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Dutch *Zinc* case highlights key transfer pricing challenges

This recent Court of Appeal decision encapsulates some complex issues including burden of proof, application of the arm's length principle and the impact of transfer pricing on business restructuring. ***Rezan Ökten***, ***Sebastian Frankenberg*** *and* ***Gijs van Koeveringe*** *explore the finer detail of the dispute, and provide some key takeaways for practitioners.*

Transfer pricing related court cases have typically been uncommon until now.[1] Although there are some well-known disputes such as *Starbucks*, *Nike* and *Ikea*, transfer pricing court cases are few and far between compared to other areas of tax. Recently, the Dutch Court of Appeal dealt with a remarkable transfer pricing dispute about the business restructuring of a multinational group in the *Zinc* case. This case illustrates some of the key issues which may arise in transfer pricing:

1. The burden of proof and transfer pricing documentation;
2. How transfer pricing can impact business restructuring; and
3. How to correctly apply the arm's length principle and select the most appropriate transfer pricing method.

Background

The *Zinc* case involved a Dutch taxpayer (the "Taxpayer") that is part of a multinational group (the "Group") which processes zinc and related raw materials. Before 2003, the Taxpayer was responsible for the most important functions of the zinc business, owned the relevant assets (ie raw materials), and controlled economically significant risks relating to the zinc smelting activities. In addition, the Taxpayer independently concluded purchase agreements, supply agreements and hedging arrangements. From a transfer pricing perspective, the Taxpayer was therefore considered an entrepreneur in transactions relating to the Group's zinc business and was remunerated accordingly.

From 2003 onwards, the Group gradually transferred all non-production activities from the Taxpayer to a centralised global organisational structure, the Global Marketing and Services team. The underlying motive for this transfer was to benefit from economies of scale for procurement, sales and deploying personnel.[2]

In 2009, the Group established a Belgian group entity which concluded a two-year Cooperation Agreement ("CoopA") with the Taxpayer. Under the CoopA, the Belgian entity supplied raw materials to the zinc smelting companies, including the Taxpayer. The smelting companies subsequently processed these raw materials, and then returned the finished product to the Belgian entity.

In 2010, the Group relocated its headquarters from London and Brussels to Switzerland as part of a substantial global business restructuring. Following the relocation, a newly established Swiss group entity became responsible for controlling production planning, procurement, logistics and sales and, furthermore, the restructuring transferred activities that were part of the CoopA between the Taxpayer and the Belgian entity. This terminated the CoopA. Taking into account the remaining one-year term of the CoopA, the Taxpayer received a conversion fee of €28 million for indemnification. The Group took the position that the business restructuring converted the Taxpayer from an entrepreneur to a toll manufacturer. As a toll manufacturer, the Taxpayer would receive a limited cost-plus remuneration going forward.

However, the Dutch tax inspector took a different view. He found that the Taxpayer was still responsible for the most important functions after the restructuring, implying that the Taxpayer should receive a non-routine remuneration instead. The tax inspector challenged both the amount of the conversion fee and the Taxpayer's post-restructuring function. This led to an upward adjustment of the Taxpayer's taxable profits. The view of the tax inspector is somewhat remarkable, as one typically would expect a higher (lower) conversion fee to go hand-in-hand with a lower (higher) post-restructuring remuneration. The Taxpayer took the case to District Court ("the Court").

First instance proceedings[3]

The case initially developed into a solely procedural case centring on transfer pricing documentation and the division of the burden of proof between a taxpayer and the tax inspector.

The Dutch Corporate Income Tax Act includes a general transfer pricing documentation clause which requires taxpayers to substantiate the arm's length nature of their transfer prices through appropriate transfer pricing documentation.[4] The Court ruled that the Taxpayer fulfilled those documentation requirements, since the Taxpayer prepared several reports which substantiated the conversion fee calculation as well as the remuneration for its post-restructuring activities.

Furthermore, the Court ruled that the party challenging the arm's length nature of the transfer prices should bear the burden of proof. Therefore, the tax authorities bore the burden of demonstrating that the conversion fee and the post-restructuring remuneration fee did not comply with the arm's length principle. In fact, the tax inspector bears a double burden of proof. First of all, he must demonstrate that the respective intragroup transaction was motivated by shareholder interests rather than by business motives.[5] If the tax inspector successfully defends and passes the "first" burden of proof test, he must subsequently demonstrate the non-commercial nature of the transfer price (ie the divergence from the arm's length principle).

The Court concluded that the tax inspector did not sufficiently substantiate his claim that the Taxpayer failed to determine its transfer prices in accordance with the arm's length principle. As such, the tax inspector did not meet the burden of proof test, so the Court upheld the Taxpayer's challenge.

The appeal[6]

The tax inspector appealed the Court's decision.

It seems that the tax inspector made considerably more effort to substantiate his claim on appeal, as the Court of Appeal took a much closer look at the key transfer pricing considerations of the case rather than procedural ones. What makes the case even more interesting is the fact that the Taxpayer and the tax inspector managed to reach a compromise; they negotiated a settlement during the proceedings. The Court's decision formalised the settlement. Accordingly, the Court of Appeal reduced the Taxpayer's taxable amount from €188 million (based on the tax inspector's initial adjustment) to €122 million for the fiscal year 2010.

The settlement indicates that the Taxpayer did not convert from an entrepreneur to a toll manufacturer following the 2010 restructuring, implying that the Taxpayer has remained to perform more activities than would be the case for a toll manufacturer. However, it was also determined that the newly established Swiss entity also performs important functions, with its headquarters employing approximately hundred employees. The Taxpayer and the tax inspector agreed, therefore, that the profit split method is the most appropriate transfer pricing method for the case at hand, given that both the Dutch and Swiss entities make valuable contributions to their joint smelting activities, and jointly control substantial risks.

Furthermore, the parties agreed that the Taxpayer was entitled to 100 per cent of the profits from its zinc smelting activities until 2010. The value of the Dutch zinc business prior to the business restructuring in 2010 was determined as the present value of the expected profits. Following the business restructuring, the Taxpayer transferred parts of its business to the Swiss entity. Under the post-restructuring functional analysis (assessing the functions performed, assets employed, risks assumed at the level of the Taxpayer), the transferred business represents 28% of the total zinc business prior to the restructuring.

The parties agreed that there is a direct link between the determined profit split percentage and the calculation of the value of the transferred business. Therefore, the arm's length conversion fee that the Taxpayer should receive amounts to 28 per cent of the total combined smelting profits. Going forward, the Taxpayer should receive 72 per cent of the total combined smelting profits.

Practical takeaways

The outcome illustrates the willingness of the Dutch tax authorities to cooperate with taxpayers. However, this also implies that the Taxpayer could have avoided lengthy legal wrangling if it had consulted the Dutch tax authorities at the outset (i.e. before the business restructuring in 2010). In a statement following the outcome of the case, the Dutch State Secretary of Finance stipulated that taxpayers may request advance certainty for transfer pricing matters and indirectly suggested that an Advance Pricing Agreement (APA) would therefore have been a suitable approach in this case. In the authors' view, taxpayers should seek certainty through an APA for any transfer pricing case in the Netherlands involving business restructurings (in particular in combination with application of the profit split application).

The State Secretary expressed some other noteworthy views on the case. He indicated that if a taxpayer has presented itself as an entrepreneur from the get-go (for example, through its transfer pricing documentation, annual financial accounts and/or tax returns), the taxpayer cannot retroactively argue that it de facto performed routine functions instead. The State Secretary also states the importance of an exit taxation (ie conversion fee) in the case of a transfer of functions and risks. The amount of the exit taxation should adhere to the value of the transferred functions and risks and the corresponding profit potential.

We note that the Taxpayer's position seemed to evolve significantly during the process. The difference between a toll manufacturer (initial position) and an entrepreneur (outcome of the settlement) is significant from a transfer pricing perspective, both in terms of functionality and in terms of type and level of remuneration. Such a major shift in the Taxpayer's position could indicate inaccurate underlying transfer pricing analyses. This validates the importance of proper and sufficient transfer pricing documentation. However, the Taxpayer might also have had different and justified reasons for agreeing to such significant change in relation to its transfer pricing position. The Taxpayer's joint zinc business has been financially underperforming in recent years, leading to significant tax losses. Although the agreed conversion fee increased the taxable amount in 2010 (compared to the Taxpayer's initial position), the outcome of the case implies that 72 per cent of any future losses are allocated to the Netherlands, leading to a decrease of the Dutch taxable base. As such, an initial assessment of the court proceedings indicates a favourable outcome for the tax inspector, although time will tell whether this outcome also benefits the tax inspector in the long run.

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Endnotes

1. Exceptions include, for example, India, where there are relatively more transfer pricing court cases.
2. Any changes in the Group structure before the restructuring in 2010 were not part of the scope of the dispute under consideration, due to an earlier settlement agreement between the Taxpayer and the tax inspector. Therefore, the article does not explore any further details in relation to changes in the Group structure before 2010.
3. Zeeland/West-Brabant (the Netherlands) District Court, 19 September 2017.
4. Article 8b-3 Dutch Corporate Income Tax Act 1969.
5. Shareholder motives being opposed to business motives in the context of Dutch case law.
6. Court of Appeal 's-Hertogenbosch (the Netherlands), 13 March 2020.

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