

18 May 2018

# Global Tax Alert

News from Transfer Pricing

## Dutch Finance Secretary publishes new Decree on application of the arm's-length principle and OECD Guidelines

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### Executive summary

On 11 May 2018, the Dutch State Secretary of Finance (the Finance Secretary) published a [new transfer pricing Decree \(the Decree\)](#).<sup>1</sup> The Decree contains a number of new sections and changes in light of the amendments to the Organisation for Economic Co-operation and Development's (OECD's) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017* (OECD Guidelines<sup>2</sup>) as a result of the G20/OECD's Base Erosion and Profit Shifting (BEPS) plan and specific developments in Dutch case law.

By means of this Decree, the Finance Secretary has provided information regarding the position of the Dutch tax administration with respect to the application of the arm's-length principle and OECD Guidelines in the Netherlands. The Decree provides a further interpretation of the arm's-length principle where the OECD Guidelines leave room for interpretation or where there is ambiguity. These insights can help taxpayers in assessing the view that may be taken by the Dutch tax administration in similar cases.

## Detailed discussion

### Applicability of changes in the OECD Guidelines

One of the objectives of the Decree is to align the wording and guidance with the changes in the OECD Guidelines as a result of the G20/OECD's BEPS plan, more specifically BEPS Actions 8-10 (*Aligning Transfer Pricing Outcomes with Value Creation*) and BEPS Action 13 (*Guidance on Transfer Pricing Documentation and Country-by-Country Reporting*). The Finance Secretary is of the opinion that, insofar the changes in the OECD Guidelines are a further clarification of the application of the arm's-length principle, such changes are also applicable to years in which the changes were not yet published. The Decree does not specify which changes are considered a mere clarification. However, based on earlier communication by the Finance Secretary,<sup>3</sup> one may derive that the amended guidance on the following matters is not considered a mere clarification: documentation requirements, intangibles, intra-group services, commodity transactions, and cost contribution arrangements.

The Finance Secretary reiterates that the OECD Guidelines are considered a suitable interpretation and clarification of the arm's-length principle. The Decree provides the formal position of the Dutch tax administration on the interpretation of the arm's-length principle in certain specific cases.

### Applying the arm's-length principle

#### Characterizing the transaction

The Decree follows the guidance stipulated in the OECD Guidelines, stating that taxpayers should first identify the commercial and financial relations, taking into account the economically relevant characteristics and comparability factors. The Finance Secretary confirms this also includes the new six-step approach included in the OECD Guidelines to analyze risks. In addition to the guidance included in the OECD Guidelines, the Decree states that if the risk allocation applied between associated enterprises also occurs between unrelated parties in comparable transactions under comparable circumstances, this risk allocation should be respected.

An important step of the approach is the analysis of the "control over risks" and "the financial capacity to bear the risks." The Decree does not provide additional guidance on how to interpret these concepts, but refers to the OECD Guidelines in this respect.

The Decree confirms that if multiple parties exercise control over a risk, and have the financial capacity to bear the risk, while only one party has contractually assumed the risk, the contractual risk allocation should be respected (par. 1.94 OECD Guidelines). However, care should be taken in such cases that each party receives an arm's-length reward for its (contribution to the) control function. The OECD Guidelines (par. 1.105) state this compensation may take the form of a share in the positive or negative consequences of the risks. The Finance Secretary adds that the transactional profit split method may therefore be appropriate in this situation. The Decree articulates that it does not seem arm's length that a party which contractually assumes the risks, but in fact barely contributes to the control of such risks, should be allocated all the consequences of such risks whereas the other parties receive a limited routine reward. The conclusion may be different though if the applied risk allocation can also be found between unrelated parties in comparable circumstances.

#### Recognition of the accurately delineated transaction

The OECD Guidelines (par. 1.122) include important changes to the guidance on when a transaction can be disregarded, and replaced by an alternative transaction that would be more in line with the actual conduct of parties. The Decree follows and confirms these amendments relating to the (non-) recognition of controlled transactions.

#### Comparability analysis

The Decree reiterates the importance of the functional analysis in the application of the arm's-length principle and the comparability analysis. The arm's-length test analyzes the price, but also other conditions, of the controlled transactions. The Decree clarifies that an adjustment based on the arm's-length test can also be a downward adjustment of the profit, if the Dutch entity receives a benefit solely because of shareholder motives, without performing (sufficient) compensating activities in return, and both the provider and recipient are aware of the benefit provided.

#### Transfer pricing methods

The Decree provides additional guidance on the application of cost-based transfer pricing methods. Two specific new examples are included in this respect:

- ▶ If a manufacturer, given its functionality, does not assume risks in relation to the raw materials (e.g., because it does not have the required procurement function), the cost of goods sold would generally not be included in the cost base to determine its reward.

- ▶ If goods are sold through an intermediate related Dutch company that does not perform commercial but predominantly administrative activities in relation to these transactions, such an intermediate is generally not entitled to a sales based reward, but should rather receive a mark-up on its own relevant operating costs (par. 2.39 OECD Guidelines).

## Valuation methods

With respect to the application of valuation methods, the Decree stresses the importance of considering the perspective of all parties involved in order to determine an arm's-length price. Taxpayers should take into account the tax consequences for both parties (i.e., any tax costs for the seller, and tax depreciation and/or amortization benefits for the buyer). Furthermore, in line with the OECD Guidelines, other transaction specific considerations should be taken into account in selecting the appropriate discount factor, which include the risk profile of the parties involved as well as the asset and/or the activities that are being valued.

The Decree states that if it is determined that the value of an asset is higher for the seller than it is for the buyer, the transfer of such an asset would not occur between third parties, since not entering into the transaction would then be a more attractive alternative to both parties. The considerations relating to the (non-)recognition of transactions apply in this situation.

## Intangibles

### DEMPE functions

The OECD Guidelines refer to the development, enhancement, maintenance, protection and exploitation (DEMPE) functions as being the relevant functions in relation to intangibles. Depending of the facts and circumstances, a weighing should be given to the different DEMPE functions in line with their relative importance. The Decree provides an additional interpretation on this matter compared to the OECD Guidelines, and adds that a higher weighing will generally be given to the "development" and "enhancement" functions in determining the relative contribution to the value of the intangible.

### Hard-to-value intangibles (HTVIs)

The Finance Secretary adopts the guidance stipulated in the OECD Guidelines on HTVIs. If an HTVI is transferred and subsequently the actual results deviate significantly from the projections used in valuing the HTVI, and such deviations

cannot be explained by facts that have occurred after the valuation date, the Dutch tax administration may challenge the value as determined at the moment of the transaction by referencing the actual results. A significant deviation in this context is a deviation of more than 20% between the projections and the actual result (not a 20% deviation in the price of the HTVI itself). An intangible will not be considered an HTVI if the significant deviations start to occur after a period of five years has passed from the moment third party revenue in relation to the intangible was realized.

### Purchase of shares followed by business restructuring

The Decree includes a new paragraph describing the situation that a multinational enterprise purchased shares in an unrelated entity, followed by a business restructuring as a result of which intangible of that acquired entity are being transferred. The Finance Secretary is of the opinion that in this scenario, the share purchase documentation is an essential part of the taxpayer's transfer pricing documentation that it needs to provide in order to support the arm's-length value of any transferred intangible. The value of such an intangible, as established by the acquirer in its share purchase documentation, is a good indication of the minimum price he would like to receive when subsequently transferring the intangible. This implies that the actual value for the acquirer, and therefore the minimum price he would like to receive when selling the intangible, could be higher when the specific positions of the parties involved are considered (e.g., synergy benefits expected by the buyer). Moreover, the seller will generally take into account the tax costs related to the transfer of the asset when determining the minimum price.

When the entrepreneurial function and the related intangibles are transferred to an associated enterprise and a mere routine function remains, the transfer price is sometimes determined as the difference between the discounted cash flow of the current functionality and the future, remaining routine functionality, applying a perpetual cash flow to the remaining routine function. In determining an arm's-length value for such a transfer of functions and intangibles, the Dutch tax administration will generally take the position, in particular if only one (exclusive) intercompany contract remains in the entity, that the cash flow of the (remaining) routine function should not be perpetually discounted as such routine functions are easily replaced in the market and the underlying contracts often have a relatively short tenor. As a result, the transfer price of the transferred intangibles will be higher.

### Determining the compensation for the use of intangibles

The Finance Secretary questions whether public databases contain sufficiently detailed information to perform a proper comparability analysis in order to determine the compensation for the use of intangibles. The Dutch tax administration will therefore take a critical view in assessing the use of such databases.

The OECD Guidelines state that the use of one-sided methods<sup>4</sup> are often not reliable methods to directly determine the value of an intangible. The Decree mentions that these methods can be used, however, to determine the residual profit that should be allocated to these intangibles by first determining an arm's-length reward for the routine entity (i.e., the tested party). The subsequent residual profit can be considered the reward for (the functions performed in relation to) the intangibles, under the condition that all other functions, assets and risks are sufficiently rewarded. Therefore, in these cases, where comparable uncontrolled transactions do not exist, the Finance Secretary states that it could be acceptable for taxpayers to determine the reward for intangibles following this methodology.

### Intra-group services

The simplified approach for determining arm's-length charges for low value-adding services, as newly included in the OECD Guidelines, is also incorporated in the Decree. This includes the definition of low value-adding services, the more limited benefit test required for such services, and the consideration that the application of a 5% profit mark-up for these services will lead to an arm's-length outcome. The relevant cost base includes the direct and indirect costs related to the service, including overhead and extraordinary costs. Such simplified approach cannot be taken in relation to services which the service provider also performs for unrelated parties.

### Cost contribution arrangements (CCAs)

In line with the new guidance on CCAs in the OECD Guidelines, it is mentioned that companies which only provide financing and perform control functions in relation to their financing and not in relation to the other activities performed within the CCA, can only be allocated an arm's-length return for its financing. The Decree seems to imply such a company can be considered a participant to the CCA, where the OECD Guidelines state this would not be the case. The remaining guidance on CCAs is similar to the previous Decree.

### Financial services and transactions

The Finance Secretary states that the provision of guarantees without a great level of security will not often occur between unrelated parties. With respect to the provision of intercompany guarantees, the arm's-length nature of such a guarantee should be analyzed from the perspectives of both parties to the transaction. It should therefore be assessed whether there would be business reasons based on which the guarantor is willing to provide the guarantee (e.g., without security), but also whether the guarantee is willing to utilize the guarantee and pay a compensation for it.

### Interest rates for non-businesslike loans

In line with new Dutch jurisprudence by the Supreme Court on this matter, in the case of a non-businesslike loan (i.e., a loan with credit risk that no third party would be willing to accept), the interest rate to be taken into account for tax purposes is the lower of: (i) the guarantee rule of thumb;<sup>5</sup> and (ii) the economic value of the (imputed or accrued) interest at the moment this interest becomes due.

### Transfer pricing documentation

The Netherlands has two types of transfer pricing documentation requirements. The first is the general documentation requirement applicable since 1 January 2002, which does not have a prescribed format on how to document controlled transactions (general documentation requirements). The second is the country-by-country reporting (CbCR), master file and local file requirement that is applicable for fiscal years starting on or after 1 January 2016 and only applies to taxpayers that are part of a multinational group with consolidated turnover exceeding €50 million (or €750 million for CbCR) in the preceding year (supplementary documentation requirements).<sup>6</sup> These documentation requirements, which are generally aligned with BEPS Action 13, apply in addition to the general documentation requirements.

The Decree reiterates that the general documentation requirements apply to both domestic and cross-border transactions with *associated enterprises*. The supplementary documentation requirements apply to cross-border transactions between *constituent entities*<sup>7</sup> and the arm's-length profit attribution to permanent establishments. The Finance Secretary confirms that documentation prepared in

line with the supplementary documentation requirements (i.e., a master file and local file) also complies with the general documentation requirements, insofar it relates to cross-border transactions. This also applies to taxpayers that document their domestic transactions with associated enterprises in the same way.

## Implications

The Decree and the additional guidance provided herein are of great importance to multinational enterprises (MNEs), in particular those engaged in transactions or situations described in this Alert. The Decree provides new guidance. MNEs should evaluate whether their transfer pricing policies and transfer pricing documentation should be updated to be aligned with the guidance in the OECD Guidelines and this Decree.

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## Endnotes

1. The [new Decree](#) (nr. 2018-6865 dated 22 April 2018) was published on 11 May 2018 and replaces the [2013 Decree](#) (IFZ 2013/184M dated 14 November 2013).
2. See EY Global Tax Alert, [OECD releases 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations](#), dated 14 July 2017.
3. See the Finance Secretary's letter to Dutch Parliament dated [5 October 2015, p. 18](#), and letter to Dutch Parliament dated [2 February 2016, p. 17](#).
4. One-sided methods include the resale price method, cost-plus method and transactional net margin method.
5. This rule of thumb entails that the interest rate of a non-businesslike loan is determined at the interest the borrowing group company would have to pay if it would borrow, for that matter under equal conditions and in equal circumstances, from a third party with a guarantee by the lending group company.
6. See EY Global Tax Alert, [The Netherlands passes bill on supplementary transfer pricing documentation requirements in line with BEPS Action 13](#), dated 6 January 2016.
7. The definition of constituent entities and associated enterprises is not identical.

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EYG no. 02953-181Gbl

1508-1600216 NY  
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