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Impact of the Zinc case on transfer pricing

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On 27 October 2017, an interesting court decision was published in the field of transfer pricing (TP), which has been named the 'Zinc case'. The case concerned the centralisation of full-fledged operations into low-risk operations and the question of whether the corresponding conversion fee matched the arm's length principle. In international case law, conversion disputes are rare. There was particular interest in this case as it focused on TP documentation and the division of the burden of proof between the tax authorities and the taxpayer. The court's decision reflects the importance of adequate TP documentation. The court concluded that the Dutch tax authorities had not satisfied the burden of proof and that the company's appeal was well documented. The upward correction to the conversion fee was reversed. In response, the tax inspector has lodged an appeal against the court's decision.

Facts and dispute

The taxpayer that started the procedure is a Dutch company which is part of a multinational group. Its operational activities consist of processing zinc concentrate and related raw materials. From 2003 onward, certain activities were gradually transferred to affiliated companies outside the Netherlands. This resulted in economies of scale with regard to purchasing activities, selling activities and personnel.

In 2009, a Belgian group company took over a large part of the working capital of the Dutch company by means of a business transfer agreement. In addition, a cooperation agreement was concluded in 2009 between the Belgian and the Dutch company, under which the Belgian

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company supplied raw materials to the Dutch company, which were subsequently returned to Belgium after processing in the Netherlands.

In 2010, the group decided to transfer its headquarters, which were partly located in Brussels and partly in London, to Switzerland. A business transfer agreement had been agreed between the Swiss company and the Dutch company. Under this agreement, activities relating to the management of production planning, purchasing, logistics and sales were moved to Switzerland and the cooperation agreement between the Netherlands and Belgium, that was concluded in 2009, was terminated. Approximately 100 people were employed in Switzerland at the time of these transactions. The Dutch company received a conversion fee of over €28m for the transfer of these activities, as well as the termination of the cooperation agreement with the Belgian company, which had a remaining term of one year.

The Dutch tax inspector disagreed with the conversion fee and increased the exit charge to €156m. The inspector also argued that the core functions following the contractual transfer of the aforementioned activities from the Netherlands were still being carried out in the Netherlands. Conceptually, both positions are contradictory to one another. A higher exit charge implies that the activities have been moved from the Netherlands; this runs contrary to the argument that no activities have been moved. This could lead to annual TP adjustments. This, however, does not match with the recognition of an exit charge.

Court decision

The court ruled that the Dutch group has complied with its documentation obligations. Reference is made to the various reports showing how the amount of the conversion fee has been determined. This results in the fact that the tax authorities have to prove that this transaction took place because of shareholders' motives rather than business motives, and if the tax inspector succeeds in this regard, that the transfer price is not at arm's length.

The court ruled that the inspector had not satisfied the burden of proof resting on him, thus the company's appeal was held to be well-founded and the tax assessment was reduced. Hence, there was no reason for a correction of the taxable profit in the Netherlands. More specifically, the court ruled that the transfer of activities from the Netherlands had already taken place in the years prior to 2010. Based on the functions of the group, the court agreed with the taxpayer that its activities strongly resembled those of a contract manufacturing company. All risks relating to purchasing, sales and other by-products are managed and borne by the company in Switzerland. This can also be deduced from the fact that approximately 100 people were already working in Switzerland in 2010. Since the court came to the conclusion that the activities were largely relocated from the Netherlands before 2010, the court saw no reason to increase the exit charge.

Impact of the Zinc case

In its judgment, the court confirmed that the inspector has a relatively heavy burden of proof when it comes to making TP corrections. This is particularly true if the documentation is in line with the actual facts and circumstances and is based on national and international TP guidelines and principles. The inspector first has to demonstrate that companies within the group intended to benefit each other and that the price used was not at arm's length. If the inspector does not succeed in this, no transfer price adjustment may be imposed.

It is difficult for the inspector to prove that a certain transaction is not sufficient if the taxpayer has met the documentation obligations. The importance of having documentation is emphasised in this court ruling. If the taxpayer had failed to meet the TP documentation obligations, the burden of proof would have shifted to the taxpayer. In addition, it is important that the documentation corresponds to the actual facts and circumstances and the TP is based on a sound functional analysis, according to the Organisation for Economic Co-operation and Development's (OECD's) TP guidelines and principles. This was also the case in the court ruling.

In light of the increased exchange of information between countries, it will be easier for tax authorities to gain information about activities of group companies in the future. This insight will probably lead to discussions in the field of TP in an earlier phase, not only in the Netherlands, but in other countries where local tax authorities have access to TP documentation.

In addition, the judgment also shows that it is important to remain in dialogue with the inspector to minimise the risk of a time-consuming and expensive process. In this case it seems that the differences in interpretation were fed by a difference of opinion about the facts. In the case of a fundamental difference of opinions about the facts, one of the parties should conceptually have an issue with the burden of proof, which happened in this case.

The inspector has lodged an appeal against the court's decision. Although the court's ruling appears to be in line with parliamentary history and TP policy in the Netherlands, it is difficult to predict whether the higher court will follow the ruling of the lower court. ■