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New Dutch Transfer Pricing Guidance Focuses on Financial Transactions

By Monique van Herksen and Clive Jie-A-Joen2022-07-20T03:00:37000-04:00

The Dutch transfer pricing rules were materially updated on July 1, 2022, when a new Dutch transfer pricing decree (Decree No. 2022-0000139020) was published in the Official Gazette.

The changes mainly concern the incorporation of Chapter 10 (on financial transactions) of the 2022 OECD transfer pricing guidelines. The decree also provides for new guidance on the transfer pricing treatment of intragroup financial service entities, the treatment of government support measures in relation to certain events—for example, the Covid-19 pandemic—and the use of an arm's length range.

There is little doubt that the rules will be applied using a dynamic interpretation, allowing for retroactive effect.

Set out below are a few key aspects of the new decree, particularly with regard to financial transactions.

Intra-group Loans

In light of the many years of audits and court cases in the Netherlands regarding the requalification of debt into equity and non-market price or not-at-arm's length loans ("onzakelijke leningen" in Dutch), the Dutch tax authorities intend to apply the following OECD transfer pricing rules to financial transactions:

- Whether a transaction presented as a loan by associated enterprises should be characterized as a loan depends on the outcome of the accurate delineation process described in Chapter 1 and Chapter 10 (Part B) of the OECD transfer pricing guidelines.

- When a financial transaction is characterized as a loan, the arm's length nature of the conditions of the intra-group loan, including the price, must be evaluated. If the transaction cannot be made

arm's length with an adjustment in price and/or of other conditions, part of the loan may be ignored or requalified in extreme scenarios. The arm's length interest cost/earnings can then subsequently be determined for the qualifying part of the loan.

As there is existing Supreme Court jurisprudence on this matter, it will be interesting to see how this approach to transfer pricing will be applied and respected in practice. Based on the Dutch Supreme Court jurisprudence, the entire loan (and not just a part of the original loan) is regarded as a not at arm's length loan. Any depreciation or write-down of such a loan is not deductible from the taxable profit of the lender, while the interest rate anticipated for tax purposes needs to be considered. Compared to the all-or-nothing approach in the existing jurisprudence, the transfer pricing approach set out in the new decree could serve to more proportionally determine the arm's length balance of debt-equity funding.

The new decree acknowledges that the Supreme Court case law has used other specific criteria for the qualification of a loan as equity and that that creates tension between the OECD transfer pricing guidelines and the Dutch case law. If a taxpayer were to ask for advance certainty on the application of the arm's length principle, however, the OECD transfer pricing guidelines will be taken as a starting point because unilaterally provided advance certainty should also be internationally consistent.

In the authors' experience, a debt capacity analysis can be conducted to evaluate the arm's length balance of debt-equity funding in applying the arm's length principle. This consists of a cash flow analysis to demonstrate that the borrower would be able to service the interest payments and repay or refinance the loan. In addition, market evidence can be gathered to demonstrate that an independent borrower with the same credit rating as the borrower could obtain a loan from a third party lender on a stand-alone basis.

The new decree provides that lack of control and/or financial capacity by a party in relation to certain risks can lead to the allocation of that risk, including the related remuneration, to another party who controls the risk and has adequate financial capacity to do so. Whether this remuneration can be characterized as a service fee or interest rate is not addressed in the new decree. But it will have implications for application of the interest limitation rules based on EBITDA, value-added tax, and other relevant aspects.

Financial transactions must explicitly be analyzed from a two-sided perspective and the options realistically available to the relevant parties involved. An unrelated lender more likely will issue a loan to an unrelated party whose creditworthiness, considering the intended intra-group loan, will not decrease below a certain level. An unrelated borrower will strive to organize the financing of its

business activities efficiently and with the lowest possible cost of capital, which will be impacted by the debt-to-equity ratio.

The cost of debt is largely dependent on the creditworthiness of the borrower, which is usually expressed by credit rating. The new decree provides that intra-group financial transactions that lead to a debt-to-equity ratio and interest expense which, after putting in place the intercompany loan, reduce the borrower's creditworthiness to non-investment grade (i.e., a credit rating below BBB-), will require the taxpayer to proactively substantiate that the conditions of the loan are at arm's length. In practice, many related party borrowers have non-investment grade ratings and should therefore substantiate that they can service the debt—for example, by conducting a cash flow analysis showing that the borrower can pay the interest and principal of the loan. The new decree concludes that higher risks generally lead to higher interest rates.

The new degree says that when determining the credit rating of an entity, the level of implicit support of the group can play a role. Implicit support must be considered a benefit that is exclusively allocable to an enterprise being part of the group. Implicit support results in a derived credit rating for the borrower. When determining the level of implicit support from the group and the impact on the credit rating for the borrower, the entity's role within the group must be considered. The extent to which implicit support affects the credit rating of the borrowing entity is a popular audit issue. For entities whose existence is crucial for the group, the credit rating will be equal or close to the group credit rating.

Implicit support may impact the credit rating, which in turn is relevant for determining the interest rate as well as for evaluating the balance of debt-equity ratio of the related party borrower.

When determining the interest rate, there is an apparent preference for the comparable uncontrolled price method, which determines the interest rate on the basis of available information on comparable transactions of borrowers with a similar credit rating. The cost of funds approach, which increases the cost of the issuer to borrow the funds itself with a margin for costs, a risk premium, and a fee for the required equity, may also be considered.

Interest charged in relation to a loan is reflected as a "risk-adjusted rate of return," which consists of a risk-free rate of return and a premium as reward for the risk that is allocated to the funder at arm's length. While the return for a financing party that does not control the risk may be limited to a risk-free rate of return, the borrower will have the right to deduct an arm's length interest rate. The risk-free rate of return can in general be determined in line with qualified government bonds. Any difference

between the arm's length interest rate and the risk-free rate of return (the risk premium) should subsequently be allocated to the party that is in control of the risk related to the investment in the financial asset. However, if the entire interest income is not included in taxable profit, the tax authorities may deviate from applying the arm's length principle.

Cash Pooling

The new decree also addresses cash pooling and the benefit that can be obtained when short-term receivables and loans of group entities outstanding with unrelated parties are pooled within the group in the form of a cash pool.

Where cash pool participants hold debit or credit positions in the cash pool for a longer period of time, it must be determined if these are really long term deposits or loans, as they would require an arm's length remuneration that would have been different from the remuneration applied to a short-term position.

The benefits of a cash pool include more favorable interest rates, reduced need for external loans, less administration, and more efficient management of the company's liquidity. Savings and other cash pool benefits can include group synergies. However, any synergy benefits must be allocated among the group participants through the determination of the interest rates on the debit and credit positions of the cash pool participants after consideration of appropriate remuneration for the cash pool leader. The cash pool leader generally contributes less value under notional cash pooling as compared to zero balancing cash pooling, which will impact the remuneration. The authors consider that the determination of the aforementioned interest rates applies to so-called zero balancing cash pooling structures. Under notional cash pooling, there will be virtual balancing of the debit and credit positions of the cash pool participants—i.e., there will be no inter-company transfers of the balances of the cash pool participants to the main account and vice versa.

While there may be cross guarantees in place, in general, no cross-guarantee fees ought to be applied between the parties.

Guarantees

According to the new decree, guarantees for unrelated party debt are not a common occurrence.

Therefore, in the case of a guarantee for related party debt, there needs to be a review of whether unrelated parties acting commercially and rationally would have been willing to enter into such a transaction. This review must be conducted using a double-sided analysis, which includes determining if the borrower obtains a benefit from the guarantee, taking into account the effect of existing implicit support.

Benefits from having a guarantee include obtaining better terms for the loan than without the guarantee. With a guarantee in place, the borrower obtains funds based on the guarantor's credit rating, which will usually lead to a lower interest rate for the borrower. The guaranteed borrower will be prepared to pay a guarantee fee if the cost of the funding with the guarantee is lower than the cost of funding without the guarantee. However, the benefit of implicit support must also be considered.

Having a guarantee will allow for a larger loan amount than would have been possible without one. In this case, the guarantee not only supports the credit rating of the borrower but also increase the borrower's loan capacity. The additional part of the loan obtained by the borrower resulting from the guarantee must be treated as a loan to the guarantor. This loan is subsequently contributed by the guarantor to the borrower. The guarantee provided for this part of the loan takes place based on the shareholder relationship, and no guarantee fee applies for this additional part of the loan. Only the part of the loan that qualifies as a loan to the guaranteed borrower can be considered as a service for which an arm's length guarantee fee may be determined.

For the service of providing a guarantee, there are five transfer pricing methods available to determine the guarantee fee. To the extent the comparable uncontrolled price method cannot be used, there is a preference for determining the guarantee fee based on the what is known as the yield approach. If we assume interest rates based on the following credit rating: (i) standalone rating of 6%, (ii) derived rating of between 4% and 6% (let's assume 5%); and (iii) group rating of 4%, the yield approach would produce a maximum guarantee fee of 1%.

This is the difference between the interest rates of the group rating—i.e., 4%—and the interest rate of the derived rating—i.e., 5%. Where no specific arm's length guarantee fee can be determined, the arm's length guarantee fee can be considered to be 50% of the benefit obtained by the borrower as a result of the guarantee. When group members guarantee each other's obligations, no guarantee fee applies. The benefit of such cross-guarantees will usually not exceed the benefit resulting from implicit support.

Captive Insurance

Structures for captive insurance, which involves group entities that act contractually as internal (re)insurance entities (captives), will be reviewed skeptically and analyzed closely to determine whether the transactions involved can be delineated as de facto insurance transactions by the captives. Captives will require diversification and pooling within the structures. As the group of insured parties within a captive insurance structure is smaller than when an external insurer is involved, a captive is likely to have a lower rate of diversification than the external insurer that insures comparable risks. This will lead to a higher premium to be charged by the captive to accept the risk. For that reason alone, insured parties would already be considered better off if they transfer the risk to an unrelated and more diversified insurer.

For insurance transactions, there must be a distinction between the insured risk and the insurance risk. The insured party is generally the party in control of the insured risk. Deciding to take on risk and insure that risk against negative consequences is a reflection of the control the insured party has over that risk. The captive will then perform a risk mitigation function, which is not part and parcel of the control function over the insured risk. It also needs to be determined if the captive is in control of the insurance risk. Performing underwriting functions is considered a control function with respect to insurance risk. If the captive does not perform the control functions, the insurance risk and the net proceeds resulting from investment of the insurance premiums must be allocated to the party who does control that risk.

Chapter 10 of the OECD transfer pricing guidelines describes the sale of insurance via a related intermediary, where the profit that the de facto related insurer makes exceeds that of a comparable transaction between comparable third parties. If the high profitability is attributable to the opportunity to also offer insurance at the moment and place of sale of the product and service, the additional benefit should not be allocated to the related insurer.

Concluding Remarks

The new decree updates previously issued transfer pricing guidance but more importantly puts transfer pricing for financial transactions squarely on the map. To ensure that taxpayers apply the new rules, the Dutch tax authorities have indicated that transfer pricing audits of financial transactions are to be expected.

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