no financial capacity to carry the credit risk the risk cannot be allocated to the financial service entity. In this case the arm's length remuneration is expected to be based solely on the operational cost of the financial service entity.

7. If the financial service entity and the headquarter company (or another associated enterprise) share control over credit risk and each performs quantitative and qualitative control activities, the risk can be allocated pro rata to the financial service entity. It is remarked that in comparable uncontrolled transactions, it will not often arises that the risk assumed by the financial service entity is contractually limited without considering the relative degree in which the parties exercise control over the risk.

Also addressed are **cash pooling arrangements**, which essentially regard when short term receivables and loans outstanding with unrelated parties are pooled within the group in the form of a cash pool and managed by a cash pool leader. Aspects of importance in this regard include:

1. In the event individual participants hold debit or credit positions in the cash pool for a longer period of time, it is required to determine whether there is a long term deposit or a loan transaction rather than a cash pool transaction.

2. The cash pool transaction will only be considered realistic if this does not result in a less favourable result than another option for the cash pool participant. Ergo, the options realistically available to the cash pool participant must be considered.

3. Synergy benefits resulting from a cash pool, such as a reduced need for entering into external loans, less administration and more efficient management of the company's liquidity, must be allocated amongst the cash pool participants.

4. The benefits of the cash pool are to be allocated through the determination of the interest rates on the debit and credit positions of the cash pool participants taking into account an appropriate remuneration for the cash pool leader.

5. In case of notional cash pooling, the cash pool leader is considered to contribute less value as compared to zero balancing cash pooling, which will impact its remuneration.

6. Individual participants are considered to have no influence on who participates in the cash pool and how high the amounts are for which they possibly serve as guarantor. In general, there will also be no cross-guarantee fee involved between the cash pool participants.

7. In general, no guarantee fee is due in case of cross-guarantees within a cash pool arrangement.

Considering the above, we advise that your portfolio of intercompany financing arrangements is catalogued, subjected to review, and that the underlying documentation needed for tax purposes is organized to withstand tax auditor questions. Intra-group financing arrangements are likely to be audited. Our transfer pricing team is available for a discussion or assistance in this regard.

Monique van Herksen monique.vanherksen@simons-simmons.com

Clive Jie-A-Joen clive.jie-a-joen@simmons-simmons.com