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The Newly Updated Dutch Transfer Pricing Guidance, Part 4: Intra-Group Services

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INTRODUCTION

On July 1, 2022, a new Dutch Transfer Pricing Decree No. 2022-0000139020 dated June 14, 2022 (hereinafter ''new TP Decree''),[1] was published in the Dutch Official Gazette.[2]

While the new TP Decree's most material change or update is the inclusion of extensive guidance on transfer pricing for financial transactions, it also in detail reiterates applicable rules for intra-group services. In particular it addresses shareholder services, low-value-adding services, contract research, and contract manufacturing as well as cost sharing and procurement services.

For transfer pricing purposes, the main inquiries regarding the provision of intra-group services generally regard whether the services have been actually rendered, whether the recipient of the services incurred a benefit from the services rendered, whether the services are not duplicative, and whether the transfer price for the services is arm's length. In the event that the fee for services is not directly charged out but the cost of the services is allocated out indirectly, an additional question will be whether the allocation key and the cost base used are appropriate.

Services presents a low-threshold audit topic. It is an area of business operation that is relatively straightforward to understand and conceptually consider, unlike financial transactions or intangibles. The new TP Decree sets forth detailed guidance that, if complied with, should serve to have the transfer pricing of intercompany services considered and respected upon audit.

In this fourth part of our five-part series,[3] the authors discuss the new TP Decree and position of the Dutch Tax Authorities (DTA) on services, cost sharing, and procurement activities.

SERVICES

A group service is rendered when an activity is performed on behalf of a group member to add economic or commercial value for which the group member would normally be prepared to pay. This would not include an activity performed in the function of shareholder of the group.

When choosing a method for determining the transfer price for a service, essentially the only choices

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[1] https://zoek.officielebekendmakingen.nl/stcrt-2022-16685.html.

[2] *See Netherlands Gazettes Decree Clarifying OECD Guidelines on Arm's Length Principle, Transfer Pricing for Multinational Enterprises*, Daily Tax Rpt. Int'l (July 6, 2022).

[3] *See* Monique van Herksen and Clive Jie-A-Joen, *The Newly Updated Dutch Transfer Pricing Guidance, Part 1: Basics and Treatment of Subsidies and Stimulus Measures*, 51 Tax Mgmt. Int'l J. No. 8 (Aug. 5, 2022); Monique van Herksen and Clive Jie-A-Joen, *The Newly Updated Dutch Transfer Pricing Guidance, Part 2: Treatment of Intercompany Financial Transactions*, 51 Tax Mgmt. Int'l J. No. 8 (Aug. 5, 2022); Monique van Herksen and Clive Jie-A-Joen, *The Newly Updated Dutch Transfer Pricing Guidance, Part 3: Intangibles*, 51 Tax Mgmt. Int'l J. No. 9 (Sept. 2, 2022).

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available are: (i) applying the arm's-length principle on the basis of the new TP Decree and the OECD Transfer Pricing Guidelines (OECD TPG)[5] or (ii) applying the simplified method for low-value-adding services. The new TP Decree relegates to a footnote the previously referenced possibility that the taxpayer only allocates out the costs of providing (certain) services. The footnote points to paragraph 7.37 of the OECD TPG which allows for that option (to be accepted on a discretionary basis by the tax authorities).[4]

According to the new TP Decree, a cost-based remuneration applying the transactional net margin method (TNMM) is mostly used and is determined based on a functional analysis. For services, a direct charge method is preferred, but the new TP Decree acknowledges that indirect charge methods are also used in practice, as a result of practical challenges. The DTA can accept an indirect method provided the method leads to an arm's-length result. The allocation keys can include turnover, the number of employees or personnel costs, but orders processed and relative computer equipment expenditure listed in paragraph 7.25 of the OECD TPG are also referenced as appropriate allocation keys in specific circumstances. An allocation key based on profitability is not likely to be considered arm's length, however.

Shareholder Services

Shareholder activities are not considered group services, to the extent they do not add economic or commercial value on behalf of group entities and to the extent a group entity would normally not be willing to pay for those activities. Shareholder activities should not be remunerated by other group entities, according to the new TP Decree.

The new TP Decree provides a (non-exhaustive) list of activities that are considered to qualify as shareholder activities:

1. Activities relating to the legal structure of the entity itself:

1.1 Execution of the requirements applicable pursuant to Book 2 of the Dutch Civil Code.

- Organizing, preparing and holding of the shareholder meeting;
- Activities related to the preparation and approval of the annual accounts and deposition thereof with the Chamber of Commerce;
- Activities of the Supervisory Board to the extent they regard the performance of regulatory supervision;
- Activities of the Works Council.

1.2 Execution of the General Tax Act, to the extent it regards tax obligations of the entity itself:

- Keeping an administration;
- Complying with the (administration) retention obligation;
- Filing tax returns;
- Compliance with the obligation to provide information.

2. Activities that are related to the placing/issuance/splitting of shares of the entity itself, or comparable securities on the capital market plus activities related to the filing for and maintaining of a stock exchange listing of the company itself:

- Meeting the stock market admission requirements;
- Activities that relate to the stock exchange listing such as preparing the forms that the US Securities and Exchange Commission provides for purposes of the listing, making available the annual accounts and annual report etc.;
- Membership of associations and other institutions that represent the stock exchanges.

3. Activities that are related to the implementation and enforcement of laws and regulations regarding the supervision of share transactions:

- Introduction and maintenance of a registration system based on the Financial Supervision Act;
- Reporting of share transactions by personnel of the entity pursuant to the same Act.

4. Activities that are related to the implementation of and compliance with legal requirements and rules of conduct related to corporate governance of the entity itself — e.g., implementing legally prescribed corporate governance supervision including the inclusion of a paragraph on this aspect in the annual report.

5. Activities that are related to reporting to diverse stakeholders regarding the entity itself or the group as a whole, press conferences and other

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[5] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*.

[4] The threshold to using cost is high. Not only is there discretionary authority for the tax authorities to accept it, that authority only comes into play provided (all of) the following factors are satisfied: the services in issue are not a principal activity of the associated enterprise, the profit element is not relatively significant and direct charging is not possible as a basis for determining the arm's-length price.

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cost of communication with shareholders and other stakeholders such as financial analysts and to the extent the communication regards external reporting, financial results, and future expectations of the entity itself or the group as a whole.

While previously Environmental, Social, and Governance (ESG) reporting was listed as a shareholder service, its removal from the list indicates that the related costs may require an allocation to the respective group entities. Considering the rising importance of ESG reporting and the EU Corporate Sustainability Directive that will become effective as of 2023 and require ESG measuring and reporting, there is likely to be a significant outflow of costs for compliance in this respect, separate and apart of the required investments in strategic reorientation and possible business transformations this may require. It looks like the DTA is foreshadowing that these costs ought to be allocated and charged out to group entities.

Blended Services

The new TP Decree also acknowledges that there may be so-called blended activities, which can be considered partly as shareholder services and partly as group services. For example, it mentions activities related to consolidation, mergers and acquisitions, and the introduction of and compliance with corporate governance rules, as well as activities of the Management Board and the Supervisory Board. For these activities, the qualification as group service or shareholder service can be made based on any method that would lead to an arm's-length result.

An example of a consolidation activity referenced in the new TP Decree is the use of a management information system to compile all group entity results. The collected data is used for budgeting decisions, management and evaluation of the group entities and for preparing quarterly, midyear, and annual consolidation overviews that serve for preparing the annual accounts. The latter, preparing periodic consolidated figures of the (holding) company, can be considered a shareholder activity. The organization and management of the management information system and processing of information to manage the group companies qualifies as a group service, however, making this a blended activity.

Another example regards a division of a European headquarters company that is engaged in mergers and acquisitions. The group is in need of an additional production site, and the M&A division is tasked with analysing which companies in what European countries would qualify for a potential takeover by the European headquarters company. The M&A division analysis is considered an activity conducted in the capacity of shareholder and does not merit a charge-out to group companies, according to the new TP Decree.

The same M&A division next analyses which companies on what continent would be suitable for a takeover to increase market share in that continent. The analysis results in the takeover of a company by a regional headquarters company based in Continent X. This is considered a group service to the regional headquarters company in Continent X (not being Europe) for which the European headquarters company needs to be remunerated at arm's length.

Next, the M&A division provides an acquired company assistance with the legal implementation of the merger (such as de-listing from the stock exchange, adjusting to the corporate identity of the group, and arranging and executing personnel changes). This assistance adds economic and/or commercial value to the acquired company for which an unrelated party in similar circumstances would have been willing to pay, according to the new TP Decree. Therefore, this qualifies as a rendered group service that needs to be compensated at arm's length.

Simplified Transfer Pricing Method for Services

The simplified method for low-value-adding services allows for the use of a 5% mark-up on relevant costs of qualifying services, provided it is substantiated with appropriate documentation and the costs are allocated to group entities based on an appropriate allocation key.

The simplified method also applies a simplified and more limited benefit test from the perspective of the recipient of the relevant services. The recipient needs to substantiate the benefit of certain categories of services more generally.

The criteria for and examples of these low-value-adding services are included in paragraphs 7.45–7.49 of the OECD TPG.

The DTA will normally test based on the benefit test whether a service was actually rendered and the remuneration is appropriate. In the event the simplified method is applied, the DTA will apply a pragmatic approach in testing whether remuneration is appropriate. The benefit for the recipient of the service will only need to be generally substantiated and does not have to be reduced to individual transactions. Similarly, the fixed profit margin does not need to be substantiated by a comparability analysis. The conditions formulated in the OECD TPG regarding appropriate documentation (paragraph 7.64) and the appropriate manner of calculation of the amounts to be charged (paragraphs 7.56–7.58) do need to be complied with, however.

The new TP Decree confirms that the DTA will consider a charge of the relevant costs with a 5% mark-up through an appropriate allocation key as be-

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ing at arm's length. The cost base should include direct costs and indirect costs that are related to the relevant support services and includes overhead costs. Special charges, such as reorganisation costs, etc., may need to be included as well. Which costs can be considered relevant depends on the functional analysis that forms the basis of the taxpayer's transfer pricing system.

To illustrate when the simplified method will and will not apply, a few examples are provided:

- One example regards a group, engaged in rendering legal advice on a commercial basis that has an associate of one of the group entities render advice on local legal aspects to a foreign group entity which itself is involved in advising a client on an international transaction. This activity is considered as material and part of the core business of the group. It also regards advice that is provided more than incidentally to unrelated parties. Therefore, the simplified method does not apply to this activity.
- Another example regards a legal department of a bank that is intensively involved with the design of a financial product that another group entity will offer to customers. The assistance provided is considered to add more than marginal value to the primary business processes of the group. Therefore, the simplified method cannot be applied to this activity, as it adds material value to the group.
- Where a help desk is solely engaged in answering questions of co-workers of different group companies regarding the functioning of the computer system and resolving small user problems, the assistance provided is not considered as a primary business process and does not provide more than marginal value to the primary business processes of the group. Here the simplified method with a 5% margin is applicable.
- A department of a group that exploits an international chain of hotels is engaged in the implementation and maintenance of a computer application with which the booking system, invoicing and inventory system are automated. While these activities are not likely to qualify as primary business processes, they are considered to add more than marginal value to the primary business processes of the group. As a result, the simplified method will not be applicable to determine the arm's-length remuneration for these intercompany services.
- Finally, an entity that functions as a contract manufacturer within the group produces semi-finished products is considered. These type of production activities generally belong to the primary business processes of the group. In addition, these activities tend to constitute an absolute or relative part of the total activities of the group. While the added value of this activity can be marginal, that does not mean that the activity can be considered as a supporting activity. The simplified method cannot be applied for this activity.

Contract Research and Contract Manufacturing

In the event of contract research and contract manufacturing, according to the new TP Decree, cost-based remuneration may be considered as being at arm's length. For transfer pricing purposes, the transaction will first need to be characterized based on the principles laid out in (paragraph 2 of) the new TP Decree, however.

Remuneration determined on a cost basis qualifies as arm's length in case the performance of contract research or contract manufacturing activities are performed by party A and the research or manufacturing activities are managed by party B, which incurs the costs and risks and becomes the economic owner of the developed assets or produced products. Furthermore, party B needs to have control and perform control activities in relation to the risks incurred and have the financial capacity to assume the risks. An analysis hereof must be based on the specific facts and circumstances of the case at hand.

Management of research activities and control over risk is determined by aspects such as the decision-making, planning, budgeting, performance measurements, remunerating, adjusting/redefining work responsibilities, determining of commercially valuable areas and assessing the chances of (un)successful research. The new TP Decree provides two examples to corroborate when a cost-based remuneration would be acceptable and at arm's length.

COST SHARING

The new TP Decree elaborates on cost sharing agreements, with four separate examples based on research and development. In essence, the message is that the remuneration for activities undertaken as a cost sharing participant in a cost sharing arrangement should not materially differ from the remuneration earned when the cost sharing participant would be collaborating outside of such arrangement. The principles set out in Chapters I and IV of the OECD TPG continue to apply. A cost sharing participant who takes on risk ought to be able to control those risks

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and have financial capacity to carry the negative consequences of such risk. A cost sharing participant who only provides for funding and manages risks related to the funding but not any other risk will generally only be allocated a funding-related return considering the financing risks involved (i.e., a risk-adjusted return).

Each cost sharing participant's relative share of the arrangement needs to match such participant's relative share in the expected benefits of the arrangement, and this share needs to be calculated based on market value. Where the DTA previously provided that cost sharing without a profit margin would be acceptable if all participants' contributions could be considered to be of equal value, that provision is now deleted. In other words, a profit margin is expected to be included. Some countries do not accept the inclusion of a profit margin but do accept that a fee is charged for the capital associated with the cost sharing activities. This will be acceptable for the DTA provided the outcome is at arm's length.

The new TP Decree confirms that when evaluating cost sharing arrangements, the tax authorities need to account for the fact that transfer pricing is not an exact science. Nevertheless, taxpayers are required to substantiate that unrelated parties in comparable circumstances would enter into similar agreements.

The new TP Decree provides four (previously provided) cost sharing examples (and eliminates an example) in which two unrelated parties enter into a cost sharing agreement where they intend to jointly develop a product. The results of the cost sharing agreement will be such that each of them gets the exclusive ownership of the relevant rights for their respective jurisdictions. The examples assume that both parties contribute to the cost sharing agreement in equal measure of cost/value. The DTA therefore concluded that the cost sharing activities could be conducted on a cost basis by each party. Consistent with other parts of the new TP Decree, all references to remuneration at cost have been removed and reserved for exceptional situations, indicating that a chargeout at cost will not be tolerated unless exceptional circumstances exist.

GROUP PROCUREMENT

Central procurement often leads to synergy benefits. Commercial arguments for central procurement include cost savings (bundling of purchasing power and purchasing expertise) reducing the necessary working capital and improving product quality. This is often accompanied with the desire to set up a central procurement office close to the market where the relevant products are sourced.

Central procurement activities can vary from supporting activities to purchasing activities that can be considered a core group function. Therefore, the functional analysis will need to consider the relative importance of the procurement function within the value chain of the group. Also to be determined is what parts of the group perform the respective procurement activities.

Procurement functions of a routine nature will incur little risk. This includes selecting potential suppliers, (local) coordination with suppliers, quality control of the purchases, and arranging transportation and other logistics activities. In practice, these activities rarely, if ever, trigger price or inventory risk. The new TP Decree confirms that on occasion the activities can include more complex characteristics, and that the determination of product assortment (considered as a separate function) can be involved.

After the functional analysis, the question arises what transfer pricing method can be considered appropriate to determine an arm's-length fee for the activities performed. This fee can vary from a routine fee (based on operational costs or a fee related to the purchasing value) for routine activities to a transactional profit-like fee if the activities can be considered a core function.

According to the new TP Decree, local purchasing agents will mainly perform supporting functions. In general, they are remunerated with a fee based on the purchasing value. The percentage of the fee is expected to increase to the extent the agent has more responsibilities, and to decrease to the extent the purchasing volumes increase. In practice it turns out to be challenging to find comparables based on purchasing value, however. Therefore, the new TP Decree announces that the DTA will choose the TNMM in such situations as a reference to determine the arm's-length nature of the fee. The cost base will in those cases be limited to the operational costs of the procurement office. The cost of goods sold is not considered part of that basis.

Furthermore, to the extent that the group realizes an increase of purchase discounts as a result of the centralized procurement function, this benefit will in principle not be allocable to the centralized procurement office. It will need to be allocated to the divisions of the group that make it possible for the procurement office to achieve such discounts. Only to the extent that extra discounts are obtained as a result of specific knowledge and skills of the procurement office, will allocations to the procurement office be considered arm's length, and requirements for substantiation that such is the case should be expected.

SUMMARY FINDINGS

The guidance on services in the new TP Decree is pretty much consistent with the OECD TPG and with

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previous guidance. What does appear material is that references to group services rendered at cost appear reserved for exceptional situations and likely will require persuasive substantiation. This also applies to the part of blended services that are not shareholder services, to contract research and contract manufacturing and to cost sharing. Furthermore, as ESG reporting is removed from the list of shareholder activities, it appears that (part of) such cost could be allocated to the respective group entities.

As to procurement services, the new TP decree underscores that whoever renders those services should not necessarily be allocated synergy benefits or the benefit of volume discounts. Anyone wishing to so allocate should expect to have to substantiate why that would be arm's length.

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