RECENT TRANSFER PRICING COURT CASES IN THE NETHERLANDS: OVERVIEW AND TAKEAWAYS

INTRODUCTION

Tax and transfer pricing (TP) are becoming areas of greater focus from different angles. Not only they can affect the bottom line, but they can also affect the organisation's reputation and governance. Thus, it has become paramount to consider and assess the regulatory framework and court decisions, particularly for transfer pricing, where recent developments have taken place, and tax authorities and tax courts alike are making their assessments and decisions considering said developments.

According to the OECD's TAS Database 2022, 723,396 tax audits were conducted in the Netherlands in 2020. Out of that number, 188,624 tax audits ended up in an adjustment made to taxpayer's declaration. Due to the current and forecasted economic environment, it is not farfetched to expect that the scrutiny from the Dutch Tax Authorities (DTA) will increase, as governments around the globe need to increase tax revenues to fund increased social protection needs.

Below, we present a brief summary and our takeaways from the most recent court decisions in the Netherlands. Whilst the specifics of the TP cases which were adjudicated in 2022 are diverse and touch on a wide range of industries and topics, we believe it is possible to draw a common thread between these cases which clearly shows those issues identified by the DTA (and by extension the courts) as hot topics.

First, the increased focus on financial transactions. This is also evident in the comprehensive update of the Dutch TP Decree (published July 2022) with respect to financial transactions. In particular, we see a focus on what could be deemed as an arm's length capital structuring. Second, the courts have stressed the importance of complete, accurate and consistent TP framework. The analysed cases demonstrate that courts heavily rely on the exact wording used in TP reports (as well as supporting documentation), and expect that large multinational groups are fiscally informed and in control of their tax policy.

Transfer pricing is becoming more relevant in the current tax audit context, and thus, it is important to make sure that not only transfer pricing documentation is available in advance, but also that the entire transfer pricing and tax narrative is aligned to ensure the best outcome from the potential scrutiny by DTA or tax authorities from all around the world.

THE NETHERLANDS VS. TOBACCO GROUP[1]

On October 17, 2022, the District Court of North Holland ruled in favour of the DTA and dismissed two appeals of Dutch companies of an internationally operating tobacco group (further jointly referred to as the Plaintiff) against the disallowance of certain fees charged by various group companies related mostly to financial transactions (factoring fees, guarantee fees). The respective tax audits covered years from 2008 to 2010 and 2011 to 2013; and resulted in transfer pricing adjustments totalling over EUR 300 million for these reporting periods.

Two Dutch subsidiaries of the UK parent company were engaged in holding and financing activities and the production and distribution of tobacco products. In the periods under review they paid factoring fees, guarantee fees and interest on loans to group companies. We discuss the first two (most relevant) transfer pricing issues below.

1. Factoring fees

One of the group companies (Factor), a general partnership in a foreign jurisdiction (Country X), provided factoring services to the Plaintiff for a factoring fee. The work carried out by the Factor included performing credit risk analyses, setting and monitoring credit limits, monitoring payment terms, collection and administrative work. The annual factoring fee included €2.5 million charged as a risk premium to cover the debtors risk, and €1.2 million as an administrative fee for the accounts receivables management services and the risk analysis provided by the Factor.

An interesting fact is that the tax audit was prompted by publications in the media in Country X, as a result of which the DTA was made aware of the excess profit ruling of Factor with the Country X tax authorities. The ruling stipulated, among other things, that 92.4% of the results achieved with factoring constitute 'additional profit' that Factor would not have achieved if it had contracted with a third party. Stemming from the tax audit exercise, the DTA took the view that the factoring fee must be viewed as being non-business like and made the respective adjustments.

The court ruled that the DTA has made it plausible that an independent third party would not have been willing to pay a risk premium of €2.5 million to cover the risk on the debtor portfolio, while it could have been insured on the market for €0.4 million.

Reference was made to a credit insurance agreement concluded by the Plaintiff with a third party insurance company covering the entire debtors portfolio, which the DTA considered as a feasible internal comparable transaction of the Plaintiff. Considering the large amount of the risk premium, the court supported its complete disallowance in the factoring fee.

In addition, the court supported the position of the DTA that a correction should be made with respect to the administrative fee: such fee should be treated as a routine service fee in view of the nature of the services, and a cost plus remuneration was more appropriate to determine the arm's length amount of this fee (instead of a certain percentage of the total receivables amount as initially declared).

Our takeaways

- Internal comparable transactions (in this case, a transaction with the non-affiliated insurance company) should be carefully assessed and taken into account when determining transfer prices.
- It is important to have additional documentation to support that the services in question were actually rendered and provided benefit to a service recipient, as well as to prove the nature of such services (i.e. routine or value added services). The documents requested during the audit in this specific case included written documents confirming activities of Factor in relation to debtors (e.g. explanation of invoices, reminders, other documents exchanged with debtors). In addition, details were requested about the people actually providing intercompany services and their time spent, such as job descriptions, level of education, timesheets, annual costs incurred, etc.
- How a taxpayer responds to the tax authority's requests may make a big difference in court: in this case, the court rejected the argument of the Plaintiff alleging that the administrative part of factoring services was actually of non-routine nature, since the Plaintiff did not mention this fact in response to the request of the DTA, even though the latter requested to interpret their request "as broadly as possible".
- Taxpayer's own expertise and experience should be taken into account when determining if they were aware of the considerable chance that too little tax will be levied ('conditional intent'). The fact that the taxpayer has engaged an adviser does not exclude the possibility that conditional intent was present in their mind.

2. Guarantee fees

In order to finance their activities, the group companies issued listed bonds under the tobacco group's so-called EMTN Programme, for which the group parent company in the UK provided a guarantee.

The Plaintiff paid an annual guarantee fee of approximately €35 million to the UK parent.

The DTA took the view that the acceptance of the guarantees by the UK parent must be regarded as a shareholder act, and as such, the guarantee fee should not be considered at arm's length, hence it cannot be deductible from the taxable profit of the Plaintiff.

In the court's view, the credit facility in itself served a business purpose. The court ruled that the DTA had failed to prove that a third party would not provide guarantees for the bonds issued by the Plaintiff against a guarantee fee.
In the determination of an at arm's length level of guarantee fee, the court ruled there was an implicit guarantee enjoyed by the Plaintiff being a strategically important company within the group: no guarantee fee should have been paid to the UK parent in return, since there is no group service to that extent. The court therefore ruled that the guarantee fee was a non-deductible expense.

The court ignored the Plaintiff's argument that the implicit support approach was not yet part of the transfer pricing discussion in the years under audit because it would not have arisen until the end of 2009 in the 'General Electric Capital Canada Inc' case and that this approach only appeared in the Netherlands in the 2013 Dutch TP Decree. In this context, the court referred to the OECD TP Guidelines 1995 and a discussion of incidental benefits attributable to being a part of a group.

Our takeaways

- A fully compliant TP documentation is important; however a proactive (rather than re-active) approach to transfer pricing is a key. In view of the tax inspector, the TP documentation prepared for guarantees was insufficient. Contrary to what the Plaintiff claimed, no advice given by an expert about the correctness and/or amount of the guarantee fees has been found.
- A transfer pricing position should be re-assessed regularly and may need to take into account the relevant newly published official documents, court practice, and trends.
- Internal emails (even though it is not clear how they became part of the discussion in court) may play a big (negative or positive) role in an audit and/or court proceedings. In the case at hand, an internal email of the company shows the awareness of the company that a high amount of guarantee fee to an affiliated company is "undoubtfully going to attract attention".

THE NETHERLANDS VS OWNER B.V. [2]

On July 26, 2022, the District Court of North Holland ruled in favour of the taxpayer (B.V.) concerning its appeal on the Decision on objection made by the DTA.

1 Rechtbank Noord-Holland, 17-10-2022, ECLI:NL:RBNHO:2022:8936, 18/876 t/m 18/878 and Rechtbank Noord-Holland, 17-10-2022, ECLI:NL:RBNHO:2022:8937, 18/2499 t/m 18/2501

2 Rechtbank Noord-Holland, 26-07-2022, ECLI:NL:RBNHO:2022:6584, 18/2897.

In brief, the DTA imposed a corporate income tax assessment on B.V. for the period between October 1, 2012, to December 31, 2013, calculated according to a taxable amount of €9.5 million. By simultaneous decision, €0.5 million tax interest was charged. After objection by B.V., the DTA decided to reduce the tax assessment to a taxable amount of €3.3 million, as well related interest to €0.2 million. B.V. appealed against that revised tax assessment before the relevant Court, from which the below decision is stemming from. From a transfer pricing perspective, we outlined below two main episodes of this dispute.

1. Transfer pricing documentation

Based on Article 8b of the Dutch Corporate Income Tax Act (CITA), affiliated entities shall include in their records information showing the manner in which the transfer prices in their related party transactions have been arrived at and from which it can be ascertained whether the transfer prices arrived at are on terms that would have been agreed upon by independent parties. The starting point is that such documentation should be present at the time when the transfer prices were established.

In the case at hand, DTA argued that there was no suitable transfer pricing documentation in place justifying the arm's length nature of the intragroup loans, noting that the bond loan agreements do not constitute adequate transfer pricing documentation nor that the presented reports where technically sound. Thus, the burden of proof on the arm's length nature of interest must be reversed, and the interest expenses were not to be considered business expenses thus not deductible (at all), and that the loan and interest must be fully reclassified. B.V., on the other hand, argued that it does have sufficient transfer pricing documentation (three transfer-pricing analyses). According to B.V., the DTA, on whom the burden of proof rests, does not make it plausible that these interest charges are unreasonable. For that matter, any violation of Article 8b of the CITA, if any, cannot lead to a reclassification of a loan, but only to a price adjustment.

The court's opinion is that B.V. has not complied with the documentation requirements by referring to the agreements on the two bond loans, as it cannot be ascertained from them how the transfer prices were arrived at, nor whether the transfer prices arrived at are subject to conditions that would have been agreed upon by independent parties. The existing TP reports are disregarded by the court in this context as they were not prepared until 2021. Indeed, when the DTA asked for the documentation, these reports were not provided. With regard to the consequence of not meeting the documentation obligation, the aim of Article 8b of the CITA is not so much to change the burden of proof as to ensure that sufficient information is available to assess the arm's length nature of the transfer prices arrived at between affiliated parties.

Our takeaways

- TP documentation should be put in place at the time of conducting the related party transaction and made available to tax authorities when requested.
- Albeit that taxpayers are expressly free to choose how they record the relevant information, legal supporting documentation without a proper TP study would not suffice.
- The TP documentation should depict how the transfer prices were arrived at, and whether the transfer prices arrived at meet the arm's length principle, in a technically robust fashion.

2. Related party transactions recharacterization

The DTA argued that under Article 8 and 8b of the CITA (with reference to paragraph 1.65 of the OECD Transfer Pricing Guidelines 2010), a full recharacterization of the loans can and should take place, which the B.V. disputes. According to B.V., only an interest adjustment could be deemed as appropriated.

The DTA argues that the interest should be adjusted in full as no third party could be found who would have provided the loans under dispute with the same or very similar conditions. B.V. refers to the transfer pricing reports from which it can be inferred that the agreed interest rate is at arm's length. However, the DTA pointed out that the reports were technically unsuitable, due to various reasons (use of different classifications for the creditworthiness, namely B for the shareholder loans and BB for the intercompany loans, while the rating of the different companies should be based on the same values and it is not clear how the rating was arrived at). In this regard, B.V. failed to clarify any ambiguity about the creditworthiness of the companies concerned during the hearing process, and the broadening of the search criteria resulting in a wider arm's length range. This supported the efforts of the DTA in casting at least reasonable doubt on the supportive value of the B.V.'s three TP reports.

Notwithstanding the aforementioned, by disproving B.V.'s transfer pricing reports, the DTA has still not made it plausible that the interest should be adjusted in full. The DTA, while bearing the burden of proof for an interest adjustment, has not itself submitted a transfer pricing report. The Court decided on the basis of Articles 8 and 8b of the CITA and the case law based on them, that the disallowance of interest deduction on the loans is not justified.

Our takeaways

- It is inherent in the system of the CITA that a taxpayer has freedom of choice in the form of financing of a company in which it participates. The same freedom applies to the organization of a group, i.e. no provision of the CITA or any underlying principle contains standards as to where within a group activities are placed and where holding, intermediate holding or financing activities are carried out.
- This financing/holding freedom has recently also been confirmed by the Dutch Supreme Court (HR July 9, 2021; ECLI:NL:HR:2021:1102; *Triple-dip*). Taken together, this means that, in principle, the financing of operations and of the acquisition and holding of participations by means of loans is a business matter of a group company.
- Regarding the approach which (in some cases) allows full recharacterization of loans (according to the OECD TPG and as followed by the Dutch Secretary of State for Finance in the most recent TP Decree of July 1, 2022), it is worth to notice that the Dutch Supreme Court does not follow this line. It still follows its 'non-business-like loan doctrine', as recently confirmed in a case law (HR July 15, 2022; ECLI:NL:HR:2022:1086; *Autobar*). Therefore, taking the above observation into account, the appropriate delineation of intragroup transactions as debt is the cornerstone to justify that it is not an equity contribution and that related interest is deductible.
- DTA is becoming more sophisticated in their assessment of transfer pricing reports, and sounded technical knowledge is needed to perform the appropriate transfer pricing analyses to justify the arm's length nature of intragroup (financial) transactions.

THE NETHERLANDS VS FERTILIZER GROUP[3]

On April 13, 2022, the Court of Appeal 's-Hertogenbosch ruled in favour of the DTA concerning an appeal brought by the Taxpayer in that case against the judgement of the Zeeland-West Brabant District Court (the District Court).

In brief, the DTA imposed a corporate income tax assessment on the Taxpayer in respect of its 2012 CIT return to which the Taxpayer objected, which objection was ruled by the DTA to be unfounded. The District Court found in favour of the DTA on most issues.

The Taxpayer appealed the judgement of the District Court and was ultimately unsuccessful, with the court ordering that the Taxpayer's declared taxable amount in 2012 be adjusted upwards from approximately EUR 29 million to EUR 95 million. The Taxpayer is head of a fiscal unity that comprises E BV.

From a TP perspective, we outlined below three main episodes of this dispute.

1. Allocation of debt and equity capital to a permanent establishment

The Taxpayer holds an interest in entity K-CV (i.e. the permanent establishment: hereinafter the PE) which operates a fertilizer manufacturing plant in Libya. In essence, the DTA challenged the quantum of the object exemption claimed by the Taxpayer by asserting that interest should have been attributed to the permanent establishment in Libya.

The main thrust of the taxpayer's argument was that no loan capital (and no corresponding interest expense) should be allocated to the PE because the security situation in Libya was so precarious in 2012 that no independent third party would have been willing to provide a loan to K-CV.

The Court ruled that "*the starting point of the capital allocation approach is that a PE has the same creditworthiness as the head office, with the proviso that the functions, assets and related risks attributed to the PE must be taken into account*". In this context the Court also ruled that following the capital allocation approach the Taxpayer's argument that non independent third party would have been unwilling to provide a loan to K-CV is irrelevant, also the legal allocation of loans is irrelevant. However, the general circumstances occurring in the state in which the PE is located (such as the outbreak of the civil war) should be taken into account when making adjustment to the related (business) risks attributed to the PE.

Ultimately the Court found that the allocation of 25% loan capital and 75% equity to K-CV (this ratio was first determined in District Court based on the equity/debt ratio of the fiscal unity headed by the Taxpayer, to which a risk premium of 22% which was then applied) and an interest rate of 4.6% based on the fungibility approach leads to an allocation of interest that is in line with the arm's length principle.

This resulted in the PE ultimately having a lower profit and therefore a lower object exemption claim in the Netherlands.

Our takeaways

- The Court expressed that the starting point of the capital allocation approach with respect to a PE's debt-to-equity structure is the creditworthiness of the head office and a debt-to-equity allocation that reflects the fiscal unity's capital mix. Depending on the functions performed, assets used and related risks attributed to the PE, an abatement or premium (as the case may be) could be applied.

2. Was the profit of E BV and thus of the Taxpayer (deliberately) set too high?

The Taxpayer took the position that using the transfer prices that follow from the Group's TP Master File leads to an unjustifiably high profit for E BV and thus for the Taxpayer (same fiscal unity). Instead, the Taxpayer sought to rely on a new TP report (W Report) containing various benchmarking studies and according to which an operating margin of 6.31% should be considered arm's length. However, the remuneration achieved by E BV in the financial year 2012 amounted to 27.4% (based on the Group's TP Master File).

3 Court of Appeal 's-Hertogenbosch, 13-04-2022, ECLI:NL:GHSHE:2022:1198, 19/00771 and 19/00779; and Rechtbank Zeeland-West-Brabant, 25-07-2022, ECLI:NL:RBZWB:2022:4115, 18/8616.

The Court considered that the Fertilizer Group is a large listed multinational and accordingly may be assumed to be fiscally "in control" and that it has a so-called "tax control framework". This is evidenced by the existence of a Group TP Master File, which further demonstrates that the group to which the Taxpayer belongs has a "*set of processes and internal management measures*", and which has been used for a long series of years. The Court states that this (tax control framework) is not compatible with the Taxpayer's argument that E BV was systematically and consistently over remunerated for many financial years.

Ultimately, the Court held that the W report was not reliable and that the TP policy described in the Group's TP Master File should be applied. The Court states that the Taxpayer's argument that the remuneration of E BV was non-business like must fail for the following reasons:

- The Group's TP Master File stated that Group entities have to conform to the pricing policies outlined in the Master File. Moreover, there was no indication that the policies described therein were not followed by the Group in 2012 or that a different policy should be applied.
- Based on the wording of the W report, it was deduced by the Court that the W report is produced every year for the benefit of Group management, so that management gains insight into the performance of group entities relative to independently operating group entities so that they can check that intercompany transactions can be considered to be at arm's length.
- The W report lacks necessary information such as a description of activities, a comparability analysis, a functional analysis and substantiation of the transfer pricing method applied.
- The Court assessed the comparables accepted in the W report and found that they were defective for multiple reasons. In particular, the turnover of the Taxpayer is almost EUR 1 billion, whereas the comparables all had turnover lower than EUR 30 million. This was a relevant factor in the industry where the Group operates where scale is very important.

Our takeaways

- The fact that TP documentation exists within a group indicates a tax control framework and a group that is fiscally in control. The courts will rely on this to say that groups are in control of their transfer prices and that management was kept informed on pricing policies.
- This case demonstrates the importance of carefully considered wording of TP documentation and the consistent application of TP policies.
- The Court read deep into the specific wording used in the Master File and W Report. Assertions that TP documentation supports arm's length level of remuneration are not easily walked back in front of the Court.

3. Was the Inspector right to make an adjustment for EUR 42 million in connection with the Supply Agreement concluded between E BV and the foreign affiliate?

E BV built a new fertilizer manufacturing facility that resulted in "surplus" production equivalent to 39% of total supply. E BV entered into a supply agreement with its related party J Ltd, according to which E BV would be remunerated with a cost + 5% return on the "surplus" sold to J Ltd ("the Supply Agreement"). The other 61% of production was sold to other Group companies on the basis of a TP policy described in the Group's TP Master File (i.e. the CUP method).

The Court held that the burden of proof to show why a different TP policy should apply to the sale of the surplus vis-à-vis the rest of the production capacity was borne by the Taxpayer. In the Court's opinion, it is then up to the Taxpayer to make it plausible that here is a business reason to sell the surplus at prices that deviate from those based on the Group's TP Master File.

The Court found that through the Supply Agreement, the Taxpayer contractually transferred the production risk of E BV to J Ltd. The financial impact of shifting production risk to J Ltd had a very large financial impact on E BV's profits. By looking at historical EBIT margins, the Court found that it was unlikely that an entrepreneur such as E BV, would exchange profit on part of production for a risk free return of 5%, even though the Group is active in a volatile market. The differences between the EBIT realised in the past and a risk free return of 5% are too great for that.

Moreover, the Court considered that there had been no change to the functions performed, risks assumed and assets deployed in the Netherlands if you look at the situation before and after the Supply Agreement was entered in to. In fact, even the capital requirements of E BV remained exactly the same before and after entering into the Supply Agreement.

Therefore, by emphasizing control over risk and the actual conduct of the parties, the Court considered the Supply Agreement as one that would have never been reached between unaffiliated entities and one which did not serve the business interests of the Taxpayer.

Whilst this matter concerned the Fertilizer Group's 2012 financial year, it is perhaps also prudent to consider another case (Rechtbank Zeeland-West-Brabant, 25-07-2022, ECLI:NL:RBZWB:2022:4115, 18/8616), which considered the Group's 2013 financial year. In this case, the Court of Zeeland-West-Brabant was held that it was for the Taxpayer to prove why the surplus should be sold at prices that deviate from those based on the Group's TP Master File and the corresponding TP policy. Ultimately the Court found in favor of the DTA that the pricing of the surplus should follow the policy described in the Master File.

Our takeaways

- When deciding whether to make a change to an established TP policy it is important to take into account how functions performed, assets used and risks assumed have changed (if at all) and allow this to inform how the TP policy should look going forward. In particular, if the new TP policy is one based on a fixed return (i.e. effectively risk free) a taxpayer needs to be prepared to substantiate how risk management functions and which entity ultimately bears risk have changed as well.
- This case also demonstrates the importance of accurate and current TP documentation. In both of these cases, the Court implies that it will not readily depart from established TP documentation (particularly when it is updated yearly and purports to describe the TP policies on which the Group's transfer prices are based).