Dutch Court of Appeal Releases Landmark Transfer Pricing Decision

By Eduard Sporken and Adriaan Bijleveld

On May 12, 2022, a Dutch Court of Appeal published a ruling on an interesting transfer pricing case (see decision of April 13, 2022, by Gerechtshof 's-Hertogenbosch, no. 19/00771 and 19/00779, ECLI:NL:GHSHE:2022:1198). The case covered the financial year 2012 where the taxable profit was increased from 30 million euros ($41.55 million) to 95 million euros.

Main Issues/Questions Considered by the Court

- **Allocation of debt and equity capital to a permanent establishment**

The first question dealt with whether an arm's-length interest rate was taken into account for a permanent establishment (PE) in Libya in connection with the application of the object exemption for the PE's profits. More specifically, the dispute was whether the creditworthiness of the Dutch legal entity was correctly taken as a starting point and whether sufficient adjustments were made for the increased risk profile of the Libyan PE.

The lower District Court had ruled that, in applying an arm's-length allocation of interest expense, a division of one-quarter debt and three-quarters equity must be taken into account for the PE in Libya (see decision of Nov. 11, 2019, by Rechtbank Zeeland-West-Brabant, no. BRE 17/4994, published on Dec. 12, 2019, ECLI:NL:RBZWB:2019:4920). That decision deviated significantly from the position taken by the taxpayer, which did not take any debt into account, while the debt/equity ratio at the level of the Dutch legal entity was 47%/53%.

According to the taxpayer, a third party would never have provided any form of financing to the PE due to the political and social situation in Libya during the financial year. However, the Court of Appeal, based on its interpretation of the Dutch PE Decree (see No. IFZ2010/457M, published in the Official Daily Gazette, Jan. 27, 2011, no. 2011/1375), agreed with the lower District Court's view, that the capital allocation approach read in conjunction with the fungibility approach was regarded as the preferred method for the application of Article 7 of the OECD Model Convention in the Netherlands and therefore is the leading way for determining the amount of the PE profit exemption, even though no tax treaty existed between Libya and the Netherlands.

The operational risk relating to the local factory was considered to increase, as scheduled maintenance activities could not be performed, thereby increasing the exposure of the PE. As such the District Court took that risk into account by lowering the debt-to-equity ratio for the PE to 25%/75% (instead of 47%/53%), applying an abatement of 22%.

According to the Court of Appeal, the taxpayer was unable to provide proof that the risk abatement of 22% was not in line with the arm's-length principle. Accordingly, part of the

interest reported at the level of the Dutch legal entity was allocated to the PE. That resulted in the PE having a lower profit and a lower corporate tax object exemption claim in the Netherlands.

- **Should all assets and liabilities denominated in US dollars be valued as a whole?**

As a general rule, confirmed by the District Court and the Court of Appeal, when applying "sound business principles" it is necessary to value assets and liabilities separately. An exception to that rule may apply in situations where valuation as a whole must take place on the basis of particular facts and circumstances.

In the present case, the taxpayer had incoming and outgoing group loans, all denominated in US dollars. In the opinion of the Court of Appeal, the mere fact that assets and liabilities were denominated in the same currency was insufficient to conclude that there was a correlation between them.

- **Was the profit of the taxpayer's Dutch subsidiary deliberately set too high?**

The taxpayer wished to deviate from its own (filed) tax return by stating that the profits it reported in 2012 were too high. The taxpayer claimed downward/informal capital adjustments.

The weighted average interquartile benchmark as prepared by the taxpayer for the years 2010–2012 showed a range from 2.72% to 6.31%. The actual operational profits margin of the taxpayer was 27.4%, creating a delta of 21.09% (being 27.4% less 6.31%; in the court's decision it seems to be erroneously stated as 20.1%). The taxpayer's downward adjustment claim for 2012 alone was 203,167,984 euros.

The taxpayer was of the opinion that its transfer pricing policy, as documented in the centrally prepared group transfer pricing master file, was not in line with the arm's-length principle. A second transfer pricing report, prepared by a third-party adviser, had been prepared in order to substantiate the taxpayer's position.

The Court of Appeal pointed out that transfer pricing allocates the annual profit of the group among its group entities globally. Were the position of the taxpayer to be followed, it would mean that foreign tax authorities have been presented with incorrect financial data, i.e. profit figures that are too low. The Dutch taxpayer was part of an international listed group which, it might be assumed, it was fiscally "in control" of. In other words, the Dutch taxpayer had a "tax control framework" (i.e., a set of processes and internal control measures designed to ensure that tax risks within its business operations were known and controlled).

The assumed desire to be fiscally "in control" was not compatible with the fact that very large amounts of profit had been allocated to various group entities in an incorrect manner. The fact that the international group to which the taxpayer belonged had a set of processes and internal control measures at its disposal, as documented in the group transfer pricing master file in which transfer prices and other intercompany conditions were documented throughout the group, was evidence that such a framework was in place.

After assessing the second transfer pricing report, the Court of Appeal could not conclude

that the applied transfer pricing policy deviated from the arm's-length principle. The court also pointed to the global character of the second transfer pricing report (prepared by the third-party adviser), which omitted essential information necessary to make a proper comparability analysis, such as a functional analysis, an analysis of the economic conditions, the business strategy, the exact nature of the goods and services, the contractual conditions, the risks incurred, and the specific and unique characteristics of the companies being compared.

The Court of Appeal considered the second transfer pricing report to be no more than a benchmark report that included companies performing noncomparable activities or that were much smaller in size than the taxpayer.

The Court of Appeal concluded that the taxpayer had not made a plausible case that its profit had been determined at an unreasonably high level. Accordingly, no Dutch corporate tax reductions would be made.

- **Was the tax inspector correct to make an adjustment of 42,843,146 euros in connection with the supply agreement concluded between the taxpayer and a foreign group entity?**

The taxpayer operated a fertilizer production facility as a fully fledged manufacturer. In 2011 it opened a new factory producing 39% more fertilizer products than in previous years (the "surplus amount"). In the same year the taxpayer entered into an agreement with a foreign group entity stating that it would produce the surplus amount as a contract manufacturer receiving a guaranteed cost-based compensation (i.e., cost price plus a mark-up of 5%). For the remaining 61% of the fertilizer products, transfer prices (based on comparable uncontrolled prices) would be applied, as documented in the group transfer pricing master file.

The Court of Appeal placed the burden of proving that the transfer price applied to the surplus amount was at arm's length on the taxpayer. It determined that the taxpayer had not been able to provide proof that the legal conditions, as included in the supply agreement, were consistent with the actual economic transaction(s). In the view of the Court of Appeal, that applied in particular to transactions in which the allocation of risks played an important role, as in the present case. According to the court (at paragraph 4.55.1):

"The allocation of risks must be rational from an economic perspective. The party to whom the risks are allocated should have the knowledge to manage the risks and the ability to bear the risks. Whether a particular risk, such as in this case part of the production risk, can be transferred, therefore requires an economic analysis."

This concept of "risk and control" was introduced in the revised OECD Guidelines in 2017 (under paragraph 1.60 and further). It is worth noting that the Court of Appeal also chose to apply this concept to financial years before 2017, thereby underlining the fact that the arm's-length principle had not changed due to the publication of the BEPS reports.

Based on the above reasoning, the Court of Appeal ignored the supply agreement as it did not reflect the economic reality, since the taxpayer acted as a "fully fledged" producer with regard to the surplus amount. The turnover of the Dutch taxpayer was close to 1 billion euros in 2011, whereas the turnover of

the comparable group companies (in the benchmark) was several million euros to 30 million euros. The Court of Appeal based its conclusion on the transfer price documentation and the fact that, after the supply agreement had been concluded, as far as the functions performed, risk assumed, investments made, and capital utilized, almost nothing had changed in the Netherlands.

The court also took the view that it would be highly unlikely that a third party would transfer the production risk of 39% of its production output for a low but guaranteed cost-plus margin, while it reported significant profits for the other 69% it produced.

The taxpayer also argued that the tax inspector had not acted according to the principle of equality, as the state was obliged to treat equal cases equally and unequal cases unequally according to the degree of their inequality. The Court of Appeal found that there was no conflict with that principle, since the taxpayer had not substantiated specifically that the present case could be compared with the "EU state aid cases," i.e., Starbucks, Nike, and Apple.

Also, the fact that other group entities had entered into similar arrangements with third parties that were somewhat similar to the supply agreement did not change the conclusions of the Court of Appeal. Although the taxpayer proved that the supply agreement might also be concluded with third parties, it could not be determined whether the functions performed, risks assumed, and assets used by those third parties were comparable to the functions performed, risks assumed, and assets used by the Dutch production facility.

Finally, the Court of Appeal ruled that the profit adjustment, relating to the non-business nature of the transaction, should not be taken in 2011, the year the supply agreement was created, but from month to month in which the transaction took place.

Key Takeaways

This case shows that global (and consistent) transfer pricing documentation is crucial. Also, it should be noted that the Netherlands has a separate 2011 decree for the transfer pricing of PEs (an update to the decree is expected soon).

It is remarkable that for a financial year as long ago as 2012 the Court of Appeal referred to a tax control framework, the concept of control over risk, and actual delineation of intercompany transactions, as these concepts were introduced in the 2017 OECD Guidelines.

An appeal in cassation with the Supreme Court has been filed. In due course, the Supreme Court will examine whether a lower court properly applied the law in reaching its decision. However, the facts of the case, as established by the District Court and the Court of Appeal, will no longer be subject to discussion.

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