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# The Newly Updated Dutch Transfer Pricing Guidance, Part 5: Financial Service Entities

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## INTRODUCTION

On July 1, 2022, a new Dutch Transfer Pricing Decree No. 2022-0000139020 dated June 14, 2022 (''new TP Decree''),[1] was published in the Dutch Official Gazette.[2]

While the most material change or update in the new TP Decree is the inclusion of extensive guidance on transfer pricing for financial transactions, it also in some detail provides revised guidance for intra-group financial service providers. These are special purpose intermediary companies that exist to enable the members of a multinational enterprise (MNE) to obtain cost-efficient funding (most often) through loans with other group members or third parties. Financial service entities usually receive interest due on the loans by group members and pay interest to the (non-) affiliated holder of the loans. These service entities may also serve to receive and pay royalties, rental income or lease income.

The choice for the country of residence of these service providers is generally influenced by the tax regime in that country, although aspects like political stability, the availability of skilled human resources and a country's overall infrastructure tend to be important as well. From a tax perspective, the availability of tax treaties, the participation exemption and reduction or absence of a withholding tax on the payment of interest and royalties are considered key requirements for a financial service provider to function optimally.

Financial service entities have been a chief commodity in the Dutch economy for decades and used to benefit from standardized rulings for the determination of the arm's-length remuneration. That practice was abolished in 2001, however, when a transfer pricing decree was published and a functional analysis became required also for these service providers. A separate Question and Answer Decree was published in 2014, which dealt inter alia with how the remuneration for financial service entities was to be determined.[3] It is safe to say that the functioning of financial service providers — often nick-named ''mailbox companies'' because they appear to need nothing more than a mailbox address — has been subject to close international, European and domestic scrutiny and regularly associated with tax optimization and base erosion, and remains under close review.

To assure that financial service providers are not mere shell companies that exploit available tax treaties and other tax benefits, the rules for financial ser-

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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 Rpt. Int'l (July 6, 2022).

[3] Besluit Staatssecretaris van Financiën 3 June 2014, nr. DGB 2014/3102, Stcrt. 2014, 15958 (V-N 2014/32.6).

vice providers have been significantly tightened over the years by denying advance certainty and tax benefits if the companies do not meet substance requirements.

In this fifth part, the authors discuss the new TP Decree and position of the Dutch Tax Authorities (''DTA'') as regards financial service entities, reference the interaction between the applicable transfer pricing documentation requirements in the Netherlands and address provisions in the new TP Decree that underscore the pragmatic approach the DTA takes with respect to avoidance of double taxation.

## (FINANCIAL) SERVICE ENTITIES

A special form of services is rendered by financial service entities. These entities exist within an MNE group and enter into transactions of which the actual activities mainly consist of the legally or factually, directly or indirectly, receiving and paying of interest, royalties, rent or lease terms in whatever name or form. Entities that mainly perform these activities are referenced as Financial Service Entities (FSEs). The new TP Decree mainly addresses transactions of FSEs with group entities, including guarantees and transactions subject to guarantees. While the new TP Decree mainly discusses FSEs, the approach listed in the new TP Decree is meant to also apply to other service entities, however.

In the new TP Decree, FSEs are characterized by rendering service activities in which there is a close relationship between incoming and outgoing cash flows. They will usually (only) perform routine activities. In some cases, the FSEs may perform activities that justify the incurring of credit and market risk, however.

To determine the arm's-length remuneration for an FSE, its functions, activities and risks need to be analysed. The new TP Decree makes clear that the determination of an arm's-length fee for FSEs must — from now on — be based on Chapter X of the OECD Transfer Pricing Guidelines (OECD TPG).

In Chapter X, the consequences of risk allocation are to be closely considered when determining the arm's-length fee for transactions subject to review. For risk to be allocated to an FSE, it is required that the FSE exercise sufficient control over such risk and have adequate financial capacity to incur any negative consequences that may result therefrom. This guidance in the new TP Decree underscores that substance reviews of FSEs will be highly likely.

The risks that can result from the transactions of FSEs are mainly credit risk (debtor and currency risk), market risk, and operational risk. The incurrence of credit risk at arm's length with a strong relation to the relevant cash flows can be a justification for remuneration for the FSE to be based on the principal amount. Merely incurring operational risk (resulting from the support activities that the FSE performs) will not lead to an allocation of credit risk to the FSE, however.

In cases where the FSE has insufficient control and/or financial capacity, the risk (and related arm's-length return) ought to be allocated to the party that does have sufficient control over the risk and sufficient financial capacity. For purposes of reviewing the transfer pricing systems of FSEs, the new TP Decree distinguishes between three different scenarios:

(1) where the FSE has full control and the necessary financial capacity;

(2) where the FSE has no control and/or insufficient financial capacity; and

(3) where the FSE has partial control over the credit risk and the required financial capacity therefor.

In the first scenario, once it is established that the FSE has full control over the credit risk, a determination must be made whether the FSE (also) has adequate financial capacity to incur the consequences of such risk. In this context, consideration must be given to the extent to which the FSE can independently attract debt from unrelated parties without any group guarantees. Financing that is made available to the FSE solely with a guarantee from an associated enterprise must be considered as a capital contribution in the FSE, according to the new TP Decree. The qualification thereof as equity will not lead to an assumed increase of the FSE's financial capacity. As already mentioned in part 4, the Dutch Supreme Court applies other specific criteria for the qualification of a loan as equity. The Supreme Court essentially confirmed that a loan can be recharacterized as equity for tax purposes when the intercompany loan is a sham (as parties never intended it to be a loan), qualifies as a ''bottomless pit'' loan (meaning it's clear from the start that the loan can never be repaid), or is a so-called ''participating'' loan when the lender functions like a shareholder. Considering that those criteria are not addressed in the new TP Decree, there likely will be some tension between the OECD TPG and Dutch jurisprudence in this respect, and the new TP Decree acknowledges as much.

As FSEs commonly ask for advance certainty, it is relevant to note that the new TP Decree accords in the event of a taxpayer request for advance certainty on the application of the arm's-length principle, that the starting point for analysis will be the OECD TPG — not the Dutch Supreme Court jurisprudence. The reason presented therefor is that certainty that is provided unilaterally must be defensible internationally. The


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Dutch jurisprudence is considered incompatible with the internationally applied arm's-length principle.

Continuing with the three control and financial capacity scenarios presented above, in case the FSE exercises full control and has the required financial capacity, an appropriate interest rate must be determined based on a comparability analysis. This must be conducted based on the individual incoming and outgoing associated-enterprise transactions and in relation with the FSE's total financing position. The conditions of the controlled-party transactions are to be compared with conditions of comparable unrelated-party transactions.

For intercompany loans, the comparable uncontrolled price (CUP) method will be the most logical starting point for finding an arm's-length remuneration per transaction.

In the second scenario, the FSE has no control over risk and insufficient financial capacity to carry the credit risk, and the risks cannot be allocated at arm's length to the FSE. A fee related to the volume of the financial flows would also not be considered at arm's length. In such a case, a fee based on the FSE's own operational cost would appear most likely. It may be that the FSE incurs operational risk in relation to the performance of its own activities, but these risks will generally not be material as compared to the credit risk.

In the third scenario, the FSE has partial control and the necessary financial capacity. If the FSE and the head office (or another related party) perform control activities over the credit risk exceeding the "wider policy setting" described in paragraph 1.65 of the OECD TPG, there can be shared control. Here, control activities exist both in a quantitative and a qualitative sense. The FSE will be required to perform activities up to a certain level for both of these activities before there will be sufficient control to allocate (part of) the risk to the FSE. It is not likely in a comparable unrelated party setting that the risk carried by the FSE is contractually limited to a certain financial amount without considering the relative control parties can exercise over the relevant risks. Once the risk materializes, it would appear appropriate to divide the consequences pro rata between the entities dependent on their relative size and control in relation to the relevant transactions and the related risk. Considering the nature and number of control activities in relation to such financial service activities, it is assumed that shared control within a group rarely arises. In other words, to maintain that there is shared control, the FSE will need to exercise sufficient control over risk to substantiate the contractual allocation of risk.

As regards financial capacity and arm's-length remuneration, the same considerations apply as under the first scenario as to the extent to which the FSE can independently attract debt from unrelated parties without any group guarantees. Financing that is made available to the FSE solely with a guarantee from an associated enterprise must be considered as a capital contribution in the FSE, which will not lead to an assumed increase of the FSE's financial capacity.

In case of shared control over credit risk and required financial capacity, an appropriate remuneration needs to be determined based on facts and circumstances. When determining the arm's-length remuneration, it needs to be considered that the other intragroup party that renders control activities also needs to be compensated at arm's length.

The new TP Decree provides examples applying the above three scenarios with a main fact pattern that BV X is part of an internationally operating group, obtains financing from unrelated parties and provides for financing to foreign related parties. The financial flows all run through the (financial) accounts of BV X, and the group's treasury division consists of 50 employees.

***Example 1: Full control.*** In this example, the group's entire treasury department is employed by BV X and works in the Netherlands. This treasury department exercises control over credit risk, and BV X has sufficient financial capacity to carry that credit risk. Therefore it is concluded that the relevant functions to exercise control over credit risk are located in the Netherlands, and BV X carries that risk. Per transaction, an appropriate remuneration may be achieved using the CUP method.

***Example 2: No control.*** Here, 40 of the treasury department employees are employed by BV X and working in the Netherlands, mainly involved with support and execution activities, While the other 10 (including the CFO or Head of Treasury plus the next level of staff right underneath them) are employed by a foreign associated enterprise and working in the foreign office. Therefore it is concluded here that the relevant functions to exercise control do not exist in the Netherlands. The functions available in the Netherlands are limited to support and execution activities. A remuneration based on cost of the support and execution activities will be appropriate (regardless of whether BV X has sufficient financial capacity to carry the risk). A remuneration mechanism based on which the cost and revenue (interest) related to the loans are part of the remuneration and Dutch taxable income would not be considered appropriate here.

***Example 3: Shared control.*** Here, of the 50 treasury employees, 45 are employed by BV X and working in the Netherlands. Within the 45, 40 are engaged in support and execution activities and five are also in control of risks related to the financing of associated enterprises. The other five treasury employees are working at a foreign associated enterprise in control


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of risks related to the financing of associated enterprises together with their five counterparts in the Netherlands. Therefore, both entities are considered to exercise control over the credit risk and they have the financial capacity to carry such risk.

The relevant functions to exercise control over credit risk are partly in the Netherlands and partly abroad. An allocation of the risk to the Netherlands associated enterprise and to the foreign associated enterprise due to the presence of control functions in both is therefore appropriate. Any risk that actually materializes will need to be allocated on a pro rata basis between BV X and the foreign associated enterprise.

In this last scenario, the appropriate remuneration will need to be determined based on the facts and circumstances. It must be considered that next to BV X, there is another party that is to be remunerated at arm's length for its control activities.

The remuneration for BV X's support and execution activities can be determined the same way as in Example 2.

## TRANSFER PRICING DOCUMENTATION

The new TP Decree also addresses the interaction between the transfer pricing documentation requirements included in the Dutch Corporate Income Tax Act (CITA) Article 8b(3) applying to both domestic and cross-border transactions with associated enterprises and in CITA Articles 29b–29h referencing the Country-by-Country Report, the Master File and the Local File that solely regard cross-border transactions between associated enterprises.

Taxpayers who meet certain turnover thresholds are required to file the latter report and files. In a regulatory document called Regulation Additional Documentation Obligations Transfer Pricing of 30 December 2015 (DB2015/462M) further rules regarding the format and contents of the Country-by-Country Report, the Master File and the Local File are provided.

The documentation requirements resulting from Article 8b(3) consist of a description of the five comparability factors of related-party transactions as described in Chapter I of the OECD TPG, a substantiation of the choice for the transfer pricing method applied, and a substantiation of the conditions, including the price, that resulted from the transaction. It has been a deliberate choice to not provide for an exhaustive list of documentation requirements under Article 8b(3), and in that sense the requirement functions as an open norm. 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.

The new TP Decree provides that taxpayers can obtain certainty on the question whether the documentation requirement of Article 8b(3) has been met considering it presents an open norm. Furthermore, entities that meet the Article 29g documentation content requirements will be considered to have met their documentation requirements under Article 8b(3) 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 also be considered to have met their documentation requirements as listed in Article 8b(3) CITA.

## AVOIDANCE OF DOUBLE TAXATION

The Netherlands aims to commence mutual agreement procedures with treaty partners as early as possible. This is further described in the Decree of 15 November 2021, Nr. 2021-0000226675, Official Gazette 2021, 47634. To that extent, taxpayers can submit a request for a mutual agreement procedure (MAP) when confronted with taxation not in accordance with the provisions of a convention.

While the competent authority for the Netherlands is the Minister of Finance, the General Director of the Revenue Service Large Enterprises is mandated the task of the competent authority. MAP assistance is provided on the basis of tax treaties, the EU Arbitration Convention, and the EU Arbitration Directive as implemented in the Netherlands and in the Dutch Fiscal Arbitration Act.

During the mutual agreement procedure, double taxation can be resolved relatively easily by way of exchange of relevant facts and circumstances in certain cases. This exchange can be done under a treaty or by way of simultaneous audits.

The DTA is open to this exchange of information if the taxpayer expects to be double taxed as a result of actions of the DTA or foreign tax authorities of a country with which the Netherlands has the possibility to exchange information. This possibility will depend on the laws and the willingness of other countries to participate in this approach, however. The same applies as regards simultaneous audits.

For the above assistance, taxpayers can submit a request to the Dutch tax inspector, and therein must substantiate that the actions of the foreign tax authorities may lead to a transfer pricing adjustment.

## SECONDARY ADJUSTMENTS

In many countries, transfer pricing adjustments are not limited to taxable income but also trigger a requirement that the taxpayer administers a secondary transaction clearly showing how the adjustment was included in its P&L account and balance sheet.


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The secondary transaction can be an inclusion in the current account, a distribution of profit or an informal capital contribution. The new TP Decree confirms that from a Dutch perspective such a secondary transaction is required. A secondary transaction can lead to a secondary adjustment, however, meaning that if an interest obligation arises from a secondary transaction that is characterized as a loan or a dividend distribution, withholding tax may be applicable as to the latter.

Not all countries follow this secondary transaction approach, however. That may result in no possibility to offset the tax consequences of a secondary transaction because the deemed dividend distribution is not recognized as such in the other State. If the taxpayer can substantiate that the offset is not possible and there is no abuse aimed at avoiding dividend withholding tax, the imposition of a secondary adjustment may be waived.

The waiver is available only if the other State is not listed in the 31 December 2018 Circular of the Dutch State Secretary for Finance as a low-tax jurisdiction or one that is uncooperative for tax purposes for the applicable year.

## SUMMARY FINDINGS: ADJUSTING TOWARD OECD STANDARDS

The new guidance for financial service entities replaces the previously issued guidance on substantiating the remuneration of FSEs that was described in the Question-and-Answer Decree of 2014.[4] This reflects the DTA's continuing focus on ensuring that no tax benefits go to financial service providers that have little substance, perform low value-added functions, or are mere shell companies trying to exploit such benefits abusively.

The new TP Decree signals a clear intent to switch to the arm's-length principle and depart from Dutch Supreme Court jurisprudence that has long governed the space of the characterization of a loan as equity. Taxpayers could actively structure themselves into the characterization determined by the Supreme Court, to achieve situations where benefits conferred to a Dutch entity qualify as a capital contribution for tax purposes and essentially go untaxed. Arguably, this practice may end due to the new TP Decree. Importantly, the DTA clarifies that explaining the appropriateness of the Dutch recharacterization regime in an international context is increasingly difficult and adjustment to the OECD standard is required. Therefore, MNEs are urged to analyse and evaluate their transfer pricing policies regarding FSEs based on the new guidance.

As regards avoidance of double taxation, the DTA signals its embrace of a pragmatic approach. If and to the extent practicable, the DTA is willing to pursue exchange of information by way of a treaty provision or simultaneous audits, as requested by the taxpayer. It is also willing to waive the imposition of a secondary adjustment under certain circumstances.

[4] Question-and-Answer Decree, Service Entities, DGB 2014/3102 of 3 June 2014, Part V. *See* n. 3, above.


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