

New Dutch legislative proposal to combat tax avoidance through transfer pricing mismatches

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*In this article **Clive Jie-A-Joen** and **Rosalie van de Brug** discuss two new Dutch legislative proposals which aim to combat tax avoidance through transfer pricing mismatches. Through a combination of a theoretical discussion and practical examples, Clive and Rosalie provide a clear overview of the potential impact of the proposed legislation.*

On 4 March 2021, the Dutch Ministry of Finance published legislative proposals to tackle tax avoidance arising from different application or interpretation of the arm's length principle in the field of corporate income tax. The legislative proposals aim to prevent mismatches owing to unilateral downward transfer pricing adjustment to the taxable profit of a Dutch taxpayer on the basis of the arm's length principle to the extent that no corresponding upward transfer pricing adjustment is included in the taxable base of the foreign related entity that is party to the controlled transaction.

The new legislative proposals are expected to result in a higher structural budgetary revenue of Dutch corporate income tax to the amount of € 173 million.

We discuss below the two proposed articles in order to tackle tax avoidance by transfer pricing mismatches: respectively Article 8ba and Article 35 of the Dutch Corporate Income Tax Act 1969 ("CITA"). The legislative proposals are subject to an internet consultation (up to and including 2 April 2021) and are intended to become effective for financial years starting on or after 1 January 2022.

Proposed Article 8ba CITA

The proposed Article 8ba prohibits a downward adjustment to the taxable profit of a Dutch taxpayer on the basis of applying to the arm's length principle (i.e. Article 8b CITA) in the absence of a corresponding upward transfer pricing adjustment in the tax base of a foreign counterparty to the controlled transaction. This situation is referred to as double non-taxation.

Let's take two examples. The first example regards a situation in which the parent company A Co located in a foreign country provides an interest-free loan of € 100 to its subsidiary B NL located in the Netherlands. The interest rate when applying the arm's length principle of Article 8b CITA is 5 percent whereas the agreed interest rate of the provided loan is zero

percent. The foreign country does not include interest income in the tax base of A Co and, in accordance with the arm's length principle, B NL has tax-deductible annual interest expenses of € 5. This leads to double non-taxation. Therefore, the downward adjustment to B NL's taxable profit by deducting interest expenses of € 5 is not allowed because there is no corresponding upward transfer pricing adjustment in the tax base of A Co.

The second example regards a situation in which A NL, a parent company located in the Netherlands, provides a loan to its subsidiary B Co located in a foreign country at an agreed interest rate of 8 percent. The interest rate in accordance with the arm's length principle of Article 8b CITA is 4 percent. B Co includes tax-deductible interest expenses of € 8 in its tax base in the foreign country. When applying the arm's length principle, A NL includes interest income of € 4 in its tax base in the Netherlands. This leads to double non-taxation. Since there is no corresponding upward adjustment in the tax base of B Co, the downward adjustment to A NL's interest income is not allowed.

Article 8ba CITA regulates the taxability of non-arm's length income (please refer to the second example above) and the non-deductibility of arm's length expenses (please refer to the first example above) of the Dutch taxpayer in the case of a transfer pricing mismatch in applying the arm's length principle as of financial years starting on or after 1 January 2022 as follows:

- The first paragraph of the proposed Article 8ba includes the general provision with regard to the taxability of income and the non-deductibility of expenses: a downward adjustment to the taxable profit of the taxpayer in respect of a mutual legal relationship between the taxpayer and a related entity is not possible if the taxpayer cannot provide proof for a corresponding upward adjustment in the other related entity's tax base.

- The second paragraph contains the definition of a downward adjustment. A downward adjustment refers to higher expenses and/or lower income when applying the arm's length principle in accordance with Article 8b CITA as compared to the expenses and income, respectively, which would be considered based on the agreed conditions in determining the profit of the taxpayer. According to Article 8b, the conditions of a transaction between related entities should be in line with the conditions of a comparable transaction between non-related parties. Article 8ba only relates to the adjustment resulting in arm's length income or expenses in respect of a mutual legal relationship. The so-called secondary transaction resulting from the arm's length agreed conditions, the benefits from shareholding, is not relevant for profit determination with regard to Article 8ba. Moreover, Article 8ba is in line with Article 8b paragraph 1 and 2 as regards the definition of a related entity.

•The third paragraph of Article 8ba contains a specific provision with regard to purchase by a Dutch taxpayer of assets (including assets that can be depreciated but also receivables) belonging to a related entity. Paragraph 1 of Article 8ba may be applicable if the arm's length remuneration exceeds the agreed transfer price in the absence of a corresponding upward adjustment in the tax base of the related entity. Let's take an example to illustrate the third paragraph of Article 8ba. Suppose the parent company A Co located in a foreign country sells an asset to its subsidiary B NL at an agreed price of € 100. The price of the asset when applying the arm's length principle of Article 8b is € 200. The depreciation period of the asset is five years and there is no resale value. A Co includes the agreed sales price of € 100 in its tax base. In accordance with the arm's length principle, B NL takes into account the arm's length purchase price of € 200 for profit determination. In the five upcoming fiscal years, B NL determines depreciation expenses based on the purchase price of € 200. Therefore, the yearly depreciation expenses are € 40. This would lead to double non-taxation of € 100. Since there is no corresponding upward adjustment in A Co's tax base, the third paragraph of Article 8ba determines that depreciation expenses are based on the purchase price of € 100.

Proposed Article 35 CITA

The proposed Article 35 CITA aims to limit a taxpayer's depreciation of assets that are acquired from a related entity in the five financial years preceding the first financial year starting on or after 1 January 2022. As from the financial years starting on or after the 1st of January 2022, it is no longer possible for Dutch taxpayers to consider depreciation calculated under the transfer price determined taking into account the arm's length principle (i.e., in accordance with Article 8b CITA) under the following conditions:

- The taxpayer has acquired an asset from a related entity in accordance with Article 8b CITA during the period of the five financial years prior to the first financial year starting on or after the 1st of January 2022;
- It is possible to take into consideration the depreciation of the asset at the beginning of that book year; and
- If the third paragraph of Article 8ba would be applicable at time of acquisition, the asset has been booked at a lower value as compared to the value in accordance with Article 8b at the time of acquisition.

If these conditions are met, depreciation of the asset starting on or after the 1st of January 2022 is calculated on the basis of the lowest amount of:

- The value of the asset at the time of acquisition if Article 8ba would have been applicable at that time; or
- The book value of the asset at the time immediately prior to the first book year starting on or after 1st of January 2022.

To illustrate Article 35 CITA with an example, suppose the following situation. On 1 January 2020, B NL, a subsidiary located in the Netherlands, purchased an asset from its parent company A Co located in a foreign country at an agreed purchase price of € 500. A Co includes the sales revenue of € 500 in its tax base. The arm's length purchase price in accordance with Article 8b CITA is € 1000. B NL depreciates the asset in a period of five years and there is no resale value. In this situation, all conditions of Article 35 are met. To determine the depreciation expenses on or after the 1st of January 2022, Article 35 CITA should be taken into consideration. Calculation of depreciation needs to be based on the lowest amount of:

- The value of the asset at the time of acquisition if Article 8ba would have been applicable at that time; or
- The book value of the asset on the 31st of December 2021.

If the third paragraph of Article 8ba would be applicable at time of purchase, depreciation expenses would be based on the purchase price of € 500. The book value of the asset on the 31st of December 2021 amounts to € 600. Therefore, depreciation expenses for the remaining three years are based on € 500 and the yearly depreciation expenses are € 167. As a result, the book value of the asset after the period of five years is € 100.

Under the proposed Article 35 CITA, the previous rules regarding depreciation of assets remain applicable but the value that a taxpayer can take into consideration when calculating depreciation expenses will differ.

Concluding remarks

Under the current application of the arm's length principle in the Netherlands, conditions of controlled transactions that are not arm's length will be adjusted taking into account the arm's length principle resulting in TP adjustment to the taxable profit of the Dutch taxpayer irrespective of whether there is a corresponding adjustment to the taxable base of the counterparty to the controlled transaction. In a quest to enhance its reputation, however, the Dutch Government has proposed unilateral measures to disallow downward transfer pricing adjustment to the Dutch taxpayer's taxable profit to the extent that a corresponding upward adjustment is not included in the taxable base of the other related party to the transaction. The question is whether such unilateral measures by the Dutch government is necessary at this moment in time. It can be argued that such arrangements will need to be reported anyways under DAC6 after which appropriate European measures can be taken, if necessary. Dutch taxpayers applying non-arm's length conditions to controlled transactions will be affected by the proposed legislation. In addition, Dutch taxpayers with an unilateral APA endorsing an unilateral downward transfer pricing adjustment will be affected, since the draft legislation does not propose grandfathering rules. Interested parties can provide comments to the draft legislation in the period between 4 March 2021 and up to and including 2 April 2021. It is expected that the draft legislation

will receive comments from an EU case law perspective because of the inconsistent application of the arm's length principle in the Netherlands.