Alert
New Dutch Transfer Pricing Decree

A new Dutch transfer pricing decree was published on July 1, 2022. The new decree incorporates chapter 10 (financial transactions) of the OECD transfer pricing guidelines and addresses other updates, in particular those applicable to financial and other service entities in the Netherlands. Furthermore, clarification is provided on the use of an arm's length range and how to treat government subsidies and stimulus measures for transfer pricing purposes.

Following we provide a summary overview of the Dutch tax authorities' transfer pricing guidance and positions on issues excluding financial transactions and financial service entities (for which a separate alert is available). The rules are binding for the Dutch tax authorities and effective as of the month of July 2022, and may be applied retroactively. Tax inspectors are highly likely to audit taxpayers and apply the rules set forth in the new decree.

As regards the **application of the arm's length principle** the new decree clarifies that an accurate delineation is required of the transaction in issue. It also provides when a transaction may be ignored or revisited. This means inter alia the following:

1. The starting point of the transfer pricing analysis is the transaction as presented by the taxpayer with intercompany agreements, as elaborated with an analysis of other economically relevant characteristics so that there is a clear view of the actual conduct of the relevant involved parties.

2. To the extent actual conduct deviates from the contractual relationship, however, the former will be considered as governing for the characterization of the transaction.

3. Functions and relevant risks related to the transactions are to be determined consistent with the OECD transfer pricing guidelines. This includes the economically relevant characteristics mentioned in the OECD transfer pricing guidelines.

4. As regards the comparability analysis, the price determined based on the comparability analysis is to be considered as just one of the relevant factors. The options realistically available to the parties involved in the transaction are also relevant, as is the fact that the transaction must be considered from the perspective of all parties involved with the transaction.

5. If the intercompany price is not at arm's length based on the outcome of a comparability analysis, a price adjustment can be made for tax purposes. However, it must be considered whether an arm's length result remains for the entities involved after such an adjustment. 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 transfer pricing approach set forth in the new decree.

6. A transaction may be disregarded when the transaction as characterized in totality differs from what unrelated parties acting commercially rational would have agreed in similar circumstances, as a result of which it is not possible to establish an acceptable price for all parties. In this case the options realistically available 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.

7. A transaction may 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 which arm's length conditions can be found. The alternative transaction should however be based as much as possible on the observed facts and circumstances of the transaction in issue.

8. While traditionally the arm's length price is determined on a per transaction basis, aggregation of transactions may be required. However, if transactions are entered into with several entities and the (one) transfer pricing method used does not directly match with an individual transaction, it will always be required to be able to show to what entity what part of the total profit earned relates. This is considered important in light of prevention of double taxation and double non-taxation.

As regards the **choice and application of transfer pricing methods**, relevant provisions include:

1. The tax authorities 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 a transfer pricing method, provided the method leads to an arm's length result for the specific transaction in issue.

2. For certain situations one method will be more appropriate than another. A taxpayer is not required to consider all five transfer pricing methods and considering the circumstances choose the best method. In certain situations a combination of methods may also be used. A taxpayer is not required to use more than one method, however, and is only required to be able to substantiate the choice for the method applied.

3. The CUP method is considered hard 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.

4. In practice the TNMM is an often-used method. Where a transfer pricing method is applied that compares the results of a transaction of one of the related parties with unrelated comparables, the starting point is that this comparison takes place considering the related party that has the least complex functions (the tested party). This in general will not be the party who, considering its functions, assets and risks, is entitled to the return related to the intangibles used.

5. As regards cost-based methods, it should be considered that while prices are generally determined considering budgeted costs, if the actual cost exceed the budgeted costs, it will depend on the reason for the excessive costs whether that will require a price adjustment. Excessive costs that are due to inefficiencies that are for the account of the contracting party's performance will remain with that party, as solely that party can influence those costs.

6. Using a transfer price based on cost is only appropriate when the cost can serve as relevant indicator for the value add of the functions performed, assets used and risks incurred. This means that costs that are not a relevant indicator for that value add should not be included the cost-base when determining profit.

7. While integral costs are generally 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 forego making a profit as regards those costs.

8. Pass-through costs stay 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 stay outside of the cost base as well 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.

9. Intermediary services provided in an associated group setting, in practice consist mainly of administrative services for the benefit of a sales transaction. The resulting sales revenue may nevertheless be recorded in the P&L of the intermediary in such cases. However, the intermediary who economically does not perform a function that increases the value of the products sold or who on the basis of the characterization of the transaction does not incur any risk related to the sales transaction, should not receive any part of the profit related to the sales transaction. 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 that are related to its administrative services, and not receive a margin based on turnover.

As regards comparables and the **application of the range resulting from a benchmark analysis**, the following is provided:

1. If and when data used for comparison include comparables that can be considered highly reliable comparables, the arm's length range consists of the full range of prices / margins earned by all the comparables.

2. If and when the data used for comparison include comparables that contain comparability flaws that cannot be qualified and / or quantified to improve the reliability of the comparable data the interquartile range ought to be used.

3. 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.

4. Before and adjustment is applied, 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 if the transfer price falls within a range determined by a rolling average of multiple years. The amount 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.

5. If an adjustments is required, the adjustment will be to the median of the range in case the comparables cannot be considered highly comparable, to limit the risk of mistakes resulting from unknown comparability flaws or unquantifiable flaws.

6. Using a multiple year analysis is allowed, but to avoid the use of hindsight, such should only include the year in issue and previous years.

Transactions involving **transfers of intangibles** should consider the following guidance:

1. A transfer of intangibles to a group entity will not comply with the arm's length principle if that group entity does not contribute value to the respective assets because it does not have the required functionality and is not in the position to control the risks related to this intangible asset.

2. In unrelated relations a transaction with respect to an intangible asset is normally only entered into if both parties expect an increase of their (individual) profitability to result from the transaction. Realistically, this is only possible if there is an expected increase of profit for seller and buyer jointly as compared to their joint profit prior to the transaction.

3. in case of a transfer or intangibles, the buyer ought to add value, which is only possible if the buyer has the required functionality to do so and the buyer can control related risk. Without an expected increase of joint profit, the offering prices of the buyer will be lower than the selling price of a potential seller. The transfer of an asset would in that case not seem commercially rational, also considering that a transaction will include transaction costs.

4. In the event of a transfer of intangibles, the options realistically available of the seller and buyer will need to be considered. If total operating profit of the parties together will not increase as compared to the situation in which there would have not been a transfer, it would appear that the realistically available and more attractive option is to not enter into the transaction.

5. If the buyer of an intangible asset is located in a low tax jurisdiction, that mere fact will not be considered as contributing to the increase of joint profit, if the buyer does not also possess the relevant functionality in relation to the intangible asset. If the seller retains the relevant functionality after the transfer of the intangible, the buyer essentially will be dependent on the seller for future development of the value of the intangible and the exploitation thereof. In an unrelated party setting, the buyer would not expect operational profit. As a result, the buyer would not be able to benefit from the lower tax rate for arm's length purposes.

6. If conditions deviate from those that unrelated parties would have applied at arm's length their impact on the profit must be eliminated from the taxable income of the Dutch seller.

7. The same analysis will be applied in case legal ownership of the intangible is with group entities without a prior transfer by another group entity. If the relevant functionality is absent at the legal owner, the latter will only be allocated a relatively limited remuneration.

8. Relevant functions related to intangibles are the DEMPE functions (Development, Enhancement, Maintenance, Protection and Exploitation). Depending on the circumstances, a weighting of the DEMPE functions will be required related to the relative importance of such functions. The new decree provides that Development and Enhancement are generally considered to weigh more than Maintenance, Protection and Exploitation.

9. The Dutch tax authorities take the position that no fixed price can be determined in case of a transfer of intangibles at the time the value is highly uncertain. In that case a price adjustment clause ought to be included in the agreement between the associated enterprises through which the price is also dependent on benefits generated by the intangible in the future.

10. In case hard to value intangibles are transferred or licensed, the Dutch tax authorities may use the realized results from using the intangibles when determining the arm's length nature of the price applied to the transaction. Essentially, the Dutch tax authorities are authorized to adjust the transfer price applied at the time of the transaction based on the actual realized results (i) in the event that there is a large deviation (i.e. 20% or more as compared to the projections that formed the base of the price determination, within a 5-year period since the intangible first generated revenue in transactions with unrelated parties) between the realized results and the expectations and prognoses that formed the base of the pricing at the time of the transaction; and (ii) this deviation cannot be explained by facts and circumstances that occurred after the date of the price determination.

11. In the event of a purchase of shares of an unrelated company followed by a business restructuring, often intangibles are transferred within the group. This can lead to questions regarding the transfer price but prior to that it is relevant to determine whether in addition to the legal ownership the related functionality and related risks are transferred. An arm's length transfer price for shares of an acquired entity provides relevant information on the valuation of the enterprise of the entity. The purchase file of the buyer is therefore considered as an essential part of the transfer pricing documentation that a taxpayer must provide to support the transfer price for transferred intangibles.

12. The allocation of synergy benefits and the so-called control premium, the valuation of remaining routine functions considering assets used and risks incurred and the effect of taxes are also to be considered in the event of a transfer of intangibles following a purchase of shares.

13. While the price paid for the acquired shares will be at arm's length since the seller is an unrelated party, this does not imply that the value of the shares is equivalent to the transfer price. The buyer will only proceed with the purchase if it is expected that the acquired entity will generate more value than the price paid. The value attributed by the buyer to the intangible assets in the acquired entity can be a good indication of the price that the buyer would minimally want to receive in case these assets would be transferred. A seller will generally want to obtain sale proceeds that match the value attributed to the intangible assets plus the taxes due with respect to a potential book profit.

14. In the event that entrepreneurial functions and associated intangibles of an acquired entity are transferred to another group entity and the transferor merely performs routine functions, taxpayers sometimes determine the transfer price based on the difference between the discounted cash flow of the restructured entity prior to restructuring based on infinite life and the discounted cash flow of the same entity after the restructuring based on infinite life.

15. The Dutch tax authorities will take the position that the discounted cash flow of the (restructured) entity post-restructuring cannot be based on perpetual cash flows, since the routine functionality can easily be replaced with other contracts pursuant to which similar functions are rendered and which usually have a short term time frame.

16. While the remuneration for the use of intangibles can be determined based on publicly available databases, the new decree questions whether such databases provide information that is sufficiently detailed to provide for a comparability analysis. In practice the results of these databases are consistently critically reviewed and rejected by the Dutch tax authorities.

17. The use of a residual income analysis, in which the least complex entity that does not own any intangibles is the tested party and its arm's length margin is determined through a

one-sided transfer pricing method while the remaining profit is allocated to the intangible assets together with the related functions performed is acceptable, provided all other related functions are sufficiently remunerated.

18. A one-sided analysis based on the resale price method, the cost plus method and the transactional net margin method does not serve to directly determine the value of the intangible, however.

7. Valuation methods such as the discounted cash flow method may be applied as valuation method to determine the arm's length price in case of transfers of intangibles.

8. The arm's length price of the intangible will be somewhere between the value seen from the perspective of the seller and from the perspective of the buyer (unless the value from the perspective of the seller is higher than that of the buyer). The value resulting from the application of a valuation method is not necessarily the same as the arm's length price.

9. For valuation purposes, 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.

10. If the value of the intangible from the perspective of the seller is higher than that of the buyer, 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.

The new decree addresses the transfer pricing considerations relevant for **intra-group services**:

1. A group service is rendered in case an activity is performed on behalf of a group member that adds economic or commercial value and for which the group member would normally be prepared to pay.

2. When choosing a method for determining the transfer price for a service, the following choices are available: (i) applying the arm's length principle on the basis of the new TP Decree and the OECD TPG or (ii) applying the simplified method for low value adding services. In the event the taxpayer wants to only allocate the costs of providing services as discussed in paragraph 7.37 of the OECD TPG, all conditions of that paragraph need to be met and financing costs need to be included as well. The Dutch tax authorities have discretionary authority to approve this approach.

3. A cost-based remuneration applying the TNMM is mostly chosen and determined based on a functional analysis.

4. There is a preference for applying a direct charge method for services, but indirect charge methods are also used in practice provided the method leads to an arm's length result. Allocation keys to be used could include turnover, the number of employees or personnel costs. An allocation key based on profitability is not likely to be considered at arm's length here.

5. Shareholder activities are not considered as group services, to the extent they do not add economic or commercial value on behalf of group entities and to the extent a group entity would normally not be willing to pay for those activities. Shareholder activities are not remunerated by other group entities.

6. The new decree provides a list of shareholder activities including some examples. Activities with respect to the reporting on environmental policy pursued/to be implemented, social policy and policy with regard to sustainable entrepreneurship are not on the list of shareholder activities anymore in the new decree as compared to the 2018 decree. This caters to discussion of whether ESG activities may benefit group entities.

7. The new decree acknowledges that there may be so-called mixed activities, which can partly be considered as shareholder services and partly and group services. As example mention is made off consolidation activities and M&A activities (plus two examples) and activities relating to corporate governance compliance and Supervisory Board activities. For these activities, the qualification as group service or shareholder service can be made based on any method that would lead to an arm's length result.

8. The simplified method for low value adding services can be applied which allows for the use of a mark-up of 5% on relevant costs of these services provided its application is substantiated with appropriate documentation and the costs are allocated to group entities based on an appropriate allocation key.

9. The simplified method also applies a simplified and more limited benefit test from the perspective of the recipient of the relevant services. The recipient needs to substantiate the benefit of certain categories of services more generally. The Dutch tax authorities will normally test based on the benefit test whether a service was actually rendered and the remuneration is appropriate. In the event the simplified method is applied, the DTA will apply a pragmatic approach in testing whether remuneration is appropriate. The benefit for the recipient of the service will only need to be generally substantiated and does not have to be reduced to individual transactions.

10. Similarly, the fixed profit margin does not need to be substantiated by a comparability analysis. The conditions formulated in the OECD transfer pricing guidelines regarding appropriate documentation (paragraph 7.64) and the appropriate manner of calculation of the amounts to be charged (paragraphs 7.56 – 7.58) do need to be complied with, however. The new decree confirms that the Dutch tax authorities will consider a charge of the relevant costs with a mark-up of 5% through an appropriate allocation key as being at arm's length.

11. The cost base should include direct costs and indirect costs that are related to the relevant support services and includes overhead costs. Special charges may need to be included as well, such as reorganisation costs etc. Which costs can be considered relevant depends on the functional analysis that forms the basis of the taxpayer's transfer pricing system. (The new decree includes several examples to this extent).

12. In the event of contract research and contract manufacturing, cost-based remuneration may be considered as being at arm's length, according to the new decree. For transfer pricing purposes the transaction will first need to be characterized based on the principles laid out in (paragraph 2 of) the new decree, however.

13. In case of contract research, remuneration determined on a cost basis is arm's length if the contract research or contract manufacturing activities are performed by party A while the research or manufacturing activities are managed by party B, the costs and risks are incurred by party B and B becomes the economic owner of the developed assets or produced products. Furthermore, party B needs to have control and perform control activities in relation to the risks incurred and have the financial capacity to assume the risks. The analysis thereof will need to be based on the specific facts and circumstances of the case at hand.

14. Management of research activities and control over risk is determined by aspects such as the decision making, planning, budgeting, performance measurements, remunerating, adjusting/redefining work responsibilities, determining of commercially valuable areas and assessing the chances of (un)successful research. The new decree provides a few examples to corroborate when a cost based remuneration would be acceptable and at arm's length.

The new decree also elaborates on **cost contribution agreements**.

1. The remuneration for activities undertaken as a cost contribution participant in a cost contribution arrangement should not materially differ from the remuneration earned when the cost contribution participant would be collaborating outside of a cost contribution arrangement.

2. A cost contribution participant who takes on risk ought to be able to control those risks and have financial capacity to carry the negative consequences of such risk.

3. A cost contribution participant who only provides for funding and manages risks related to the funding but not any other risk will generally only be allocated a funding-related return considering the financing risks involved (i.e. a risk-adjusted return).

4. The relative share of each participant in a cost contribution arrangement needs to match the relative share in the expected benefits of the arrangement for that cost contribution participant, and this share needs to be calculated on the basis of market value. Some countries do not accept the inclusion of a profit margin while they do accept that a fee is charged for the capital associated with the activities. This is acceptable provided the outcome is at arm's length.

5. The new decree confirms that when evaluating cost contribution arrangements, the tax authorities need to account for the fact that transfer pricing is not an exact science. Nevertheless, taxpayers are required to be able to substantiate that unrelated parties in comparable circumstances would enter into similar agreements.

Central procurement activities often lead to synergy benefits. For transfer pricing purposes, the following is provided:

1. Central procurement activities can vary from the performance of support activities to purchasing activities that can be considered a core group function. Therefore, the functional analysis will need to consider the relative importance of the procurement function within the value chain of the group. It also needs to be determined what parts of the group perform the respective procurement activities.

2. Procurement functions that are of a routine nature will incur little risk. Those are considered to include the selection of potential suppliers, the (local) coordination with suppliers, the quality control of the purchases, and arranging transportation and other logistics activities. In practice, these activities rarely, if ever, trigger price or inventory risk. The new decree confirms that on occasion the activities can include more complex characteristics, and that the determination of product assortment (considered as a separate function) can be involved.

3. After the functional analysis, the question arises what transfer pricing method can be considered appropriate to determine an arm's length fee for the activities performed. This fee can vary from being routine (based on operational costs or a fee related to the purchasing value) for activities with a routine character to a transactional profit-like fee if the activities can be considered as a core function.

4. Local purchasing agents are considered to mainly perform supporting functions. In general they are remunerated with a fee based on the purchasing value. It is expected that the percentage of the fee will increase to the extent the agent has more responsibilities and will decrease to the extent the purchasing volumes increase. In practice it turns out to be challenging to find comparables on the basis of the purchasing value, however. Therefore the new decree announces that the Dutch tax authorities will choose the TNMM in such situations as a reference to determine the arm's length nature of the fee. The cost base will in those cases be limited to the operational costs of the procurement office. The cost of goods sold are not considered part of that basis.

5. To the extent that the group realizes an increase of purchase discounts as a result of the centralized procurement function, this benefit will in principle not be allocable to the centralized procurement office. It will need to be allocated to the divisions of the group that make it possible for the procurement office to achieve such discounts due to the centralized purchasing volumes. Only to the extent that extra discounts are obtained as a result of specific knowledge and skills of the procurement office, will it be considered at arm's length to allocate part thereof to the procurement office. It should be expected that in those cases thorough substantiation will be required that such specific knowledge and skills apply.

Transfer pricing documentation

1. The Dutch Corporate Income Tax Act (CITA) addresses the transfer pricing documentation requirements in two different places, namely in Article 8b(3) CITA and in Articles 29b-29h CITA regarding the Country-by-Country Report, the Master File and the Local File. The latter report and files apply to taxpayers who meet certain thresholds. The regulation additional documentation obligations transfer pricing of 30 December 2015 (DB2015/462M) provides for further rules regarding the format and contents of the Country-by-Country Report, the Master File and the Local File. These requirements solely regard crossborder transactions between associated enterprises and provide for a substantiation oof the arm's length income allocation to permanent establishments.

2. The documentation requirements described in Article 8(b)(3) CITA require application of the five comparability factors of related party transactions included in Chapter I of the OECD transfer pricing guidelines, a substantiation of the choice for the transfer pricing method applied, and a substantiation of the conditions, including the price, that was established with the transaction. This requirement applies both to domestic and crossborder transactions with associated enterprises. Article 8(b)(3) CITA does not provide for an exhaustive list of documentation requirements to substantiate the arm's length character of transactions and functions as an open norm.

3. In determining the appropriateness of the documentation, the proportionality principle is considered important. The starting point is that extra administrative burdens ought to be limited as much as possible. As such, the absence of a comparability study will not necessarily lead to the conclusion that the transfer pricing documentation is incomplete for taxpayers who are required to maintain transfer pricing documentation.

4. Taxpayers can obtain certainty on the question whether the documentation requirement of Article 8b(3) has been met.

5. Entities that meet the documentation content requirements of Article 29g CITA, regarding the Country-by-Country Report, the Master File and the Local File, will be considered to have met their documentation requirements as listed in Article 8b(3) CITA to the extent it regards their cross border transactions. If the requirements of Article 29g CITA are also applied by entities with respect to their domestic transactions, the entities will be considered to have met their documentation requirements as listed in Article 8b(3) CITA in its entirety.

Considering the above, we advise that your intercompany transactions are catalogued, subjected to (internal) review, and that the underlying documentation needed for tax purposes is organized to withstand tax auditor questions. There is a clear indication that transfer pricing arrangements will increasingly be audited. Our transfer pricing team is available for a discussion or assistance in this regard.

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