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5 Thoughts on a Dutch transfer pricing court case involving a business restructuring

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On September 30, 2022, the North Holland Court ("the Court") ruled on a dispute involving the delineation and valuation of a business restructuring for tax purposes. The business restructuring entailed the intercompany reallocation of certain functions of a Dutch company to a Swiss sister company as part of a larger group-reorganization. The taxpayer argued that the transfer was limited to certain assets, resulting in an exit tax valued at EUR 2 million. The Dutch tax authorities ("DTA") took the view that substantial and core company activities and responsibilities had been transferred from the Netherlands to Switzerland, along with the associated profit potential. The initial assessment of the arm's length transfer price by the tax authorities was EUR 320 million. The Court appointed an independent expert assigned a minimum value of EUR 85 million to the profit potential transferred. The Court adhered to this valuation.

This case (ECLI:NL: RBNHO:2022:9062) is the second transfer pricing case decided by the North Holland Court in a short period. On October 17, 2022, the same Court ruled on a transfer pricing dispute between British American Tobacco and the DTA. This is also demonstrated by the transfer pricing dispute between a Norwegian fertilizer manufacturer and the DTA, which has recently been referred to the Supreme Court. These decisions indicate a trend in international tax in which transfer pricing is gaining importance and disputes are more likely to lead to litigation.

The business restructuring's rationale & contractual terms

The parties involved in the case at hand are the Dutch division of a food processing multinational that also trades in (food-related) raw materials ("X NL") and its - per 2007 incorporated - Swiss group company ("X CH"). X NL's operations consisted of a cocoa processing factory and a soybean processing factory. According to its transfer pricing documentation, before 2007, X NL managed the supply chain for both its businesses (i.e., purchase, production and sales for cocoa and soybean), at its own expense and risk (as in, operated like a fully-fledged manufacturer). Each of the manufacturing facilities had its own trade department. The trade department of the soybean factory had 3 employees, whereas the trade department of the cocoa processing facility had 35 employees. This department was additionally responsible for the group's global cocoa trade (i.e., handling procurement, inventory, logistics etc. for the cocoa trade of the group worldwide).

In 2007, the group decided to reorganize its European and African operations. The reorganization[1] focused on the centralization of the main functions related to the processing process (i.e. purchase, production, planning, trading, and sales). These functions were relocated and consolidated in Switzerland. This was done to enhance control, communication and risk management, bolstering the group's competitive position in Europe. Following the reorganization, X NL made its production facilities available to X CH for a fee. X NL's transfer pricing documentation for this period described X NL as a toll-manufacturer that does not assume the risk associated with purchasing raw materials, and is therefore entitled to a nominal or routine fee.

During the reorganization, 33 X NL employees moved to X CH. A series of internal agreements governed the reorganization's legal structure. The terms and conditions of these agreements dealt with (i) the transfer of stocks, receivables, debts and trademarks, (ii) the performance of manufacturing services by X NL for X CH, (iii) customer sales support and marketing services and (iv) administrative services and logistical support services. Under the manufacturing agreement X NL agreed to process raw materials for cost plus 8.7 percent for five years. The reorganization caused a severe fall in revenue and cash flow for X NL, whereas X CH saw a steep climb in revenue and cash flows. In the years following the reorganization, the group continued to invest in X NL, expanding, increasing/innovating its production capacity in the Netherlands.

[1] Within the scope of this writing: "business restructuring", "restructuring" and "reorganization" are used interchangeably.

Compensation for a transferred intangible

According to the OECD Transfer Pricing Guidelines ("OECD-TPG") a business restructuring may involve cross-border transfers of something of value (e.g. valuable intangibles or an ongoing concern) between related parties or the termination or substantial renegotiation of existing arrangements.[2] The first step in analysing the transfer pricing aspects of a business restructuring is to delineate the transactions accurately. Subsequently, the business restructuring (as accurately delineated) should be valued at arm's-length. Crucial for the valuation is whether the transfer of something of value or termination/renegotiation would have been compensated between independent parties. Business restructurings are typically accompanied by a reallocation of profit potential.[3]

According to X NL, the restructuring at hand was primarily an asset transaction (i.e. limited loss of profit potential) with a modest arm's length transfer price of EUR 2 million. In contrast, the DTA insisted that the entire purchasing, planning, trading and sales activities had been transferred to Switzerland (i.e. substantial loss of profit potential). According to the DTA, a company would only give up these activities for a sum that compensates for the lost profit potential. Hence, the DTA recalculated the transfer price to EUR 320 million. An independent expert determined the minimum value of the forfeited potential for profit on behalf of the Court. This expert estimated this value as EUR 85 million.

X NL contended that the transfer pricing documentation governing the reorganization was inconsistent with the actual conduct of the parties concerned. This statement was contrary to its own transfer pricing documentation. According to the documentation, X NL operated as a full-fledged manufacturer prior to the reorganization. The documentation states that X NL was responsible for the production process, starting from sourcing cocoa and soybeans to delivering the final product. However, according to employees of X NL, the soybean factory had not operated independently since 2000. The Court rejected this contention put forth by X NL as it was inconsistent with the transfer pricing documentation as well as the financial statements.

The Court primarily focused on the transfer and concentration of market expertise. In X CH's functional analysis, the following paragraph was included:

> *"The group of companies has an established history in the agricultural commodities markets. Its personnel have developed an extensive knowledge of the market which the group regularly exploits to capitalize on opportunities in the European market. This expertise relates primarily to trading activities (i.e. hedging, position management and contract negotiations) which [X CH] has regularly carried out with regard to [the group] 's operations in Europe. [X CH] will be relying on this knowledge to improve the profitability of the Dutch Oilseeds business. This expertise will play a key role given that [X CH] will be setting the price and volume guidelines with regard to seed purchases and sales of meal, concluding all purchase and sales contracts and entering all hedging transactions to ensure profit variability is minimal."*

The Court held that market expertise had been essential for improving the profitability of X NL. Due to the transfer of the 33 trading employees, the activities related to the market expertise (hedging, position management and contract negotiations) formed the basis of X CH's activities post reorganization. Therefore, the Court ruled that X NL must be compensated for the transfer of market expertise as there had been (i) a transfer of 33 employees from X NL to X CH during the reorganization; (ii) a significant decline in X NL's revenue and cash flow post the reorganization; and (iii) a corresponding increase in X CH's revenue and cash flow post reorganization.

Observations

1. Taxpayer disputing own transfer pricing policies/methodology

In this instance, it stands out that X NL based its position on the actual conduct (functions performed) rather than the internal contracts/documentation. Before the reorganization, there was already (according to employees of X NL) a significant centralization/consolidation of activities in Switzerland. This is notable since this position contradicts the transfer pricing documentation and the internal contracts. X NL *de facto* challenged its own TP methods.

[2] OECD-TPG (2022), par. 9.10.
[3] OECD-TPG (2022), Par. 9.6.

This is typically counterproductive to proving one's case and would likely have a negative impact on any procedure for avoiding double taxation, such as a mutual agreement procedure ("MAP"). It is questionable whether the taxpayer caused the double taxation on its own account, jeopardizing the eligibility for an effective double taxation remedy via MAP and arbitration procedures. The argument used by X NL could also indicate that the transfer pricing policies and documentation of X NL prior to the reorganization were not aligned to the actual conduct (i.e., its functions, assets and risks). Conceptually it could be argued that X NL had accumulated excessive income prior to the restructuring; to which it was not functionally entitled.

It is not surprising that the DTA and the Court disregarded the X NL's position. This conclusion is reasonable given the shift of profit and cash flow from X NL to X CH, which corresponded with the actual transfer of 33 employees from X NL to X CH. Though, ignoring the parties' actual conduct and relying on what is stated in the internal contracts/documents contradicts the usual approach in transfer pricing cases. In such cases, the actual conduct of the parties takes priority for the tax authorities as well as the Courts.

2. Importance of proper TP documentation

The central issue in the case discussed above is the lack of proper transfer pricing documentation and limited facts. According to X NL's statement before the Court, the autonomy and responsibility of X NL prior to the reorganization outlined in the transfer pricing documentation is inconsistent with the actual conduct. According to the statement, some of X NL's activities (relating to the soybean factory) were coordinated since 2000 (7 years prior to the reorganization). Therefore, according to X NL, the core business functions were not transferred to X CH during the reorganization. However, it is challenging to reconcile this standpoint with the transfer pricing documentation, which states that the Dutch production facilities were responsible for their entire supply chains and related risk management prior to the reorganization.

In conjunction with the divergent transfer pricing documentation, the transfer of employees of X NL (representing the market expertise) to X CH appears to be a decisive factor for the Court in coming to the conclusion that X NL's position changed contractually and materially post the reorganization (i.e., 2007 onwards). Aside from transferring 33 out of 35 employees (from the trading department of X NL) to X CH, not much is mentioned in the Court documents about the functions and risks transferred during the reorganization.

This could imply that the transfer pricing documents/internal agreements were not precise/all-encompassing, leaving a lot of room for the DTA to make their own interpretations. This may account for the (significant) variation in valuation (EUR 2 million vs. EUR 320 million). Not being able to rely on the transfer pricing documents/internal agreements, the Court finally had to rely on the valuation (of EUR 85 million) provided by a valuation expert. The X NL would have been in a better position to defend its case if it had proper transfer pricing documentation (including internal contracts) for the period leading up to the reorganization as well as during and after the reorganization.

3. Determining what is being transferred

Before a transfer, and particularly during a dispute over the value of a transfer, it is essential to determine precisely what is being transferred. A good definition provides useful information for conducting a comparability analysis and assessing the valuation. However, after reading the Court's decision in this case, we are unsure of the precise nature of the transferred assets. We anticipate the transfer of a purchasing organization with expertise in procurement strategies and supplier management. There is also the possibility that significant supplier contracts have been transferred. Additionally, we can envision a link between the purchasing organization and knowledge/expertise regarding cost reduction and process optimization. Hence, the nature of the transfer (between X NL and X CH) is not immediately apparent upon reading the Court's decision.

4. Loose link between profits/profitability and transfer price

In practice, parties disputing the arm's-length value of a transfer of functions/assets use the pre-reorganization profit as a comparison point. By comparing this profit to the profit after reorganization, the value of the transferred functions/assets can be determined. The Court followed a similar approach in this case. X NL experienced a significant revenue and cash flow decline due to the reorganization, whereas X CH experienced a considerable increase. The DTA and the Court seem to have used this rationale to (i) define the scope of the transfer and (ii) assess the transfer price thereof.

Though we understand that there might be a parallel between the shift in profitability and transfer price, the comparability/proportionality in the shift could be entirely coincidental. It is based on comparing data obtained from controlled (as in, not arm's length) transactions. X NL's profits before and after the restructuring are compared to X CH's profits. Controlled

information is typically irrelevant when the arm's-length principle is used. In addition, changes in the strategies and options realistically available to parties have not been examined. These factors can impact the negotiation of the transfer's conditions.

The information provided is limited, but it could be that the profitability of X CH is influenced by much more than the 33 X NL employees transferred to X CH. To attribute the increase in profitability to these employees only because there is a significant decrease in the profitability of X NL is questionable. In the absence of proper documentation that could have been used to make an appropriate assessment and valuation, the Court seems to have had no choice but to rely on the valuation of the Court appointed expert, which is, in our opinion, a guestimate.

5. Hard-to-value-intangibles

Given the (significant) valuation disparity, we wonder why the Court did not look into whether the valuation methodologies used to value hard-to-value-intangibles could be applied to the transfer in this case. "Hard-to-value intangibles" are intangible assets (as defined in Chapter 6 of the OECD-TPG) whose value is hard to estimate due to the unpredictability of future events. Using this concept, the tax authorities (ex-post) can evaluate the valuation's appropriateness based on the actual results generated by intangible assets. Numerous people have doubts about this proposition. It may, however, enable (at least in theory) taxpayers who are presented with significant adjustments, such as X NL, to spread out and possibly reduce their tax burden (depending on future results).

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