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In this article, the authors examine a recent legislative proposal to bring Dutch transfer pricing rules into line with OECD and EU initiatives.

On March 4 the Dutch government started a public internet consultation by releasing two draft bills of law and explanatory memoranda. The proposals include consultation documents that target reverse hybrid mismatches (as part of the implementation of the EU anti-tax-avoidance directive, known as ATAD 2)[1] and mismatches resulting from the application of the arm's-length principle.[2]

The latter proposal is considered to be in line with the initiatives of the OECD and the European Commission to combat international mismatches and intends to avoid international double nontaxation by means of denying downward transfer pricing adjustments. The proposed rules could immediately affect Dutch corporate taxpayers involved in international intragroup transactions. Interested parties can submit comments until April 2. It is expected that a legislative proposal will be sent to parliament in the course of 2021 and that the proposed rules will become effective for tax years starting on or after January 1, 2022.

The Informal Capital Doctrine

Based on the arm's-length principle, taxable profits or losses from domestic or cross-border transactions between related parties are in principle adjusted to reflect the profits or losses that would have been realized if the transactions had occurred between unrelated parties. The arm's-length principle is codified in article 8b of the Dutch Corporate Income Tax Act 1969 (Wet op de vennootschapsbelasting 1969) and provides that at arm's length, expenses are in principle deductible, regardless of whether a corresponding profit is recognized or taxed at the level of the related party.[3] The detailed workings of the arm's-length principle are set out in transfer pricing regulations that adopt the OECD Transfer Pricing

[1] Council Directive (EU) 2016/1164 of July 5, 2016; and Dutch consultation document on the reverse hybrid rule (ATAD 2) (Mar. 4, 2021) (in Dutch).

[2] Consultation document on the legislative proposal "Act Combating Mismatches as a Result of the Arm's Length Principle" (Mar. 4, 2021) (in Dutch).

[3] Article 8b of the Dutch Corporate Income Tax Act 1969 considers a party to be related, directly or indirectly, if it participates in the management, control, or capital of another party. Parties are also considered related if a third party, directly or indirectly, participates in the management, control, or capital of the first-mentioned parties.

Guidelines for Multinational Enterprises and Tax Administrations.[4]

A profits adjustment resulting from application of the arm's-length principle may lead to secondary adjustments such as a "deemed dividend" or a "capital contribution" characterization, hence the name "informal capital doctrine." The doctrine was acknowledged for the first time in a 1957 Dutch Supreme Court decision, and again in a 1978 decision.[5]

In the latter case, the Supreme Court decided that because no actual interest was paid by a Dutch debtor to its related creditor (its Swedish grandmother company), the benefit was not subject to tax at the level of the Dutch debtor. The benefit was considered a result of the internal shareholders' relations and not a taxable operating result. The nonpaid interest was therefore deductible. Based on this case, application of the doctrine has been accepted and tax rulings in line with the doctrine have been issued.

Figure 1 illustrates a textbook example of how the Dutch informal capital doctrine works. Foreign Company provides an interest-free loan to related Dutch Company. If the loan had been provided to a third party at arm's length, there would have been a 5 percent interest charge (based on a transfer pricing study). Although no interest is actually paid by Dutch Company, the arm's-length principle is applied, and Dutch Company may adjust the interest to be taken into account by imputing a 5 percent "deemed interest" to its Dutch tax base. Dutch Company can therefore, in principle, deduct a deemed 5 percent interest expense. There may not be an inclusion of the deemed interest in Foreign Company's tax base if the foreign jurisdiction does not have transfer pricing rules or has a different interpretation of the arm's-length principle.

In recent years, the informal capital doctrine has been under scrutiny as part of a unilateral approach to combating tax avoidance and international tax mismatches. Following introduction of the revised Dutch tax ruling policy on July 1, 2019, specific requirements, such as the "economic nexus with the Netherlands" and "no tax avoidance motive" requirements, were introduced.[6] In the run-up to publishing the new ruling policy, a list of illustrative examples of deemed abusive situations for which rulings will no longer be issued was published.[7]

The first example on the list, "tax saving as its sole or decisive motive," concerned the informal capital doctrine. On April 15, 2020, an advisory committee report on taxation of multinationals in the Netherlands (the Ter Haar Committee) was published. The Ter Haar Committee advised the Dutch government to deny the deduction of imputed arm's-length expenses to the extent that no corresponding profit is taxed at the recipient level. Last Budget Day (Prinsjesdag), September 15, 2020, the Dutch government announced that a legislative proposal to abolish the informal capital doctrine would follow. The consultation document did not, therefore, come as a surprise.

The Consultation Document

The draft bill of law targets rendering the arm's-length principle ineffective in cross-border situations to the extent that it leads to reduced profits in the Netherlands without a corresponding inclusion in the counterparty's jurisdiction.

Under the proposed rules, a new article 8ba will be added to the Dutch Corporate Income Tax Act 1969 as of January 1, 2022. A downward adjustment of a transaction between related parties will be denied unless the Dutch taxpayer can demonstrate that:

- there is a corresponding upward adjustment in the same transaction; and
- the corresponding upward adjustment is subject to tax in the related party's jurisdiction.

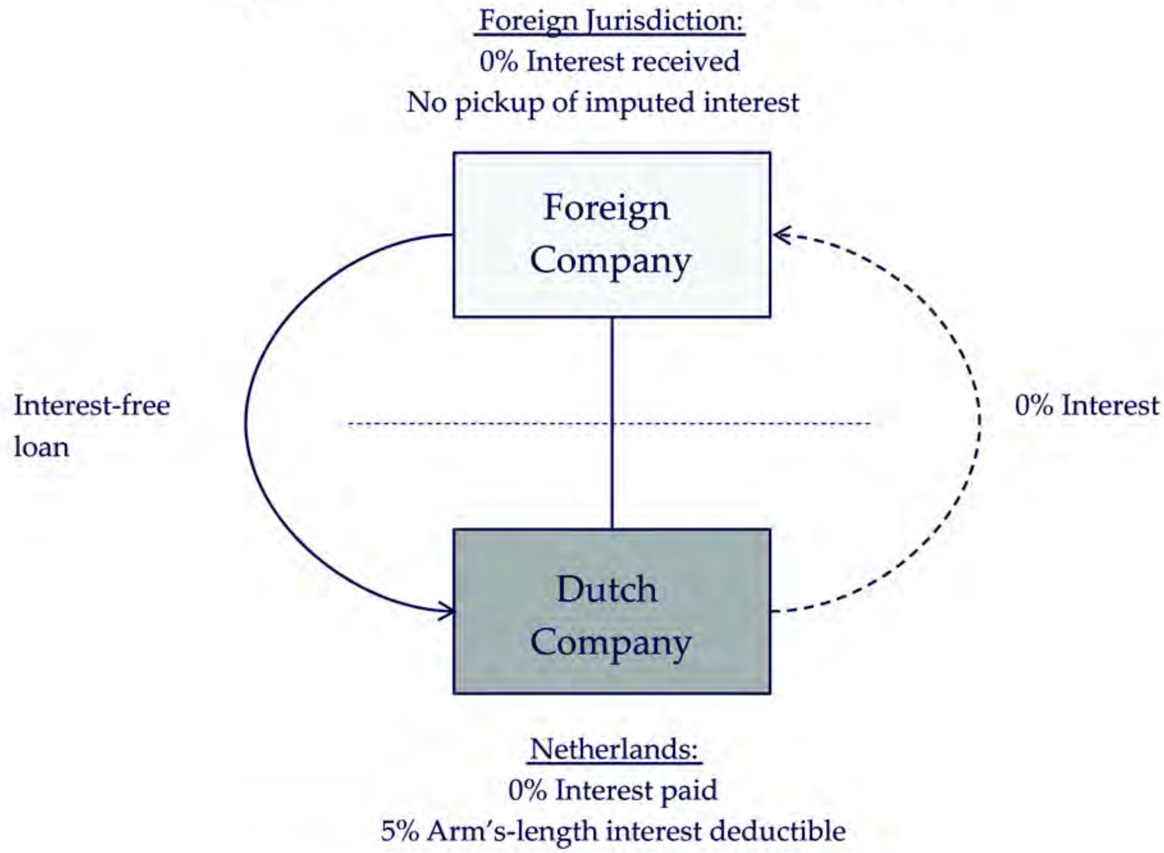
[4] Dutch State Secretary of Finance, "Decree on Transfer Pricing, the Arm's Length Principle and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," Stcrt. 2018, 26874 (Apr. 22, 2018).

[5] Dutch Supreme Court, No. 13 084, BNB 1957/165 (Apr. 3, 1957); and Dutch Supreme Court, No. 18 230, BNB 1978/252 (May 31, 1978) (known as the "Swedish grandmother case").

[6] State Secretary of Finance, "Decree on Advance Tax Rulings With an International Character," BWBR0042342 (June 19, 2019).

[7] Letter from the State Secretary of Finance, No. 2019-0000063508 (Apr. 23, 2019).

Figure 1. Base Case Dutch Informal Capital Doctrine



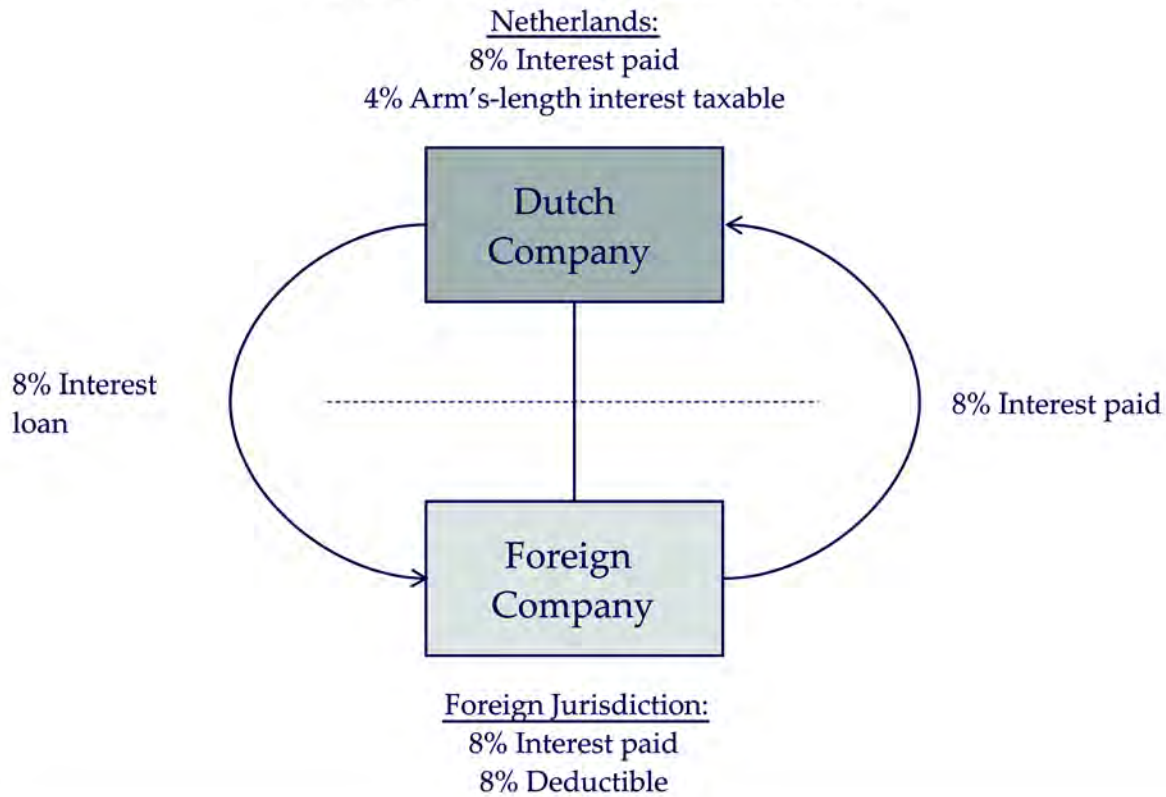
A downward adjustment is defined as taking into account higher expenses or lower profits than a third party would have agreed to. An upward adjustment is considered subject to tax if it is included at some point in the related party's tax base. Jurisdictions that tax upward adjustments at a 0 percent rate or that would exempt the upward adjustment because of a domestic exemption (for example, an object exemption for permanent establishments) would also qualify, as long as the upward adjustment is included in the base. Jurisdictions that do not levy profit taxes, on the other hand, would not qualify because the upward adjustment would not be part of any tax base.

The effective tax rate at the level of the related party is not relevant, and available tax losses or an applicable group relief regime can be used to offset losses against these upward adjustments, for example. The tax base of the related party that is part of the transaction or arrangement is decisive, and an upward adjustment at the level of another company within the group (for example, because of the application of controlled foreign corporation legislation) is not relevant.

It is up to the Dutch taxpayer to convincingly demonstrate that the above requirements are met. There are no specific administrative requirements or forms to be kept in file other than the general administrative requirements. The burden of proof lies with the taxpayer.

Figure 2 illustrates how the proposed rules would function. In this scenario, Dutch Company provides an 8 percent interest-bearing loan to its subsidiary, Foreign Company. At arm's length, interest would have been 4 percent. Foreign Company pays 8 percent interest and deducts 8 percent from its tax base. Under the arm's-length principle, Dutch Company may adjust its taxable income downwards and take an arm's-length 4 percent interest into account as a profit. The foreign jurisdiction does not apply a corresponding upward adjustment for the 4 percent interest not included in the Dutch taxable

Figure 2. Downward Adjustment Denial



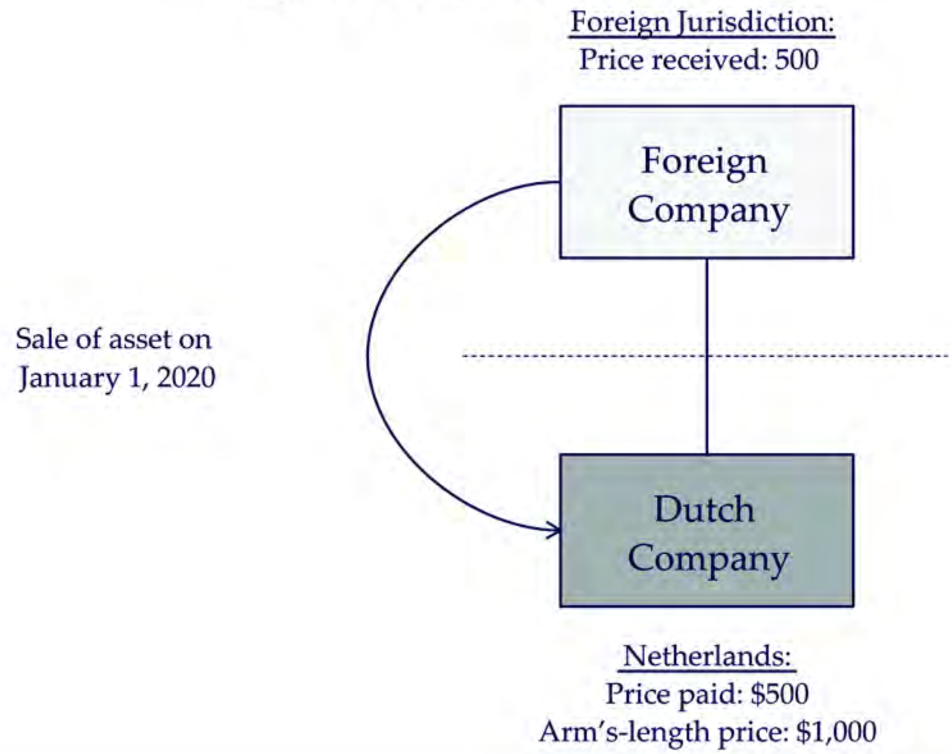
profit. The amount of the adjustment (4 percent) is considered a "deemed dividend" in the Netherlands (likely exempt under the Dutch participation exemption). Proposed article 8ba provides that the downward adjustment at the level of Dutch Company would be denied because there is no corresponding upward adjustment subject to tax in the foreign jurisdiction. Dutch Company would have to take the 8 percent paid interest into account as a profit, and no deemed dividend would be recognized.

The proposed rules will also apply to assets — operational and others, such as receivables — acquired from related parties on or after January 1, 2022. If a taxpayer acquires an asset from a related party and the agreed price is lower than the arm's-length price, only the arm's-length price can be taken into account and used for depreciation purposes by the taxpayer if it can be demonstrated that the difference (between the agreed price and the arm's-length price) resulted in a corresponding adjustment (that is, an increase in income) subject to tax in the related party's jurisdiction. If this cannot be demonstrated, the agreed price should be taken into account in the taxpayer's accounts.

Surprisingly, the proposed rules also introduce a new article 35 to the Dutch Corporate Income Tax Act 1969. The new article contains a depreciation limitation for assets acquired from a related party in the five years preceding the first tax year commencing on or after January 1, 2022. The rule has partial retroactive effect and provides that the depreciation of assets still depreciable as of January 1, 2022, may be limited. A Dutch taxpayer would no longer be allowed to use an asset's arm's-length price for depreciation purposes if the proposed article 8ba (see above) would have been applicable at the moment of the acquisition (that is, the price actually paid was lower than the arm's-length price and did not result in a taxable upward adjustment at the level of the seller). In this case, the depreciation going forward will be based on the lower of:

- the amount that would have been taken into account upon the acquisition if article 8ba had not been applicable; or

Figure 3. Depreciation Limitation



- the asset's book value immediately preceding the tax year starting on or after January 1, 2022.

Figure 3 illustrates how the depreciation limitation would work in practice. Dutch Company bought an asset from its related Foreign Company for $500 on January 1, 2020. The arm's-length price would have been $1,000, so in 2020 Dutch Company was allowed to use $1,000 for depreciation purposes. The asset depreciates over five years with no residual value, and a tax book year is equal to a calendar year. The foreign jurisdiction has not applied a corresponding taxable adjustment in 2020. Article 35 will be applicable because:

- the asset was acquired from a related party in the five-year period preceding January 1, 2022;
- the asset is still depreciable on January 1, 2022 (there are three more depreciable years left); and
- the transfer pricing adjustment would have been denied in 2020 if article 8ba had been applicable.

The depreciation amount for the following three years will be the lower of:

- the amount that would have been taken into account (that is, the actual price paid of $500); or
- the asset's book value immediately preceding the tax year starting on or after January 1, 2022 (that is, its tax book value on December 31, 2020, of $600).

As of January 1, 2022, Dutch Company will be allowed to depreciate $166 per year (500 divided by three). The residual value of the asset after expiration of the five-year depreciation period will be $100, instead of $0 under current law. Because of the proposed rules, the residual value ($100) will be higher than it would have been under the current rules ($0), which would result in a lower recognized profit upon a future sale of the asset. This is acknowledged by the legislature.

Concluding Remarks

Although the consultation document and the proposed rules did not come as a surprise, the exact scope and workings of the downward adjustment denial were still unknown. The proposed rules would add another layer of complexity to the already rapidly expanding set of antiabuse rules in the Netherlands. Because the burden of proof lies with the taxpayer, this will create another administrative burden for taxpayers.

Under the arm's-length principle of article 8b of the Dutch Corporate Income Tax Act 1969, taxpayers are required to document intragroup transactions. However, demonstrating how the transactions are treated for tax purposes in the related party's jurisdiction may be complicated and burdensome. The same applies to the partial retroactive effect of the depreciation limitation for assets acquired in the last five years, which may result in the need for complicated calculations.

The State Secretary of Finance made clear in 2019 that tax rulings will no longer be issued confirming the application of the informal capital doctrine. We assume that application of transfer pricing rules under the proposed rules will be something for which upfront confirmation will be possible on, for example, whether an upward adjustment is considered included in the related party's tax base. It would be a welcome clarification to the legislative proposal if taxpayers could get upfront confirmation on the applicability of the proposed rules. ■