

Mismatches in non-arm's length transfer pricing tackled

On March 4, 2021 a [public internet consultation](#) was launched on a bill to combat mismatches when applying the arm's length principle. The bill focuses on informal capital arrangements. The public consultation will end on April 2, 2021.

Background

An arm's length principle applies for corporate income tax purposes (Section 8b Corporate Income Tax Act 1969). Under this principle, in legal relationships between affiliated parties the profit for tax purposes should be determined in accordance with the conditions that would have been agreed by independent third parties under comparable conditions (the arm's length price). If no arm's length price is used, then affiliated parties are obliged to adjust the price to the arm's length price when calculating the profit for tax purposes. If, for example, non-arm's length low interest is paid to an affiliated party, then the creditor must take higher arm's length interest into account. The debtor will deduct the higher arm's length interest. This is even the case if the affiliated counterparty, for example the recipient of the interest, is not established in the Netherlands and the corresponding income is not taxed; this is what the Supreme Court ruled in the 1970s.

The application of the arm's length principle can therefore lead to mismatches in international relationships, if a downward adjustment of the profit for tax purposes in the Netherlands does not involve a corresponding upward adjustment that is included in the tax base in the other country.

Adjustment on the income and expenses side

Based on the bill launched for public consultation, downward adjustments of the Dutch profit for tax purposes on the basis of the arm's length principle in transactions between affiliated entities will, in principle, no longer be taken into account. However, the downward adjustment may be taken into account insofar as the taxpayer can convincingly demonstrate that a corresponding upward adjustment is subject to profit tax at the other (affiliated) entity with which the legal relationship was concluded.

A downward adjustment may consist of taking, on the basis of the arm's length principle, higher expenses or lower income into account, than would have been taken into account on the basis of the actual conditions agreed between affiliated parties.

The consultation document states that a corresponding upward adjustment is subject to profit tax, if a country has a profit tax and the amount of the corresponding upward adjustment is included in the tax base in that country. That may also be the case if the corresponding upward adjustment is subject to tax at a 0% rate. These conditions are also met if the upward adjustment is included in the tax base, but no tax is levied on that adjustment due to the application of an objective exemption. On the other hand, if there is no profit tax in the state where the affiliated entity is established, there can be no upward adjustment that is subject to a profit tax.

Assets

The bill that was launched for public consultation also contains rules for assets acquired in financial years commencing on or after January 1, 2022. A separate rule applies for assets acquired before the first financial year commencing on or after January 1, 2022.

Assets acquired in financial years commencing on or after January 1, 2022

The bill opened for public consultation also aims to combat double non-taxation that may arise in the capital account as a result of a different application of transfer pricing. This occurs, for example, if at the entity transferring an asset to a Dutch taxpayer the agreed lower transfer price is subject to a profit tax, while the taxpayer capitalizes the acquired asset in the Netherlands at the (higher) arm's length price on the basis of the arm's length principle and subsequently depreciates the higher value for tax purposes.

If a taxpayer has acquired an asset from an affiliated entity at a transfer price that is lower than an arm's length price, then for the purposes of entering the price in the accounts the taxpayer may only take that increase to the arm's length price into account insofar as a corresponding increase is subject to a profit tax at the other entity. It is up to the taxpayer to convincingly demonstrate the latter.

The term 'asset' not only covers depreciable operating assets, but also other assets.

If the asset was acquired at an arm's length price, then according to the consultation document the above rule does not apply.

Assets acquired in five preceding financial years

For assets acquired in the five financial years preceding the first financial year commencing on or after January 1, 2022 (hereinafter: 2022 financial year), a depreciation limitation will apply, under certain conditions, as of the 2022 financial year.

In short, the following conditions apply to the depreciation limitation:

- the taxpayer acquired an operating asset from an affiliated entity in the period of five financial years preceding the 2022 financial year;
- at the commencement of that financial year the operating asset can still be depreciated;
- if, at the time the operating asset was acquired the aforementioned book value limitation (as of the 2022 financial year) would have applied, that operating asset would have been stated at a lower value than the value determined at that time with due observance of the arm's length principle.

If these conditions are met, then as of the 2022 financial year the depreciation on that operating asset will be calculated on the basis of the lower of the following amounts:

- a. the value at which the operating asset would have been recorded in the accounts at the time of its acquisition, if the book value limitation would have applied at that time;
- b. the book value of the operating asset at the time immediately preceding the 2022 financial year.

After the value to be used for calculating the depreciation has been determined on the basis of these steps, the ordinary depreciation rules continue to apply.

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informal capital arrangements (including deemed dividend) have been under scrutiny for some time in the light of international tax mismatches. The report of the Advisory Committee on the Taxation of Multinationals ('the Ter Haar Committee') also addressed restricting mismatches on the basis of informal capital structures. This bill was therefore certainly not unexpected.

The bill opened for public consultation has a certain substantive retroactive effect due to the depreciation limitation for assets acquired in the five financial years preceding the first financial year commencing on or after January 1, 2022.

The public consultation closes on April 2, 2021. If consent is given, the responses will then be published. After the public consultation, the responses can be included in the drafting of the final bill.

Please feel free to contact your advisor at Meijburg & Co, if you have any questions or would like to discuss the above matters.

Meijburg & Co
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