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International Tax Law. Transfer prices, application of the arm's length principle and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines)

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no. 2018/6865
Directorate-General for Tax and Customs Policy and Legislation, International Tax Policy and Consumer Taxes Directorate

The State Secretary for Finance has decreed the following:.

On cross-border transactions there is consensus among the OECD member countries on the arm's length principle set out in article 9 of the OECD Model Tax Convention. The arm's length principle is described in more detail in the OECD commentary on article 9 of the OECD Model Tax Convention and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

In 2002 the arm's length principle was codified in the Netherlands by section 8b of the Corporate Income Tax Act (VPB) 1969.

Because the OECD Guidelines provide an internationally accepted description of the arm's length principle, I consider them to be an appropriate interpretation and clarification of the principle defined in section 8b of the Corporate Income Tax Act 1969.

This Decreer defines the arm's length principle in more detail. It focuses mainly on aspects where the OECD Guidelines leave countries scope for their own interpretation or where there is a lack of clarity.

1. Introduction

1.1 Abbreviations and terms used

OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017
BEPS	Base Erosion and Profit Shifting
MNE	Multinational Enterprise[1]

For the sake of clarity, this Decree refers in parentheses to corresponding chapters or paragraphs of the OECD Guidelines (as published in 2017) to which the text of this Decree relates.

[1] In this Decree, 'multinational enterprise' means an enterprise that operates in various countries and may consist of several legal entities.

1.2 Reason for this decree

This Decree replaces the Decree of 14 November 2013, no. IFZ 2013/184M. This Decree pays attention to recent developments, including the results of the OECD's BEPS project, which was aimed, among other things, at aligning transfer pricing outcomes with value creation within an MNE. This project has led to changes to the OECD Guidelines. In so far as these changes further clarify the application of the arm's length principle, I believe that these amendments also apply to years in which these changes had not yet been published.

Major changes compared with the previous Decree are:
- clarification of the process in which a transaction to be assessed between associated parties is characterised (2.1);
- a further explanation of the application of the transfer pricing methods in specific situations (various sections);
- amendment of the section on the pricing of intangible assets when the valuation is highly uncertain (5.2);
- a new section on hard-to-value intangibles (5.3);
- a new section on the purchase of shares in an independent company followed by a business restructuring (5.4);
- a section on the remuneration for low-value-adding services (6.3);
- textual changes to bring the terminology more into line with that used in the amended OECD Guidelines.

1.3 Transfer prices and supervision

When assessing transfer prices it should be borne in mind, as also stated in the OECD Guidelines, that determining transfer prices is not an exact science. That is why tax administrations are encouraged to be flexible in their approach and not demand that taxpayers determine their transfer prices with an accuracy that is unrealistic considering all the facts and circumstances. The Dutch Tax and Customs Administration will also observe these principles.

In the field of transfer pricing, as in other fields, constructive cooperation is required between the Tax and Customs Administration and the taxpayer and it is important for each party to understand the position and interests of the other. Lack of clarity can be prevented by making pricing agreements in advance. In this regard, I would refer to Decree DGB 2014/3098 on the procedure for handling requests for advance pricing agreements (APA's).

The foregoing does not alter the fact that there may be situations where there is a non-arm's length shift of profit and action is required. In such cases, the Tax and Customs Administration will assess the extent to which the imposition of a fine is appropriate in the light of the relevant facts and circumstances.[2]

1.4 Relationship with the OECD Guidelines

On several points the OECD Guidelines leave countries scope for their own interpretation. On other points practice requires clarification of the OECD Guidelines. On these points this Decree provides insight into the Dutch viewpoints and, where possible, removes ambiguities.

In recent years the OECD Guidelines have been amended as a result of the BEPS Project. The OECD Guidelines are still developing rapidly and will continue to be expanded and amended at regular intervals in the future. If necessary, this Decree will also be adapted to new developments.

[2] This does not mean that deviations from the policy set out in this Decree will automatically lead to the imposition of a fine.

1.5 Relationship with the EU Joint Transfer Pricing Forum

A major task of the EU Joint Transfer Pricing Forum is to eliminate double taxation and remove administrative obstacles to the efficient application of the transfer pricing rules. The Netherlands follows the recommendations of the EU Joint Transfer Pricing Forum as much as possible, except where it makes a reservation.

1.6 Coordination of implementation

At the Tax and Customs Administration, coordination of implementation in the area of transfer prices is in the hands of the Transfer Pricing Coordination Group (CGVP). In this regard, I would refer to Decree no. 2018-4380.

In the fight against non-arm's length profit shifting, the Tax and Customs Administration's Transfer Pricing Coordination Group will, if necessary, work with the Tax Havens and Group Financing Group and the Anti-Tax Avoidance Coordination Group.

2. The arm's length principle (chapters I and III)

2.1 General

Introduction

The arm's length principle is defined in article 9 of the OECD Model Tax Convention (see also paragraph 1.6 of the OECD Guidelines). In 2002 the arm's length principle was codified in the Netherlands by section 8b of the Dutch Corporate Income Tax Act 1969.

The starting point of the arm's length principle is that for tax purposes associated enterprises are assumed to act towards each other under the same conditions as independent companies would act in similar circumstances. This means that a result must be achieved in which the taxable profit made by associated enterprises on their mutual transactions is comparable with the profit that independent enterprises would make in similar circumstances with similar transactions. The OECD Guidelines are designed to provide insight into how the arm's length principle must be applied in practice.

Considering the above, I assume that the OECD Guidelines have in principle a direct effect on Dutch legal practice. In addition, the OECD Guidelines play a major role internationally in relation to the application of treaties and the avoidance of double taxation.

Given the importance of the arm's length principle, this section will first look at the general ideas on the application of this principle, as set out in the OECD Guidelines.

The application of the arm's length principle

<u>Characterisation of the transaction</u>

Every transfer pricing analysis must be based on a good understanding of the role of each member of the multinational enterprise and the commercial and financial relations between these members and the transactions (whether or not identified by the MNE) in which those relationships are expressed (see paragraphs 1.34, 1.35 and 1.50 of the OECD Guidelines). Before the price of a specific transaction between associated parties can be determined, the transaction must be characterised as such. This requires an analysis of the economically relevant characteristics of the transaction, consisting of (see paragraph 1.36 of the OECD Guidelines):

- the contractual terms;
- the functions performed, taking into account assets used and risks assumed, including how those functions relate to the wider generation of value by the MNE;[3]
- the characteristics of property transferred or services provided;
- the economic circumstances of the parties and of the market in which the parties operate;
- the business strategies pursued by the parties.

The starting point in characterising the transaction, prior to the application of the arm's length principle, is the transaction as structured between the associated parties with contractual terms in the mutual agreement(s), supplemented if necessary with information from other documents on mutual rights and obligations.

This information must then be supplemented with an analysis of the other economically relevant characteristics of the transaction. All this information together provides insight into the actual conduct of the parties involved. If the actual conduct does not correspond to the contractual elements of the transaction, the actual conduct will in general determine the characterisation of the transaction.

As indicated above, an analysis is also made of the functions exercised and the economically relevant risks associated with the transaction.

The analysis of the risks in a related transaction consists of the following steps.

- Identification of the economically significant risks.
- Analysis of how these risks are contractually divided between parties in the transaction characterised on the basis of the agreements and conduct.
- Analysis of how the parties to the transaction relate to the risks on the basis of the following questions:
  a. Who exercises control and performs risk mitigation functions with regard to the risks?[4]
  b. Who actually bears the upside and downside consequences of the risks involved?
  c. Who has the financial capacity to bear the consequences of the risks?[5]
- Interpretation of the allocation of the risks on the basis of the analysis described in the aforementioned questions a, b and c, with an assessment being made as to whether the party that actually bears the risks does exercise control over these risks and has the financial capacity to bear the possible consequences of the risks.
- If a risk allocation used by the parties involved occurs in comparable transactions in comparable circumstances between independent parties, the risk allocation must be respected.
- Determination of whether a reallocation of risks is required (depending on whether the party actually bearing the risk does exercise control over this risk and whether this party has the necessary financial capacity).

[3] Taking into account the specific circumstances of the transaction and industry-specific factors.
[4] Paragraph 1.65 of the OECD Guidelines gives the following definition of 'control': 'Control over risk involves the first two elements of risk management defined in paragraph 1.61; that is (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.'
[5] Paragraph 1.64 of the OECD Guidelines gives the following definition of 'financial capacity': 'Financial capacity to assume risk can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materialises.'

In practice, situations are conceivable in which several parties exercise control over the risks and have the financial capacity to bear those risks, while only one of those parties has contractually assumed the risks. In such cases, paragraph 1.94 of the OECD Guidelines stipulates that the contractual risk allocation is to be respected. This does not alter the fact that the other party or parties must be compensated at arm's length for exercising the control function performed by that party or those parties. Paragraph 1.105 of the OECD Guidelines stipulates that this compensation, if commensurate with the contribution to the control function, can also be a share in the upside and downside consequences of the risks. In my view, this means that in such cases the transactional profit split method may be appropriate. It does not seem at arm's length that, on the basis of paragraph 1.94 of the OECD Guidelines, a party which bears risks under the contract but actually makes a minimal contribution to control is allocated all downside and upside consequences of the risks concerned and the other party or parties receive limited, routine compensation. If the risk allocation used by the parties concerned actually occurs in comparable transactions in comparable circumstances between independent parties, the conclusion of this analysis could be different.

After all the steps in the analysis of the risks have been taken, the transaction is characterised. This characterisation can therefore deviate from what has been contractually agreed between the associated parties or their interpretation thereof. On the basis of the characterised transaction, an appropriate price must be determined, taking into account the arm's length risk allocation. In principle, this should be done on the basis of comparable transactions between independent parties that result from a comparability analysis.[6] The economically relevant characteristics mentioned above also form the elements of this comparability analysis.

<u>Disregarding the transaction</u>

According to the OECD Guidelines, questioning a transaction as such is only possible if the characterised transaction (including the possible adjustment of the risk allocation), viewed in its totality, differs from what independent parties acting in a commercially rational manner would have agreed in similar circumstances, so that it is not possible to set a price acceptable to all parties. The perspective of both parties and the options realistically available to each of them must be taken into account at the time the transaction is entered into (paragraphs 1.122 to 1.124 of the OECD Guidelines). In this situation, the consequences of such a transaction should be disregarded for tax purposes.

Paragraph 1.122 of the OECD Guidelines makes it possible to question the transaction itself in extreme cases. This prevents the contractual design from making application of the arm's length principle impossible. If possible and appropriate, according to this paragraph, the transaction can be replaced by an alternative transaction for which arm's length conditions can be found. This alternative transaction should be based as much as possible on the established facts and circumstances of the case (paragraph 1.124 of the OECD Guidelines). Disregarding and possibly replacing a transaction with an alternative transaction take place for the purpose of determining the taxable profit.

Paragraphs 1.11 and 1.122 of the OECD Guidelines recognise that associated parties enter into transactions that independent parties would not enter into. In such situations, a comparison of conditions within the meaning of paragraph 1.6 of the OECD Guidelines with conditions agreed in comparable transactions between third parties is not possible. However, the mere fact that comparable

[6] It should be noted that in the case of taxpayers who only need to have transfer pricing documentation on the basis of section 8b of the Corporate Income Tax Act 1969, the absence of an analysis or study of the prices (in databases) that are established in comparable situations between independent parties will not result in the reversal of the burden of proof.

transactions between third parties cannot be found does not mean that the related transaction is not at arm's length. In such a case, it will have to be examined whether conditions can be found under which it is conceivable that independent parties acting in a commercially rational manner would enter into such a transaction in comparable circumstances. It must then be determined whether these conditions match the conditions of the controlled transaction. If arm's length conditions for the relevant transaction can be found in this way, these must be used and the transaction as such must be recognised.

Comparability analysis

The functional analysis of the parties involved in the transaction is important in characterising the transaction, and is also an essential part of applying the arm's length principle and the required comparability analysis. After all, the functions performed, the associated risks and the assets used determine the remuneration for the parties involved.

The arm's length test set out in paragraph 1.6 of the OECD Guidelines is applied to the conditions under which the associated parties have entered into a transaction or as adjusted in the process of characterising the transaction as described above. In doing so, they are compared with the conditions that independent parties would have agreed to in comparable transactions in comparable circumstances. In this context, the price is only one of the conditions (see paragraph 1.7 of the OECD Guidelines). A number of principles play an important role in this comparison of conditions. For example, paragraph 1.38 of the OECD Guidelines stipulates that account must be taken of the options realistically available to the parties concerned under arm's length conditions and the fact that independent parties will enter into a transaction only if they do not have a clearly more attractive alternative. It is also important that the conditions should be compared from the perspective of all parties involved in the transaction.

If only the price of the controlled transaction deviates from the price that would have been established between independent third parties, a price adjustment can be made for tax purposes.[7] When adjusting the price and/or other conditions of an individual transaction or specific group of transactions, an analysis must be made, depending on the facts and circumstances of the case, of whether there is still an arm's length profit for the company concerned after that adjustment, given the functions performed, the assets used and the risks assumed. In some cases, the price and/or other conditions of other transactions with other group companies may also have to be adjusted if they have not been determined in accordance with the arm's length principle.

2.2 Aggregation of transactions (paragraphs 3.9 to 3.12)

Under the OECD Guidelines, arm's length compensation must in principle be determined on a transactional basis. Such a determination on a transactional basis can cause problems in practice. If an assessment per transaction is not really possible, for instance because there are a large number of similar transactions, the transactions can be assessed on an aggregated basis in order to determine the arm's length character. In that situation, the taxpayer is expected to substantiate that the transfer price taken into account with regard to the aggregated transactions as a whole complieswith the arm's length principle.

2.3 The use of a range (paragraphs 3.55 to 3.66)

[7] This adjustment can also be downward if a Dutch company receives a benefit solely on the basis of shareholder motives, i.e. for no consideration or for a (not arm's length) low consideration, and both the provider and the recipient of the benefit are aware of this.

In some cases an unequivocal transfer price cannot be determined. However, since the determination of transfer prices cannot be considered an exact science, the application of the transfer pricing method applied will often lead to a range of values within which the transfer price to be applied lies. The range is determined by the highest and the lowest value found. When applying an arm's length range, and after the range has been determined, several questions arise: which observations in the range can be used for comparison purposes and up to which observation can an adjustment be made?

In determining the range, a distinction must be made between situations in which the comparables consist of readily comparable figures and a situation where less accurate comparables are used. If the comparables consist of readily comparable figures, the range will be composed of all these figures. If less accurate comparables are used, it might be necessary to increase the reliability of the comparables by applying statistical methods. One example is the interquartile range approach. Such statistical methods narrow the range so that a relevant range remains consisting of more accurate comparables.

After the range has been determined, an assessment must be made to see whether the compensation for the transaction to be assessed is within this range. If the compensation lies within the range, no adjustment will be made. If the compensation is outside the range and the taxpayer cannot provide good reasons for this, an adjustment will be made. In my view, in such a case the adjustment should be made up to the point within the range that corresponds best with the facts and circumstances of the intra-group transaction in question. If it is plausible that one specific point within the range corresponds best with the conditions of the intra-group transaction, an adjustment can be made up to that point. If no such point can be identified because comparability defects still remain as referred to in paragraph 3.57 of the OECD Guidelines, the Dutch Tax and Customs Administration takes the view that an adjustment should be made up to the median (the middle observation in the range) (see paragraph 3.62 of the OECD Guidelines). It is possible that the other State involved does not accept the adjustment up to the median observation within the range. In such situations the competent authority of the Netherlands will, at the taxpayer's request, consult the other State in order to reach agreement on a point within the range that is acceptable to both States.

Sometimes there will be a shift within the range because the transfer price originally determined is adjusted downward or upward. In that situation the taxpayer must be able to substantiate the changed circumstances justifying an adjustment of the transfer price. Moreover, the condition for accepting such a shift within the range is that the changed pricing is actually laid down in the agreements concluded between the parties and is actually charged. If no changed circumstances can be identified that justify an adjustment of the transfer price, the change in the transfer price will generally be for tax reasons. In those situations the Tax and Customs Administration will not agree to the change in the transfer price.

2.4 Use of multiple year data (paragraphs 3.75 to 3.79)

When assessing a transaction, it can be useful to examine data covering multiple years. The use of multiple year data can prevent adjustments being applied in a certain year even though, when several years are considered, the group receives compensation that is in line with the arm's length principle. However, application of multiple year data can also lead to insights developed later being used to assess a situation that occurred previously (hindsight). The OECD Guidelines indicate that tax administrations are not allowed to apply such insights developed after the fact. That is why, when using multiple year data, only data from the year in question and previous years can be used. An example of this is working with a moving average. This leads to the following methodology:

- First it is assessed whether the compensation for the transaction to be assessed lies within the arm's length range determined for the year in question. If the compensation lies within the annual range, no adjustment is applied.
- If the compensation lies outside the annual range, the assessment is repeated on the basis of moving averages over a number of years. The length of the period will partly depend on the length of the product's life cycle. If the average compensation for the transaction being assessed falls within the multiple year range, no adjustment is applied.
- If the compensation lies outside both the arm's length annual range and the arm's length multiple year range, an adjustment is applied in accordance with section 2.3.

2.5 The effect of government policy (paragraphs 1.132 to 1.136)

Some government interventions can be regarded as market factors in the country concerned and must be taken into account as such in the transfer price. Paragraph 1.136 of the OECD Guidelines describes two possible approaches to a situation where, for instance, a country prevents or blocks the payment of an amount of money. Under Dutch tax law, the compensation related to the deliverable must be recognised in the result, but it may be in accordance with good business practice to write down (at least in part) a receivable that has arisen in connection with the provision of deliverables. In this respect, the costs associated with the transaction can be taken into account. When the receivable arises, an assessment must obviously be made to see whether any circumstances can be identified that ought to lead to the conclusion that the situation does not involve a receivable but the provision of capital (see for instance the Supreme Court judgment of 27 January 1988, no. 23.919) or that it involves a non-arm's length loan, which would mean that a write-down cannot be charged to the result (see for instance the Supreme Court judgment of 25 November 2011, 08/05323). In addition, the taxpayer must of course be able to make a plausible case for a write-down.

2.6 Requests for a reduction in a transfer price adjustment (paragraphs 3.13 to 3.17)

In the event of a tax audit by the Tax and Customs Administration, the taxpayer can submit a request to reduce a proposed adjustment of a transfer price if it is of the opinion that the Administration's proposal does not take account of offsetting transactions. Under the OECD Guidelines, tax administrations have a discretionary power as to whether or not to grant such requests. The distinction in the OECD Guidelines between making a plausible case for a particular set-off when submitting a tax return and making a plausible case for an alleged set-off at the moment that adjustments are proposed following a tax audit is not relevant to Dutch practices. In both cases the taxpayer retains its statutory right to lodge an objection and apply for judicial review.

3. Transfer pricing methods (chapter II)

3.1 Introduction

Chapter II of the OECD Guidelines sets out the three traditional transaction methods (comparable uncontrolled price method, resale price method and cost plus method) and the transactional profit methods (the profit split method and the transactional net margin method, or TNMM). Depending on the circumstances, one of these five acceptable methods should be opted for.[8]

The Dutch Tax and Customs Administration will always start its transfer pricing investigation from the perspective of the method used by the taxpayer at the time of the transaction. The taxpayer is in principle free to choose a transfer pricing method, provided that the chosen method leads to an arm's length result for the specific transaction. In certain situations, however, one method will lead to better outcomes than another. Although the taxpayer is expected to take into account the reliability of the method for the situation in question when choosing a transfer pricing method, it is explicitly not the intention for the taxpayer to assess all methods and then justify why the method it has chosen in the given circumstances leads to the best outcome (the best method rule). In some situations, a combination of methods can also be used. A taxpayer is not obliged to use multiple methods, but will have to make a plausible case for its choice.

In general, it can be noted that the comparable uncontrolled price method is difficult to apply in practice because comparable uncontrolled transactions are almost impossible to find. This is one of the reasons why, in practice, the TNMM is often used as the transfer pricing method.

If a transfer pricing method (such as the TNMM) is chosen where the results of the transactions of one of the associated parties are compared with the results of comparable transactions of independent parties, the basic principle is that this comparison is made with the party with the least complex functions (the 'tested party'; see also paragraph 3.18 of the OECD Guidelines). In general, this will not be the party which, in view of its functions, assets and risks, is entitled to the proceeds with a strong relationship to the intangible fixed assets in use.

3.2 Points to consider when applying cost-related transfer pricing methods

In the case of the cost plus method and the TNMM (with costs as a profit level indicator), the determination of the cost base is an essential part of applying the method.

Budgeting versus actual costs

In general, prices will be determined in advance on the basis of the budgeted costs. If the actual expenses associated with the transactions are higher than these budgeted costs, it depends on the cause whether this difference will lead to a price adjustment. In general, it can be assumed that higher expenditure due to inefficiency will be borne by the contracting party performing the services. After all, this is the contracting party that can influence these expenses. An independent party will not accept a price adjustment in this situation.

A condition for correct determination of the transfer prices on the basis of budgets is that these budgets are set in the commercially correct way.

Cost base and disbursements

Paragraph 2.98 of the OECD Guidelines shows that a transfer pricing method that bases the transaction-related profit on the costs is only appropriate if these costs are the relevant indicator of the value of the functions performed, assets used and risks assumed. In such a situation, this means that the costs that do not constitute a relevant indicator for this value should not form part of the cost base for calculating the profit.

[8] See paragraph 2.9 of the OECD Guidelines for the possibility of departing from these methods.

Although paragraph 2.99 of the OECD Guidelines states that when TNMM is used and the profit is related to the costs incurred, the full costs are often included in the base, the possibility is left open to keep part of the costs outside the base if an independent party would be prepared not to make a profit in relation to such costs in a similar transaction. To illustrate the above, I would refer to paragraph 7.34 of the OECD Guidelines where it is concluded that an (associated) agent that purchases services from a third party is only entitled to a mark-up on the costs of its own functions, assets and risks, and not on the costs of the services provided by third parties. These costs with a 'disbursement' character will remain outside the cost base on which a profit mark-up is calculated. Well-known examples of disbursements are costs that are initially paid by the contracting party but generally tend to be charged separately to the client, such as legal fees, court fees and costs of providing services.

The costs of raw materials that are processed by a producer without this party – given its functionality – being exposed to risks in relation to the raw materials as such can in general also be left out of the cost base, because in principle only the operational costs of this producer are the relevant indicator for the value of the functions it performs, the assets used and the risks assumed.[9] In such cases, this producer performs no relevant function with respect to the purchase of the raw materials and does not run any risks with regard to them.

Cost-related remuneration for sales of goods through an intermediary

In practice, a party that is part of a group may sell goods through an associated Dutch intermediary that does not itself carry out relevant sales activities but mainly provides administrative services for the sales transaction. The sales realised in such cases are sometimes recognised in the annual accounts (profit and loss account) of the intermediary.

Paragraph 2.39 of the OECD Guidelines stipulates that an associated intermediary of this kind, which does not perform any economic function in the value chain that increases the value of the goods, or which bears no risks in relation to the sales activities on the basis of the characterisation of the transaction, should not obtain a share in the profit related to these sales transactions, because it would not have been granted this in the case of independent parties.

Such an intermediary will in principle have to be rewarded with a profit mark-up based on its own relevant operational costs, including the costs related to its administrative services, and not through a turnover-related remuneration.

3.4 Valuation methods

Section D.2.6.3 of chapter VI of the OECD Guidelines states that valuation methods, and in particular the discounted cash flow method, depending on the facts and circumstances, may be used by taxpayers and the Tax and Customs Administration as part of the five transfer pricing methods described in chapter II of the OECD Guidelines, or as a valuation method that can be used to determine an arm's length price when using or transferring an intangible asset. Sections D.2.6.3 and D.2.6.4 of chapter VI of the OECD Guidelines provide guidance on the use of valuation methods and the interpretation of the various parameters.

It is important that paragraph 6.157 of the OECD Guidelines emphasises that the valuations must take place from the perspective of all parties involved in the transaction in order to arrive at an arm's length price. The arm's length price will then be between the value of the intangible asset from the seller's

[9] Such a manufacturer is usually referred to as a toll manufacturer.

perspective and the value from the buyer's perspective (unless the value from the seller's perspective is higher than the value from the buyer's perspective). The value resulting from the application of a valuation method is therefore not the same as the arm's length price for the transaction. I would like to emphasise that when determining the arm's length price, the tax consequences of the transfer must be taken into account. In the event of an asset transaction, the seller must take account of the possible taxability of the book profit resulting from the transfer of the (intangible) asset. The seller will want to be compensated for this. In the event of an asset transaction, the buyer must take account of the consequences of possible tax benefits from the amortisation of the (intangible) asset acquired. I would refer in this context to paragraph 6.178 of the OECD Guidelines and example 29 in chapter VI of the OECD Guidelines.

A transaction where the value from the seller's perspective is higher than the value from the buyer's perspective will not take place between independent parties acting in a commercially rational manner. After all, both parties have a better alternative, namely not entering into the transaction. In such cases, I consider section D.2 of chapter I of the OECD Guidelines to be applicable.

Paragraphs 6.170 to 6.173 of the OECD Guidelines look at the discount factor for determining the present value of the expected future cash flow. With regard to the choice of the correct discount factor, based for example on the weighted average cost of capital (WACC), the risk profile of the parties involved, the asset to be valued and the activity to be valued must be taken into account.

4. Secondary adjustments (paragraphs 4.68 to 4.78)

Paragraphs 4.68 to 4.78 of the OECD Guidelines deal with the consequences of secondary transactions. In many countries the application of a transfer price adjustment is not restricted to an adjustment of the profit; another requirement is that, by creating a secondary transaction, the accounts must show how the adjustment has been recognised in the profit and loss account and the balance sheet of the taxpayer. A secondary transaction can for instance be a set-off in the current account, a distribution of profit or an informal capital payment. From the Dutch point of view, a secondary transaction is always necessary for recognition of the transfer pricing adjustment. A secondary adjustment can arise from a secondary transaction, for instance taking into account interest on the debt receivable or a subsequent dividend tax assessment on a profit distribution. Not all countries apply the same system. This may lead to a situation where the other State involved is not prepared to set off for instance the dividend tax levied as a secondary adjustment because the fictitious dividend payment is not acknowledged. If the taxpayer makes a plausible case that – considering the difference in tax systems between the respective States – the dividend tax cannot be set off and there is no abuse aimed at avoiding dividend tax, the secondary adjustment is omitted.

5. Tangible / intangible fixed assets

5.1 Transactions concerning tangible / intangible fixed assets

If tangible/intangible fixed assets are transferred to a group company that does not add value to the relevant assets because it lacks the required functionality and is therefore unable to control the risks relating to the asset, the transaction will not satisfy the arm's length principle.

After all, based on the arm's length principle, associated parties are expected to strive for profit maximisation. Independent parties will normally enter into a transaction relating to a tangible/intangible fixed asset only if they can both expect an increase in their own profit. This expectation is only a realistic possibility for the seller and buyer if it involves an increase in the joint profits of the buyer and seller compared to the joint profits of both without the transaction. The expected profit increase can only occur if the buyer adds value in some way. This is only possible if the buyer possesses the relevant functionality and is therefore able to control the relevant risks. If there is no expected increase in the joint profit, the bid price of a potential buyer will be lower than the price asked by a potential seller. In that case, transfer of the asset is not commercially rational and will not take place, partly because the transfer also entails transaction costs. Such a transaction between associated parties does not satisfy the arm's length principle.

In addition, in the arm's length assessment, attention must also be paid from the perspective of both the seller and the buyer to whether the seller and/or the buyer have other realistically available options that are more attractive to them. In the situation described above, it is a realistically available and more attractive option for both the seller and the buyer not to enter into the transaction. The total operating profit that the parties would achieve jointly is not higher than if the transfer had not taken place. Because the transfer would be accompanied by extra costs (for example, the drafting of contracts), the joint operational result is expected to be even lower than if no transfer had taken place.

Sometimes the buyer of a tangible/intangible fixed asset is established in a low-tax jurisdiction. The mere fact that the buyer is established in a low-tax jurisdiction does not lead to an increase in the joint profit if the buyer does not have the relevant functionality in relation to the asset in question. The buyer will become entirely dependent on the seller for the future value development and the exploitation of the asset if the functionality in relation to it remains with the seller after the transfer. Under arm's length conditions, the buyer cannot then expect an operating profit. As a result, under arm's length conditions, it cannot benefit from the lower tax rate.

On the basis of the arm's length principle, the disadvantage of using conditions that deviate from conditions that would have been agreed by independent parties, should be eliminated from the taxable profit of the Dutch seller. This disadvantage is the difference in profit compared with a situation where the transfer did not take place.

For an illustrative example, I would refer in this connection to example 1 in paragraph 1.125 and the example in paragraphs 9.122 to 9.124 of the OECD Guidelines.

In some situations, the legal ownership of tangible/intangible fixed assets is held by group companies without a preceding transfer by another group company. If the legal owner also lacks the relevant functionality in these situations, the treatment by the Tax and Customs Authority will take place in accordance with the principles outlined in this section. This means that only a relatively limited remuneration can be attributed to the legal owner of the tangible/intangible fixed asset if it does not perform the relevant functions in respect of the asset.

The OECD Guidelines often refer to the DEMPE functions in describing relevant functions regarding intangible fixed assets. These functions relate to Development, Enhancement, Maintenance, Protection and Exploitation. Depending on the facts and circumstances, an assessment must be carried out of the relative importance of the various DEMPE functions. In general, the Development and Enhancement functions will be given more weight in the assessment of the relative contribution to the value of the intangible asset in question.

5.2 Determination of the arm's length price when the valuation at the time of the transaction is highly uncertain (paragraphs 6.181 to 6.185)

When transferring intangible assets, it can be difficult to determine the value at the time of the transfer, because insufficient insight exists into the future benefits and risks. Paragraph 6.185 of the OECD Guidelines notes that if independent firms would have agreed a price adjustment clause in similar circumstances, a tax administration should be permitted to determine the pricing on the basis of such a clause.[10] This refers to an arrangement in which the compensation is in line with the benefits that the intangible asset generates in the future. Agreeing a benefit-dependent payment helps to ensure that taxation is more in line with the benefits actually achieved. The Dutch Tax and Customs Administration will also take the position that it is not at arm's length to agree on a fixed price if the valuation at the time of the transaction is highly uncertain and independent parties acting in a commercially rational manner would not have agreed on a fixed price in a similar situation. In such cases, for example, an adjustment clause should be included in the agreement between the associated parties where the price is partly dependent on the future income. An example is a situation where a new intangible asset has been developed that is transferred to an associated company at a time when its success is still insufficiently visible, for example because the intangible asset has not yet generated any revenue and the estimation of its future revenues is linked to major uncertainties. In this situation, the valuation at the time of the transaction is highly uncertain and the inclusion of a price adjustment clause is reasonable.[11] It should be noted that a price adjustment clause may lead to both an upward and a downward adjustment of the price originally agreed.

5.3 Hard-to-value intangibles (paragraphs 6.186 to 6.195)

In the case of the transfer or licensing of intangible assets as described in paragraph 6.189 of the OECD Guidelines, where it is difficult for the Tax and Customs Administration to assess the value in relation to the present transactions due to major uncertainties regarding future value development, the Tax and Customs Administration can use the results actually achieved with the relevant intangible assets when assessing the arm's length nature of the price at the time the transaction occurred. If it turns out that there are major discrepancies between the results achieved and the expectations and resulting forecasts that formed the basis for the price determination at the time of the transaction and that these discrepancies cannot be explained on the basis of facts and circumstances occurring after the date of the price determination, the Tax and Customs Administration can still question the price determined at the time of the transaction with a reference to the results actually achieved. I believe that a major discrepancy is a difference of over 20% compared with the projections that formed the basis for the price originally set. If such a discrepancy occurs only after a period of five years after revenues were realised for the first time with the intangible asset in transactions with independent parties, the intangible assets will not be regarded as 'hard-to-value intangible assets' (in accordance with paragraphs 6.186 to 6.195 of the OECD Guidelines).

5.4 The purchase of shares in an independent company followed by a business restructuring

In practice, it often happens that an MNE buys shares of an independent company, after which the intangible assets present in it are transferred to another group company. This can lead to discussions between taxpayers and the

[10] Paragraph 6.185 of the OECD Guidelines also leaves open the possibility of renegotiation if independent parties would also have renegotiated in the case of anomalous values.
[11] See also the Supreme Court judgment of 17 August 1998, no. 32.997.

Tax and Customs Administration about the arm's length price to be determined for the transfer of the intangible assets. Prior to this, it is important to determine whether, in addition to the legal ownership of the intangible assets, the associated functionality and the related risks are also transferred. In such cases, the other sections of this Decree (including sections 5.2 and 5.3) also apply in full.

In paragraph 6.147 and example 23 in the Annex to chapter VI of the OECD Guidelines, it is stated that the arm's length price for the shares of the purchased company contains useful information for the valuation of this company. I am therefore of the opinion that the acquisition file (with the exception of those elements that taxpayers can show to be irrelevant for tax purposes), which is usually held by the buyer of the shares, is an essential part of the transfer pricing documentation to be provided by the taxpayer in support of the price of the intangible fixed assets transferred.

In addition, when determining the arm's length price for the transfer of the intangible assets, chapters VI and IX of the OECD Guidelines in any event play a role and attention should be paid to the allocation of the expected synergy benefits, the tax interpretation of the control premium, the valuation of the routine function that remains behind (taking into account the assets used and risks incurred) and the effects of taxes.

Although the price of the purchased shares is at arm's length because the seller is an independent party, this does not imply that the value of the shares for the buyer is equal to this price. On the contrary, the buyer will generally only make a purchase if it expects to create more value with the acquired company than the price it has to pay for it. The value that the buyer of the shares, when determining their value, has attributed to the intangible assets in the acquired company may well be a good indicator of the minimum price it would like to receive when transferring these assets.

In addition, in the case of a transfer of the intangible assets, the seller must take account of the fact that, in contrast to a transfer of shares, corporate income tax will have to be paid on any book profit in the event of a transfer of the assets. In general, the seller will, taking into account the corporate income tax payable, want to see at least a sales return equal to the value it attributes to the intangible assets plus the tax due on a possible book profit.

The Tax and Customs Administration is sometimes confronted with situations where the entrepreneurial functions and associated intangible assets of an acquired company are transferred to another group company and only a routine function is left behind. In such cases, the transfer price is sometimes determined by taxpayers by deducting the expected 'perpetual' cash flow of the routine function (discounted using a discount factor based on this routine function) from the discounted expected total cash flow of the acquired company if no transfer had taken place. When assessing a transfer price determined in this way, the Tax and Customs Administration will generally take the view, especially if only one (exclusively) controlled contract is left behind, that the expected cash flow of a routine function cannot be discounted as perpetual, because such functions can be replaced relatively easily in the market and, partly for that reason, contracts with such functions generally have a relatively short duration.

5.5 The determination of the remuneration for the use of intangible assets

In practice, the remuneration for the use of intangible assets by taxpayers is often determined using royalty percentages from various databases. The question, however, is whether this publicly available information is sufficiently detailed to conduct a comparability analysis in a responsible manner. The OECD Guidelines state in any event that a comparability analysis in the case of intangible assets will often show that no comparable uncontrolled transactions can be found. The Tax and Customs Administration will therefore critically assess the use of such databases.

In analyses in which the resale price method, the cost plus method or the TNMM is the most appropriate method, the party with the least complex functions, which does not use its own intangible assets, is chosen as the tested party. In such cases, an arm’s length price or an arm’s length profit for the tested party can be determined without having to determine the value of an intangible asset used in the transaction itself. Paragraph 6.141 of the OECD Guidelines stipulates that the one-sided methods mentioned above are themselves not reliable methods for directly determining the value of an intangible asset. In certain circumstances, however, these methods can result in a residual profit attributable to the intangible asset by first determining the remuneration for the tested party. This residual profit then forms the reward for the intangible asset used and the related functions performed. A condition, however, is that the residual profit must be allocated to the intangible asset and all other functions, risks and assets have been sufficiently remunerated.

Where appropriate, in the absence of comparable transactions between independent parties, it is therefore acceptable to determine the amount of the compensation to be paid by the tested party for the use of an intangible asset in this manner, provided the above-mentioned conditions are met.

6. Intra-group services (chapter VII)

6.1 Introduction

According to the OECD Guidelines, an intra-group service exists if an activity is carried out for the benefit of a group member which adds economic or commercial value and for which that group member would normally be willing to pay. This does not include activities that are carried out in the capacity of a shareholder.

In deciding what method to use to determine the transfer price, a choice can be made from one of the methods referred to in section 3.1 above. In practice, cost-related remuneration is often opted for. A functional analysis will have to be carried out to determine whether the remuneration for the intra-group services in question should be determined in this way. This approach will usually be applied only with regard to the more routine services.

In applying this approach, arm’s length remuneration can, in principle, only exist if a suitable profit mark-up was taken into account when determining the remuneration. Only in specific situations as also described in paragraph 7.37 of the OECD Guidelines might there be reasons to refrain from a profit mark-up.

With regard to on-charging of intra-group services, there is a clear preference for a direct-charge method. However, in practice an indirect-charge method is also widely used because the application of the direct-charge method leads to major practical problems. If such practical problems exist, the Tax and Customs Administration will follow the indirect-charge method chosen by the taxpayer. Here, too, the method must lead to a reliable result and the outcomes must be in accordance with the arm’s length principle. The relation between for instance turnover, the number of employees or personnel costs could be relevant as an allocation key. An allocation key where the payment to be charged depends on the profit is not very likely to lead to an outcome in accordance with the arm's length principle.

6.2 Intra-group services and shareholder activities (paragraphs 7.9 to 7.10)

Section 6.1 states that, according to the arm's length principle, an intra-group service exists if an activity is carried out for a group member which adds economic or commercial value to it and for which that group member would normally be willing to pay. This does not include activities which are carried out in the capacity of shareholder.

The activities mentioned in the list of shareholder activities set out below are deemed to have been carried out in the capacity of a shareholder and are therefore not considered as intra-group services in so far as they do not add any economic or commercial value for group members and if and in so far as that group member would not normally be willing to pay for it. The taxpayer should therefore not charge other group companies for that part of the activities. Under each category of activities several examples are mentioned of activities falling into that category.

List of shareholder activities

1. Activities associated with the legal structure of the company itself

1.1. Implementation of requirements from Book 2 of the Civil Code
   - organising, preparing and holding the shareholders' meeting
   - the activities involved in preparing and adopting the annual accounts and filing them with the Chamber of Commerce
   - the activities of the Supervisory Board in so far as they relate to the performance of its statutory supervisory duties
   - the activities of the Works Council

1.2 Implementation of the State Taxes Act (AWR) in so far as this relates to the tax obligations of the company itself
   - keeping accounts
   - compliance with the obligation to retain records
   - filing tax returns
   - compliance with the obligation to provide information.

2. Activities associated with placing/issuing/splitting shares in the company itself or comparable instruments on the capital markets and activities relating to applying for or retaining a (foreign) stock exchange listing of the company itself
   - compliance with the admission requirements of a stock exchange
   - the activities associated with a stock exchange listing, for instance the preparation of forms provided to the US Securities and Exchange Commission in connection with the listing, the provision (free of charge) of the annual accounts, annual report, etc.
   - the membership of the associations and other bodies representing the stock exchanges.

3. Activities associated with the introduction and enforcement of statutory rules regarding supervision of share transactions
   - the introduction and maintenance of a registration system pursuant to the Financial Supervision Act (WFT)
   - company personnel reporting share transactions under this legislation.

4. Activities associated with the introduction of and compliance with statutory rules and rules of conduct concerning corporate governance of the company itself or the group as a whole[12]

[12] The group as a whole consists of the company itself and its direct and indirect subsidiaries.

- introduction of corporate governance supervision prescribed by legislation, including inclusion of a section on this subject in the annual report
- an account or report on the environmental policy, the social policy and the corporate sustainability policy pursued or to be pursued.

5. Activities associated with reports to various interested parties regarding the company itself or the group as a whole
   - press conferences and other costs of communication with shareholders and other interested parties, such as financial analysts, in so far as the communication is associated with external reporting, financial performance and future expectations of the company itself or the group as a whole.

The above list is not exhaustive. This means that activities not included in this list must always be assessed individually to determine whether intra-group services or activities performed in the capacity of shareholder are involved.

When qualifying activities as intra-group services or shareholder activities, there may be 'mixed' activities. This refers to activities carried out by a department or other group of persons operating in the group which qualify partly as intra-group services and partly as shareholder activities. Examples of mixed activities are consolidation activities, activities relating to mergers and acquisitions (M&A), activities associated with the introduction of and compliance with statutory rules and rules of conduct concerning corporate governance and activities of the Board of Directors. In this connection the qualification of the activities as intra-group services or as shareholder activities can take place on the basis of any method leading to an outcome in accordance with the arm's length principle.

The following examples illustrate situations involving activities of a mixed nature.

Example A (consolidation activities)

A group operates a management information system incorporating the results of all group companies. This information is used for budget decisions, control and assessment of the group companies concerned and for the preparation of the quarterly, biannual and annual consolidation figures forming the basis for the annual accounts. As regards the establishment and maintenance of the management information system and the processing of information for controlling the group companies, these are intra-group services. As regards the ultimate preparation of the periodically consolidated figures of the holding company (or intermediate holding company), on the basis of the information obtained, these are activities which are carried out as a shareholder.

Example B (merger and acquisition activities)

A department at the European head office of the group deals with mergers and acquisitions. The group needs an extra production location in Europe and the department analyses which businesses in the various European countries are eligible for a potential takeover, which will be carried out by the European head office itself. The analysis by the mergers and acquisitions department is an activity carried out in the capacity of a shareholder and no compensation should therefore be demanded from the group companies for this activity.

Example C (merger and acquisition activities)

The mergers and acquisitions department in the example referred to above analyses which businesses on continent X (not in Europe) are eligible for a potential takeover in order to increase the market share on that continent. The analysis leads to a takeover of a business by the regional head office of continent X. An intra-group service is provided to the regional head office of continent X. An amount must be charged for this activity, which leads to arm's length remuneration.

Example D (merger and acquisition activities)

A department of the group that deals with mergers and acquisitions assists a business taken over with the legal implementation of the takeover (for instance removal of the shares from the stock exchange), with the adaptation to the group's system and corporate identity and with the formulation and implementation of the plan for the staff. Through this assistance, economic and/or commercial value is added to the group company taken over for which an independent third party would have been prepared to pay in comparable circumstances. An intra-group service is provided to the group company concerned. An amount must be charged for this activity, which leads to arm's length remuneration.

Certainty in advance

If desired, certainty can be obtained in advance from the tax inspector as to whether an activity qualifies either as an intra-group service for group companies or as an activity carried out as a shareholder. Such requests are considered as requests to which the Decree establishing the Transfer Pricing Coordination Group (no. 2018-4380) applies. In the event that the taxpayer wants certainty with regard to both the qualification of the activities and the arm's length nature of the transfer price, it can request an advance pricing agreement.[13]

6.3 Low value-adding services (paragraphs 7.43 to 7.65)

Section 6.1 of this Decree indicates that in principle there can only be arm's length remuneration for group services provided if an appropriate profit mark-up is taken into account when determining the cost-related remuneration. In practice, arm's length remuneration for group services is often determined in accordance with the TNMM. Low value-adding services deserve specific attention.[14]

The simplified method

Based on the results of the BEPS Project, the OECD Guidelines include sections focusing on a specific group of services: 'the low value-adding intra-group services'. These sections set out an optional simplified approach for taxpayers to determine the remuneration for these specific services, which I intend to include in implementation policy by means of this Decree. With the support of appropriate documentation, it is possible with a limited fixed profit mark-up of 5% on the relevant costs of these services and via an appropriate allocation key to recharge costs (including the profit mark-up) to the eligible group entities. This simplified approach goes hand-in-hand with a simplified and more limited benefit test from the perspective of the recipient of the services concerned; the advantage of certain categories of services needs to be demonstrated in a more general manner (see paragraphs 7.54 and 7.55 of the OECD Guidelines). These low value-adding services have the following characteristics (see also paragraph 7.45 of the OECD Guidelines):

- They are of a supportive nature.
- They are not part of the MNE's core business.
- They do not require the use of unique and valuable intangible assets

[13] See the Decreer on the procedure for handling requests for advance pricing agreements of 12 June 2014, no. DGB 2014/3098.
[14] In this context, I would also like to refer to the 'Guidelines on low value adding intra-group services' of the EU Joint Transfer Pricing Forum (Brussels, February 2010, JTPF/020/REV3/2009/EN), partly in relation to section 1.5 of this Order.

and do not lead to their creation.
- They have no relation to the significant risks as run within the company.

Paragraph 7.47 of the OECD Guidelines enumerates activities that cannot fall under the simplified approach. Paragraph 7.49 of the OECD Guidelines lists activities that are generally likely to fall under the simplified approach. The simplified approach does not apply to services that the service provider also provides to independent parties.

Where the Tax and Customs Administration, in the case of services provided by an associated party, performs the benefit test described in paragraph 7.6 of the OECD Guidelines to assess whether a service has actually been performed for which compensation is required, the Administration will, if and in so far as the fee charged relates to services that fall under the relevant simplified method chosen by the multinational company, assess in some other way whether compensation is appropriate. In that case, the conditions set out in the OECD Guidelines must however be met; in this regard, I would refer to the appropriate documentation and the appropriate method of calculating the amounts charged. The benefit of the services concerned for the recipient of the services will only need to be substantiated in a general manner and need not be traced back to individual transactions. In this way, a pragmatic approach is advocated.

When developing the appropriate calculation method, the determination of the relevant costs to be allocated (see paragraphs 7.56 to 7.58 of the OECD Guidelines) and the substantiation of the allocation key to be chosen (paragraphs 7.59 to 7.60 of the OECD Guidelines) are important. The fixed profit mark-up does not need to be substantiated by a comparability study.[15] Paragraph 7.64 of the OECD Guidelines focuses on the content of the required documentation.

In view of the nature of the services described here ('the low value-adding intra-group services'), I assume that recharging the relevant costs with a limited fixed profit mark-up of 5% via an appropriate allocation key will lead to an arm's length outcome.

Relevant costs

The cost base includes the direct costs and indirect costs associated with the relevant support services as well as the overhead costs. The relevant costs also include special expenses (such as redundancy costs, reorganisation costs and wages in kind). Which costs are relevant follows from the functional analysis that underlies the taxpayer's transfer pricing system.

Separate legal entity

The above applies irrespective of which legal entity within the group performs the support services. This means that no correction will be imposed both if all relevant costs are charged for support services that are performed in an entity within which other activities are also performed, and if the support services are performed by a separate legal entity (in that case a shared service centre, for example, may be involved).

The above is illustrated by the following examples.

Examples

[15] A comparability study is a study of the pricing of uncontrolled comparable transactions.

Example E

A group is active in the provision of legal services to third parties. An employee of one of the group companies provides advice on local legal matters to a foreign group company involved in advising a client on an international transaction. The simplified approach cannot be applied to this activity because it involves activities that are part of the group's core business. Moreover, the services concerned are also provided to independent parties on a more than incidental basis.

Example F

A legal department of a bank is intensively involved in the development of a bank product that another group company wants to offer. The activity of the legal department is an activity that adds more than marginal value to the group's core business. The simplified approach cannot be applied to this activity.

Example G

A helpdesk department only deals with questions from employees of various group companies about the computer system, the software used and solving minor user problems. Based on the nature of the activities, the relative scale of the activities within the group and the added value of the activities, the taxpayer demonstrates convincingly that the activities do not involve one of the group's core business processes and do not add more than marginal value to the core business. In this case, it is sufficient to recharge all relevant actual costs with a profit mark-up of 5% (application of the simplified approach).

Example H

A group operates an international chain of hotels. A department engages in the construction and maintenance of a computer application within the group, which automates the booking system, the invoicing and the inventory system. The department's activities probably do not belong to the group's core business but in any event add more than marginal value to the group's core business. The simplified approach cannot be applied to this activity.

Example I

A company is engaged in the production of semi-finished products under the direction and for the risk of another group company ('contract manufacturer'). Such production activities are generally part of the group's core business. In addition, these activities, together with similar or related activities (such as the production activities of the client), generally constitute a relevant part of the group's total activities in absolute or relative terms. The fact that the added value of this activity may be marginal is therefore not sufficient to characterise the activity as a support activity. The simplified approach cannot be applied to this activity.

Approval policy

If a taxpayer does not opt for the optional simplified determination of the remuneration for these specific services in accordance with paragraphs 7.43 to 7.65 of the OECD Guidelines, no correction will be made on the basis of a cost/benefit analysis in accordance with paragraph 7.37 of the OECD Guidelines if the taxpayer chooses to charge all relevant actual costs for the services with limited added value as described in paragraphs 7.43 to 7.65 of the OECD Guidelines. The comments I made above about the optional simplified determination of the remuneration for these specific services with regard to the relevant costs and the separate legal entity are fully applicable to this approval policy. Compared with the optional simplified method as described in the OECD Guidelines, however, the financing costs must also be included in the costs when only recharging the relevant actual costs without a profit mark-up.

6.4 Contract research

In certain situations where group company A (executor) concludes an agreement with group company B (principal) and contractually develops intangible fixed assets for the account and risk of group company B (contract research), a cost-related remuneration may be deemed to be arm's length. For the transfer price analysis, the transaction must be characterised in accordance with section 2.1. of this Decree.

Cost-related remuneration is possible if contract research activities are carried out by group company A and group company B manages the research activities, bears the costs and risks and becomes the economic owner of the assets developed. Group company B must also exercise control over the risks involved and have the financial capacity to be able to bear the consequences of the risks involved (see also section 2.1 of this Decree for these terms).

In the analysis, each case must in any event be assessed on the basis of the specific facts and circumstances. The following elements play a role in deciding who manages the research activities and also exercises control over the associated risks: decision-making, planning, budgeting, measuring performance, remuneration, adjusting/redefining areas of activity, determining the commercially valuable areas and assessing the likelihood of research being successful or unsuccessful.

This is illustrated by the following examples.

Examples

Example J

A group is headquartered in country X. The group engages in the production and sale of consumer products. In order to maintain its market position and improve it where possible, ongoing research is carried out into the possible improvement of existing products and the development of new products. To this end, the group has two R&D centres that are housed in a separate company, established in country X (R&D X, as part of the head office) and in the Netherlands (R&D NL) respectively. The research programmes for the group as a whole are drawn up by R&D X after the strategic decision-making by the group management. Based on separate contracts, R&D NL is then used to carry out part of this research programme. R&D NL must submit to R&D X the detailed project plans drawn up to implement the part of the research programme assigned to it. R&D X approves these project plans and the related budgets. Even if R&D NL has suggestions regarding the adjustment of the research programme and/or the project plans already submitted, these suggestions must be explicitly submitted to R&D X. R&D NL regularly reports to R&D X on the progress of the research and the depletion of the budgets. If the budgets are exceeded, R&D NL must request additional financial resources from R&D X. Not all research activities lead to success. The contractual conditions between R&D X and R&D NL stipulate that all risks associated with the activities developed by R&D NL are borne by R&D X. R&D X becomes the owner of all legal and economic rights arising from the research. R&D X has sufficient equity to bear the financial risks associated with the research. R&D X pays R&D NL a cost-related fee calculated on the basis of the cost plus method or the TNMM.

Conclusion: The functions of R&D NL are limited to the execution of the R&D

activities. These are carried out on behalf of and under the supervision of R&D X (including control and decision-making). The risks associated with the R&D activities are borne by R&D X. R&D X is able, both financially and in terms of expertise, to bear the risks for which it is responsible and to exercise control over them. The activities of R&D NL are rightly deemed to be contract research. Applying a cost-related remuneration is appropriate in this case.

Example K

A group is headquartered in country X. The group engages in the production and sale of consumer products. In order to maintain its market position and improve it where possible, ongoing research is carried out into the possible improvement of existing products and the development of new products. The R&D activities concerning product line A are carried out in the Netherlands and are assigned to a Dutch company (R&D NL). Sales activities and the role of European head office are also assigned to this Dutch company. R&D NL operates completely independently, within the framework of strategic decision-making by the group management.

Company Y also forms part of the group. Company Y is located in country Y. Company Y employs two people, both having an administrative and financial background.

R&D NL and company Y have entered into an agreement for an indefinite period with regard to R&D NL's R&D activities. Not all of these research activities lead to success. The contractual conditions between company Y and R&D NL stipulate that all risks associated with the activities developed by R&D NL are borne by company Y. Company Y becomes the owner of all legal and economic rights arising from the research. Company Y has sufficient equity to bear the financial risks associated with the research. Company Y pays R&D NL a fee calculated on the basis of the costs incurred by R&D NL with a profit mark-up.

Conclusion: The functions of R&D NL encompass the entire R&D activity (from deciding what research to carry out, to its implementation). R&D NL therefore independently manages the R&D activities. The contractual conditions stipulate that the risks associated with this R&D activity are borne by company Y. However, Company Y does not have the necessary expertise to exercise control over the risk it faces. In reality, this control is exercised by R&D NL, so that the risk should also be attributed to R&D NL. On the basis of the actual situation, no contract research activity is therefore carried out by R&D NL, with the result that the calculation of remuneration on the basis of the costs incurred with a profit mark-up for R&D NL does not result in arm's length remuneration in this situation.

7. Contributions to a cost contribution arrangement (CCA) (chapter VIII)

For CCAs, the arm's length principle elaborated in the OECD Guidelines should be followed, especially chapter VIII. On the basis of the arm's length principle, the remuneration should be related to the functions performed (taking into account the risks involved and assets used). This means that the remuneration of the participants in a CCA should not fundamentally differ from the remuneration that the companies in question would receive if they were to work together outside a CCA. The basic principles set out in the other chapters of the OECD Guidelines (in particular chapters I and VI) apply in full to the question of whether the CCAs comply with the arm's length principle. This means, for example, that a participant in a CCA who assumes risks also has to exercise control over these risks and must have the financial capacity to bear the downside effects of them. For example, a participant in a CCA who provides only the financing of the CCA and exercises control only over risks related to that financing and therefore not over the risks regarding the other activities within the CCA is generally only entitled to arm's length compensation for financing, taking into account the financing risk (risk-adjusted rate of return).

Chapter VIII of the OECD Guidelines stipulates that the relative share of each participant in the contributions to the CCA should correspond to that participant's relative share in the total expected benefits. In practice, whether this is the case must be assessed on a case-by-case basis. The arm's length principle implies that both the relative share of each participant in the contributions to the CCA and that participant's relative share in the total expected benefits are determined on the basis of the open market value. If, however, it is plausible that the average relative value added of the individual contributions that the various participants make to the CCA is approximately the same, it is in accordance with the arm's length principle, when determining whether everyone's share of the total expected benefits corresponds to their share in the contributions, to take the cost price of the contributions as the starting point. In this respect, reference is made to example P below. If stakeholders opt for a distribution of the expected benefits on the basis of the cost price of the contribution, supporting evidence will be required that plausibly demonstrates the equivalence of the average relative added value of the participants' contributions.

Some countries do not accept the charging of a profit mark-up, while they do accept charging a fee for the assets involved in the activities. Both methods can lead to the same outcome. The choice of a particular method in some countries can, with a view to the acceptability of the amounts charged, be followed for Dutch tax purposes, provided the result is in accordance with the OECD Guidelines.

Some examples of CCAs relating to R&D activities are given below to illustrate the above-mentioned principles.[16]

Examples

Example L

Group company A and group company B act as the head office of continent A and the head office of continent B respectively. Both are engaged in the production and sale of group products. Both have an R&D centre. The group decides to research the development of a new product. The market prospects for the product are good but major research has to be carried out before the product is ready for production and sale. The product has market potential on continents A and B.

Group companies A and B decide to conclude a cost contribution arrangement for carrying out the required research. A provides the research capacity and the initial development results and B provides knowledge, know-how and researchers. A and B agree several dates when group companies A and B will jointly decide on the next phase of the project. The ratio between the open market value of A's contribution and that of B is 1:1. The total expected value of the development result of the product is equally large on continents A and B. A and B agree that each of the participants will bear the costs of their own contribution. In addition, it is agreed that group company A will become the legal and economic owner of the development result as far as continent A is concerned and that group company B will become the legal and economic

[16] In the examples, for the sake of simplicity, no account is taken of a difference in the timing of the contribution made by each of the parties. In commercial relationships, such differences would be taken into account when determining the value of the contribution, in so far as they are relevant to the value of the contribution, so that this should be taken into consideration in practice when determining arm's length remuneration in a situation where a CCA is agreed between associated parties.

owner of the development result as far as continent B is concerned. Strategic project planning and management (including oversight and decision-making on the project) take place on an equal basis.

Conclusion: The cost contribution arrangement leads to an arm's length result. Both A and B can be considered as participants in the CCA, because in return for their contributions both participants acquire part of the right being developed and can also operate/use it independently. Finally, both participants' relative share of the contributions corresponds to their relative share of the total benefits expected (i.e. the right that the participants acquire).

Example M

Group company A is engaged in the development, production and sale of consumer products on continent A. Group company A has carried out initial research into the feasibility of developing a new product. The conclusion is that the product can probably be developed successfully. The market prospects for the product are good. The product is also very suitable for the market on continents B and C. Group companies B and C are engaged in the development, production and sale of similar products for the markets on continents B and C. Group companies A, B and C decide to conclude a cost contribution arrangement for the research necessary to develop the new product. In order to ensure successful development, the following arrangements are made:

- Equal contribution by all: formulation of a research programme and the decisions to be taken for each progress phase of the project identified in the research programme (strategic project planning and management, including oversight and decision-making, for the project).
- Contribution by A: results of the initial research. Costs incurred for development: €1 million. Open market value of the research result: €2 million.
- Contribution by B: development capacity (personnel + fixed assets). The expected costs associated with this development capacity are €1.8 million. If this development capacity had to be hired on a contract research basis from third parties, €2 million would have to be paid for this (= open market value).
- Contribution by C: liquid assets amounting to €2 million for the expected additional costs (procurement of materials from third parties and hiring of third parties).

The participants agree that each of the participants will bear the costs of their own contribution. The total expected value of the development result on continents A, B and C is expected to be the same, so that the value of the right to be developed is expected to be the same for all the continents. The group companies agree that group companies A, B and C will become the legal and economic owners of the development result for continents A, B and C respectively.

Conclusion: The cost contribution arrangement leads to an arm's length result. A, B and C can be considered as participants in the CCA because in return for their contribution the participants obtain part of the right being developed and can also operate/use it independently. Finally, the participants' relative share of the contributions corresponds to their share of the total benefits expected (i.e. the right that the participants acquire).

Example N

Group company A, group company B and group company C are engaged in the production and sale of similar consumer products on continent A, continent B and continent C respectively. Group company A has an R&D centre. Group companies B and C employ several product experts who also have knowledge of product development, but they do not have their own R&D centre. Group company A carried out initial research into the development of a new product. The market prospects for the product are good for continents B and C, but major research needs to be carried out before the product is ready for production and sale. The expected total value of the development result on continents B and C is expected to be the same. The product does not appear to be interesting for continent A.

Group companies A, B and C decide to conclude a cost contribution arrangement with the following conditions:

- B and C jointly set up a research programme, with equal contributions, for the further development of the product. In addition, they provide equal capacity to manage the project (strategic project planning and management, including oversight and decision-making).
- Contribution by A: results of the initial research. Costs incurred for development: €1 million. Open market value of the research result: €2 million.
- Contribution by A: development capacity (personnel + fixed assets): A's R&D department elaborates on the project plan and submits the details to B and C. A's R&D department then undertakes the implementation of the research, and regularly reports to B and C on the course of events. The expected costs associated with this development capacity are €1.8 million. The open market value of the development capacity, if work is carried out under contract, is €2 million.
- Contribution by B and C: they each pay A €2 million as compensation for A's contribution. In addition, each bears half of the additional costs paid to third parties (procurement of materials, hiring of third parties) amounting to €2 million.
- The participants each bear the costs of their own contribution.
- B and C acquire the legal and economic ownership of the development result for continent B and continent C respectively.

Conclusion: A is not a participant in the cost contribution arrangement because it cannot derive any benefit from the development result. A actually sells the initial development result to B and C in combination with the performance of contract research activities for B and C. However, B and C can both be regarded as participants in the CCA because in return for their contribution (money and management) they acquire part of the right being developed and can also operate/use it independently. A provides development capacity and the initial development result with a total open market value of €4 million and it receives €4 million in compensation. Such compensation is arm's length. The contribution of both participants in the CCA (B and C) and the benefit to be expected (the right that they acquire) are equal. Although the contract can therefore not be considered as a CCA for A, the remuneration arising from the contract can be deemed to be arm's length for all participants.

Example O

Group company A is engaged in the development, production and sale of consumer products. Group company B employs a limited number of persons with a financial and administrative background. Group company A carried out initial research into the development of a new product. The market prospects for the product are good for continent A and continent B, but additional research needs to be carried out before the product is ready for production and sale. The expected total value of the development result for continents A and B is expected to be the same. Group companies A and B decide to conclude a cost contribution arrangement with the following conditions:

- Contribution by A: initial development results and development capacity. The total costs in this respect are €5 million. The total open market value is €10 million.
- B pays A €5 million and 50% of the costs in so far as they exceed the

projected costs of €5 million.

- A and B become the economic owners of the development result in so far as it relates to continent A and continent B respectively.
- A becomes the legal owner.

In addition to the contract, A undertakes the overall management of the project (including oversight and decision-making).

Conclusion: The functions of A encompass the entire R&D activity (from deciding what research is carried out to implementation). A directs the R&D activity independently. The contractual conditions stipulate that 50% of the risks associated with this R&D activity will be borne by B (B pays €5 million and 50% of the costs in so far as they exceed the projected costs, and becomes the economic owner of the developed right). However, B is unable to exercise control over the relevant risks in relation to the R&D activity in view of the functions it performs. In reality, control over the entire risk is exercised by A, so that the entire risk must also be allocated to A. In addition, A has the financial capacity to bear these risks. The remuneration that A receives must be in line with the functions performed by A and the associated risks.

On the basis of the agreement between A and B, however, B shares the positive and negative consequences of the risk controlled by A with A. The conditions of the contract concluded between A and B are therefore not arm's length. The function of B is limited to financing A's R&D activity and exercising control over the associated risks. The remuneration of B, which exercises no control over any specific risk relating to the R&D activity, should only consist of arm's length compensation for financing A's R&D activities, taking into account the financing risk (see paragraph 6.61 of the OECD Guidelines, which refers to a risk-adjusted return).

In this example too, the amount of remuneration received by the participants in a CCA should not differ fundamentally from the remuneration they would receive if they were to work together outside a CCA.

In addition, I would like to point out that if and in so far as B provides financing to A and does not exercise any control over the risks relating to this financing, B can at most be entitled to a risk-free return (see paragraph 1.103 of the OECD Guidelines).

<u>Example P</u>

Group company A and group company B are engaged in the development, production and sale of similar consumer products on continent A and continent B respectively. A and B decide to jointly develop a new product. Their development departments are comparable, i.e. the quality level (know-how and experience) and the cost structure are similar. The costs associated with the contributions during the entire development process have a ratio of 1:1. The expected values of the development result on continent A and continent B also have a ratio of 1:1. A and B decide to enter into a cost contribution arrangement with the following conditions:

- A and B jointly set up a research programme, with equal contributions, for the further development of the product. In addition, they provide equal capacity to manage the project (strategic project planning and management, including oversight and decision-making).
- The participants each bear the costs of their own contribution.
- A and B acquire the legal and economic ownership of the development result for continent A and continent B respectively.

Conclusion: A and B can be regarded as participants in the CCA because in return for their contribution they obtain part of the right being developed and can also operate/use it independently. Furthermore, the participants have plausibly demonstrated that the average relative added value of their contributions is comparable. In determining the ratio between each party's share in the total expected benefits, A and B can take the cost price of these contributions as the starting point.

If the average relative added value of the contributions by A and B were not comparable, for instance because the knowledge and experience of the employees of A and B are very different, the determination of the ratio of the total expected benefits cannot be based on the cost price of the contributions, but should be based on the open market value of the contributions.

The examples given above are based on a stylised representation of reality. In practice, it will be difficult to determine the exact open market value of the contributions of the participants in the CCA and to determine the exact open market value of the benefits arising from the CCA. It will also be difficult in practice to determine whether the contribution provided by both participants has a comparable average relative added value when it comes to assessing whether the ratio in the total expected benefits from the CCA can be related to the costs that can be allocated to the contributions of the participants instead of to the open market value of these contributions. The Tax and Customs Administration must bear in mind that transfer pricing is not an exact science, especially when assessing CCAs. Nevertheless, taxpayers can be expected to demonstrate convincingly that independent parties in comparable circumstances would conclude a similar agreement under comparable conditions.

8. Intra-group procurement

Joint purchasing in a group context leads to benefits in many cases, including benefits from synergy. In this regard, I would refer to section D.8 of chapter I of the OECD Guidelines, which describes the principle and illustrates its application (examples 3, 4 and 5, paragraphs 1.168 to 1.173 of the OECD Guidelines). Commercial arguments for deciding to centralise purchasing activities include cost savings (pooling purchasing power and/or procurement expertise), reducing the necessary operating capital and improving product quality. Often there is also a wish to establish a purchasing office close to the market where the products are purchased.

Procurement-related activities can range from carrying out support activities to purchasing activities that can be regarded as core functions of the group. The functional analysis focuses mainly on the relative interest of the purchasing function in the group's overall value chain. An assessment must then be made to decide which members of the group carry out the various purchasing activities. Finally, the activities can be analysed.

If the purchasing activities are of a routine nature, few risks will be run. Such activities include:
- selection of potential suppliers;
- (local) coordination with suppliers;
- quality control of the purchases;
- arranging transport and other logistics activities.

In practice, such activities entail few, if any, price or inventory risks.

Sometimes the activities are of a more complex nature and may also involve putting together the product range (which ought to be considered a separate function).

The functional analysis is followed by an assessment of what is a suitable transfer pricing method for the activities carried out to determine an arm's length remuneration. This remuneration can range from a routine remuneration (based on the operational costs incurred, or a fee based on the purchase value) for activities of a routine nature to a profit split-type remuneration if the activities can be considered a core function of the enterprise.

Local independent procurement agents are known to mainly provide support activities and generally receive compensation related to the purchase value. Logically, the compensation percentage will be in direct proportion to the responsibilities of the agent and in inverse proportion to the purchase volume. When looking for reliable comparables, it proves difficult in practice to make a comparison on the basis of a percentage of the purchase value. That is why, in those situations, the Tax and Customs Administration will usually apply the TNMM (with the net operating profit being linked to cost) when assessing the arm's length nature of the remuneration. In this regard, the cost base remains limited in principle to the purchasing office's operational costs, in view of the routine nature of the purchasing activities. The cost price of the purchases does not form part of the cost base.

If, by centralising the purchasing activities, the group manages to realise higher discounts than before as a result of the increased purchase volume, this extra benefit cannot in principle be allocated to the centralised purchasing office. Such a benefit must be allocated to the members of the group that enable the purchasing office to realise the extra discounts by their joint purchase volumes. Only if and in so far as extra discounts are realised by the specific knowledge and skills present at the purchasing office allocation of part of this to the purchasing office will be arm's length (see also the Supreme Court judgment of 23 April 2004, no. 39 542).

9. Guarantees in loan agreements

The issuing of a guarantee for third-party debts is unlikely to be a common occurrence, and certainly not without stipulating substantial security.

In the case of a guarantee between associated enterprises, it must be investigated whether arm's length conditions can nevertheless be found under which third parties acting in a commercially rational manner would be prepared to enter into such a transaction. Assessing a controlled transaction against the arm's length principle should always be done from a two-sided perspective. The arm's length nature of a guarantee by an associated enterprise must therefore be assessed not only from the perspective of the enterprise that issues the guarantee, but also from the perspective of the enterprise for which the guarantee is issued. It must therefore also be assessed whether the associated enterprise for which the guarantee is issued wants to make use of that guarantee under arm's length conditions and is prepared to pay a fee for it.

Among associated enterprises such as group companies, guarantees in connection with loans are provided for various reasons.. These guarantees must be reviewed against the arm's length principle if an intra-group service is involved.

Lenders can receive a guarantee from associated companies for the following reasons, among others:

- the lender does not want to provide a loan (or wants to provide only a smaller one) without a guarantee;
- the lender does want to provide a loan but offers the group company less favourable conditions without a guarantee;
- the lender wants to prevent the group company to which funds are lent becoming insufficiently solvent due to acts by the parent company.

If the group company is unable to raise a loan in the capital market independently, without the guarantee of associated companies, the guarantee is in principle provided in the shareholders' sphere and does not constitute a group service for which a fee must be charged. However, this changes the loan from a loan by a third party into a loan by an associated guarantor. If the lender calls in the guarantee from the guarantor, a write-down of the receivable from the associated group company by the guarantor also takes place in the shareholders' sphere.

If the group company is deemed to be able to raise a loan independently, it must be assessed to what extent it would be able to stipulate more favourable loan conditions than a comparable independent company without an explicit guarantee from an associated company, purely because it is a member of a group. It will then obtain these more favourable loan conditions on the basis of an implicit guarantee. This implicit guarantee is the assumption of the capital market that the group will enable the group company in question to fulfil its obligations. If and in so far as this is the case, this does not constitute a group service for which a fee must be charged (see paragraph 7.13 of the OECD Guidelines).

In the other cases, where more favourable loan conditions are obtained by an explicit guarantee from an associated company, for which an independent third party would be prepared to pay, this will be an intra-group service for which a fee must be charged (the guarantee fee).[17]

In determining the guarantee fee due, both the credit rating of the group company concerned and the credit rating of the group as a whole play a major role.

Companies forming part of a group are in principle given a credit rating from credit rating agencies based not only on their own relevant indicators as independent enterprises but also on the relevant indicators of the group as a whole of which they are members and on the position they occupy within the group. This credit rating is referred to below as a 'derivative rating'. This derivative rating must be distinguished from the stand-alone rating, which the company concerned would have if it were not a member of the group in question. If there is no explicit guarantee, the capital market is prepared to lend to the group company on the basis of the derivative rating.

The capital market will charge an interest rate dependent on the relevant rating. An example of the difference between the interest rates to be applied is the following:

- On the basis of the stand-alone rating:	6%
- On the basis of the derivative rating:	between 4% and 6%
- On the basis of the group rating:	4%

I am of the opinion that, if the guarantee constitutes a service, the fee payable for it cannot in principle be higher for tax purposes than the difference between the interest rate corresponding to the derivative rating and the interest rate corresponding to the group rating. That is the maximum benefit that the group company can obtain from the existence of the explicit guarantee.

The derivative rating will be between the stand-alone rating of the group company and the group rating. The derivative rating, and therefore the level of the guarantee fee, will depend mainly on the strategic importance of the group company for the group as a whole.

[17] All this is subject to the condition that the guarantee does not take place in the shareholders' sphere for reasons other than those stated in this section.

If the strategic importance of the group company is so great that being unable to fulfil the obligations with respect to the capital market will lead to high costs for the group as a result, for instance, of a lower group rating or damage to reputation, the derivative rating will tend towards the group rating. The interest that a strategic group company could stipulate independently, without an explicit guarantee, is close to the interest based on the group rating. If the group company is of relatively minor strategic importance for the group as a whole, the derivative rating will tend towards the interest based on the stand-alone rating of the group company.

In addition to the above, the Supreme Court's judgment of 1 March 2013, no. 11/01985, is also important. It ruled that, in the case of a guarantee under an umbrella credit facility, a company's acceptance of joint and several liability for all the debts of other companies taking part in the credit arrangement arises from the intra-group relations between this company and those other companies. The acts of the companies are in that case governed by the group interest and they thereby accept a liability exceeding the liability that exists when capital is borrowed independently. Comparable joint and several liability will rarely be found among independent parties and, in addition, it will be difficult to determine an arm's length fee for the mutual guarantee of the various associated parties.

For the sake of completeness, I would also refer to example 2 in paragraph 1.167 of the OECD Guidelines.

10. Internal (re)insurance activities

Intra-group companies sometimes act formally as an internal (re)insurer towards members of the group. In some cases, this type of company lacks the activities which characterise a professional (re)insurer, such as product development, marketing and sales, acceptance of insured parties, asset/liability management and development of an independent reinsurance policy. In addition, in these cases there is no 'active' diversification outside the group of the risks present at the reinsurer that are associated with the internal (re)insurance activity, but only a 'passive' diversification within the group. I would like to look at two forms of intra-group (re)insurance activities in more detail.

In some of these situations (passive poolers), the members of the group actually pool their risks with the internal (re)insurer without the latter carrying out the activities that are normally carried out by a professional reinsurer.

In other situations, where the insurance is offered as a by-product, proceeds of insurance that have actually already been realised are transferred to an internal (re)insurer in a non-arm's length manner.

In the cases referred to above, only limited remuneration is appropriate for the internal (re)insurer, taking into account its often purely mediating role.[18]

Passive poolers

A passive pooler only insures group risks. This is often the excess that the group wants to retain itself or which it is obliged to retain by external insurers. Usually the passive pooler is an extension of the risk management department of the head office. Such a company is forced to accept all insured parties in the group and is usually forbidden to insure the risks of parties outside the group. That is why it does not carry out the typical insurance activities and

[18] Judgment of the district court of Zeeland/West Brabant, 17 January 2014, no. AWB11/03717

does not diversify outside the group. The company mainly performs an administrative and/or mediating role, which only justifies limited remuneration. The other benefits created via this company, such as the pooling benefit resulting from the fact that, together, less capital needs to be retained, the benefits resulting from centralised negotiations with any (re)insurers and the investment income generated with the premiums received by the internal (re)insurer accrue to the group members pooling their resources in this way. A comparison can be made with an intra-group purchasing office whose activities are of a routine nature (see section 8 of this Decree).

Insurance as by-product

This relates to situations where the insurance is offered as a by-product for customers (independent customers) of products or services of a group with activities outside the insurance sector. Examples include cancellation insurance and taking out insurance for an extra warranty period. The policy for the customer is generally in the name of a third-party (independent) insurer under the supervision of the local regulator. After deduction of a fee for the third-party (independent) insurer, the premium is passed on as a reinsurance premium to the internal reinsurer. In practice, it is not the internal reinsurer that offers the insurance as a by-product but the group member carrying out the main activity of the group. That member provides diversification via its customer base and is thereby able to generate the insurance benefits for the group. The internal reinsurer does not actually perform any insurance function and therefore, on the basis of the arm's length principle, ought not to bear any insurance risk. Such a company only performs a minor administrative role, which justifies a limited remuneration.[19]

11. Loan transactions

General

In the case of controlled financing transactions, too, the conditions used must be checked against the arm's length principle. In the case of a loan transaction, this includes all the conditions of the transaction, including the risk allocation and the price. The end result of the loan agreement recognised as such after this test should be a price (interest charge/interest income) that satisfies the arm's length criteria set out in section 8b of the Corporate Income Tax Act 1969.

The OECD Guidelines

On the basis of the OECD Guidelines, the arm's length test for loan transactions starts with the characterisation of transactions as described in section 2.1 of this Decree. An adjustment of the risk allocation may also be required for loan transactions. This often involves a risk allocation that does not occur between independent parties under comparable circumstances. This includes, for example, incorrectly not stipulating certain securities with regard to the repayment of a loan.

If the transaction cannot be made at arm's length with an adjustment of the price and/or the other conditions, this may lead in extreme cases to the disregarding/requalification of the loan or part of it (paragraph 1.122 of the OECD Guidelines). Taking the foregoing into account, an arm's length interest charge or interest income can then be determined for the remaining loan. In the arm's length test, the perspective of each of the parties involved plays an important role.

[19] See also: judgment of the district court of The Hague, 11 July 2011. AWB08/9105, LJN BR4966.

The two-sided perspective

The independent lender, with due regard for its functionality in the market and the associated choices regarding the acceptance of risks, wants to minimise its risks. It will usually base its decision on whether to provide the loan on whether the independent borrower can (re)pay the loan and the interest charged on it. It would therefore rather grant a loan to an independent party whose creditworthiness, after the loan transaction has been entered into, does not fall below a certain level. Creditworthiness is often expressed in credit ratings. Credit ratings from AAA to BBB-[20] denote high to satisfactory creditworthiness. In addition, the likelihood that the independent borrower will ultimately be unable to pay interest and repay the loan is deemed to be low. The borrower is then regarded as 'investment grade'. Potential borrowers with a credit rating lower than BBB- are regarded as not 'investment grade' because the likelihood that they will ultimately be unable to pay interest and repay the loan is considered too high. The rating is determined on the basis of certain indicators, including interest coverage[21] and the debt-to-equity ratio. Only in special situations is an independent lender willing to accept a lower borrower credit rating than BBB-. An independent lender with a diversified loan portfolio would rather make a loan to such a company than an independent lender that has only one or a very limited number of loans outstanding. On the basis of the foregoing, an associated lender which provides a loan to a borrowing group company that is insufficiently creditworthy (after the loan the rating is lower than BBB-) must demonstrate that the loan was agreed under arm's length conditions.

The independent borrower will strive to organise the financing of its business activities so efficiently that the cost of capital is minimised.[22] The equity amount in relation to the debt amount plays an important role in the level of the cost of capital. On the one hand, it is advantageous to finance part of the business activities with borrowed capital. This increases the return on the invested equity capital, partly because the interest payment is in principle tax-deductible. On the other hand, above a certain threshold the additional costs of raising borrowed capital become so high that this increases the cost of capital and reduces the return on the invested equity capital.

The amount of these costs of the borrowed capital largely depends on the creditworthiness of the borrower. An independent borrower will generally not enter into a loan transaction that reduces its creditworthiness below investment grade/BBB-. Such creditworthiness means that borrowed capital cannot be raised or can be raised only at very high cost. In addition, emergencies cannot be dealt with and the bankruptcy risk is too high.

In view of the above, in the case of a controlled financing transaction that leads to a debt-to-equity ratio and interest charges such that, after the loan transaction has been entered into, the borrowing group company is insufficiently creditworthy (a rating below BBB-), this company must demonstrate that the loan has been agreed under arm's length conditions.

Dutch case law

The Supreme Court judgment of 25 November 2011, no. 08/05323, concerned the question of whether a controlled loan could be written down in a domestic context. The Supreme Court indicated that if, in the case of a loan between associated parties, the interest rate is not determined in accordance with the arm's length principle, the taxable profit must be calculated on the basis of an

[20] Standard & Poor's names. Moody's, for example, uses Aaa to Bbb.
[21] Operating profit divided by the interest charge.
[22] This is also called the weighted average cost of capital (WACC) in the literature.

interest rate that does comply with this principle. The determination of that interest rate should be based on what has been stated in this section.

According to the Supreme Court, if the interest rate adjustment referred to above results in the loan becoming essentially profit-sharing, the nature of what the parties have agreed is affected. If it is impossible to determine profit-independent interest rates under which an independent third party would have been prepared to grant the same loan to the borrowing group company, under otherwise the same conditions and circumstances, the Supreme Court assumes that the provision of such a loan by the lending group company would entail a debtor risk that the third party would not have taken. In that case, barring special circumstances, it must be assumed that the lending group company has accepted this risk with the intention of serving the interest of the associated company in the capacity of shareholder or sister company/subsidiary. The Supreme Court calls this an unbusinesslike loan. Any write-down loss on such a loan may not be deducted from the (taxable) profit of the lender.

The interest to be taken into account for tax purposes must then be determined for the unbusinesslike loan. To this end, the Supreme Court applies two rules: i. the rule of thumb;[23] and ii. a market value (WEV) rule.[24] The lowest applies as the interest to be taken into account for tax purposes.

Re i

The interest on the unbusinesslike loan is based on the interest that the borrowing group company would have to pay if it were to borrow with a guarantee from the lending group company under the same conditions and circumstances as a third party. The result is that the interest thus determined is deductible by the borrowing group company and tax on it is paid by the lending group company. The difference between the interest actually charged and the interest determined on the basis of the creditworthiness of the lending group company lies in the capital sphere.

Re ii

The application of the market value rule is particularly relevant if the unbusinesslike loan is interest-free or the agreed interest remains outstanding. The interest to be taken into account for tax purposes is then determined on the basis of the market value of each interest instalment at the time it falls due.

The assessment of the arm's length nature of the loan can take place both at the time it is issued and during its term. This assessment must take place from the perspective of the lending and the borrowing party. Referring to what has been stated above with regard to the perspective of the parties concerned, in the case of an associated lender that provides a loan to a borrowing group company that is insufficiently creditworthy (after the loan has been taken out, the rating is below BBB-), the loan may also be non-arm's length under the approach proposed in the above-mentioned judgment. In my opinion, the same applies to a borrower which, as a result of the controlled loan transaction, sees its credit rating drop below BBB-.

The Supreme Court holds that the interest on an unbusinesslike loan, a loan with an unbusinesslike debtor risk, should be determined on the basis of the creditworthiness of the lending group company, but did not explain in its judgment how to deal with the creditworthiness of the lending group company in relation to the creditworthiness of the borrowing company.

If the lender has a higher credit rating than the borrower, the interest that the

[23] Supreme Court judgment, 25 November 2011, no. 08/05323.
[24] Supreme Court judgment, 15 March 2013, no. 11/02248.

lending group company itself would be charged will be taken as the appropriate interest to be taken into account for tax purposes. If the lending group company does not have a better credit rating than the borrowing group company, i.e. if this company is not itself investment grade, the fictitious guarantee does not add anything. In that case, no more than the risk-free interest on the loan may in any event be taken into account.

12. Grants, tax incentive measures and partly deductible costs

In practice, it is commonly asked whether grants and tax benefits received can be deducted from the cost base, especially in situations where a cost-related remuneration is used to determine the arm's length price. In the Netherlands, it can be assumed that grants are deductible from the cost base if there is a direct connection between the grant and the provision of the product or service, and compensation is granted in the form of a discount on or a contribution to the costs. Examples include a grant for the use of more expensive but more environmentally friendly raw materials, a bonus on the acquisition of an energy-efficient business asset and also a contribution under the investment allowance scheme (IPR). Conversely, extra levies, for instance for the use of environmentally harmful raw materials, lead to an increase in the cost base applied. Reductions in tax and social insurance remittances referred to in section 3 of the Salaries Tax and Social Insurance Contributions (Reduced Remittances) Act reduce the wage costs and also the cost base on which the profit mark-up is calculated.

Grants and tax benefits which are awarded to the entity as such and have no causal connection with the activity to which a cost-related remuneration is attributed are not deductible from the cost base used. In so far as they belong to the taxable profit, they are credited separately to the profit and loss account.

If the tax allowances are granted in the form of a deduction from the taxable profit, such as the investment tax credit, they are not deductible from the cost base. First the profit is calculated on the basis of the allocated costs and then the allowance is deducted separately from the taxable profit.

Under tax legislation, certain cost categories are only deductible to a limited extent, for instance the costs pursuant to section 3.14 of the Income Tax Act 2001, the costs of depreciation of buildings pursuant to section 3.30a of the Income Tax Act 2001 and the costs pursuant to section 10, subsection 1 (j) of the Corporate Income Tax Act 1969. These costs are part of the cost base on which the profit mark-up is calculated. The restriction on deducting these costs is applied by adding the non-deductible part of the costs to the profit when determining the taxable profit.

13. The documentation requirement

In the Corporate Income Tax Act 1969 the documentation requirement with regard to transfer pricing is regulated in two different places.

First, there is the documentation requirement defined in section 8b, subsection 3 of the Corporate Income Tax Act 1969. This documentation consists of a description of the five comparability factors of the controlled transactions as described in chapter I of the OECD Guidelines, a substantiation of the choice of the transfer pricing method used and a substantiation of the conditions, including the price, applicable to the transactions. When codifying the documentation requirement under section 8b, subsection 3 of the Corporate Income Tax Act 1969, it was deliberately decided not to give an exhaustive list of documents necessary to support the arm's length nature of the transactions. In that sense there is an open standard.

When assessing the adequacy of the documentation under section 8b, subsection 3 of the Corporate Income Tax Act 1969, the proportionality principle should play an important role. The basic principle is that the additional administrative burden resulting from section 8b, subsection 3 of the Corporate Income Tax Act 1969 should be reduced to a minimum.

In view of the open standard used, I realise that there may be uncertainty among taxpayers as to whether the documentation available will be deemed sufficient by the Tax and Customs Administration. It is therefore possible to obtain certainty from the competent inspector about whether the documentation requirement set out in section 8b, subsection 3 of the Corporate Income Tax Act 1969 has been met (see also Decree no. 2018-4380 establishing the Transfer Pricing Coordination Group).

Second, sections 29b to 29h of the Corporate Income Tax Act 1969 contain provisions on documentation relating to taxpayers who meet certain standards. This documentation requirement relates to the country-by-country report, the master file and the local file. The Decree of 30 December 2015 laying down supplementary transfer pricing documentation requirements (DB2015/462M) contains further rules for the form and content of the reports and files.

Section 8b, subsection 3 of the Corporate Income Tax Act 1969 deals with both national and cross-border transactions with associated entities, while the obligations set out in sections 29b to 29h of the Corporate Income Tax Act 1969 relate to cross-border transactions between associated group entities and the provision of evidence supporting an arm's length profit allocation to permanent establishments.

I am of the opinion that entities which comply with the documentation requirements set out in section 29g of the Corporate Income Tax Act 1969 in terms of content also comply with the obligation set out in section 8b, subsection 3 of the Corporate Income Tax Act 1969 in so far as it concerns cross-border transactions.

If the requirements set out in section 29g of the Corporate Income Tax Act 1969 are also applied by entities to domestic transactions with associated entities, I believe that the documentation requirement set out in section 8b, subsection 3 of the Corporate Income Tax Act 1969 is complied with.

14. Early consultation about possible double taxation

Double taxation as a result of transfer pricing adjustments is undesirable. On the basis of tax conventions concluded and the EU Arbitration Convention, the International Tax Policy and Consumer Taxes Directorate of the Ministry of Finance, as competent authority, provides assistance to taxpayers faced with taxation which is not in accordance with the provisions of a convention. The basic principle is that double taxation must be eliminated as quickly and efficiently as possible. In this connection the Netherlands is seeking to begin early consultation procedures with treaty partners. Further details can be found in the policy decree of 29 September 2008, no. IFZ2008/248M, Government Gazette no. 188.

Experience shows that in some cases double taxation can be eliminated in a relatively simple manner during the consultation procedure by sharing facts and circumstances of relevance to the case in question. That is why, if a taxpayer expects to be faced with double taxation in the area of transfer pricing as a result of activities by a tax administration in a country with which the Netherlands has the possibility of exchanging information, the Dutch Tax and Customs Administration is prepared to examine ways of avoiding possible double taxation at the earliest possible stage by sharing information or jointly carrying out audit activities. Taxpayers may submit a request to that end to the Dutch tax inspector.

The likelihood that the activities of the foreign tax administration will lead to an adjustment to transfer prices must be present and must be convincingly demonstrated by the taxpayer in their written request. The scope for avoiding double taxation by exchanging information or jointly carrying out audit activities will depend on the legal options available and the willingness of other countries to cooperate in such a process.

15. Entry into force

This Decree enters into force on the day after the date of publication of the Government Gazette in which it appears.

16. Repeal of old Decrees

This Decree replaces the Decree of the State Secretary for Finance of 14 November 2013, no. IFZ 2013/184M.

This Decree will be published in the Government Gazette.

The Hague, 22 April 2018

M. Snel
State Secretary for Finance