

Amendment of the Transfer Pricing Decision, application of the arm's length principle and the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) of 30 March 2001, No. IFZ2001/295M. Revised decision.

**International Fiscal Affairs Department/Multilateral affairs division**

**Decision of 21 August 2004, No. IFZ2004/680M**

**The State Secretary of Finance has decided the following.**

In the past years in monitoring multinational enterprises the Tax Administration has seen that the tax policy with respect to internal transfer prices is unclear with respect to certain points and that the OECD Guidelines could be worked out in more detail. Therefore, I have now decided on the following measures in order to clarify points and, within the scope of the OECD Guidelines, to permit a more flexible approach. This decision supplements the decision of 20 March 2001, No. IFZ2001/295M (the "Transfer Pricing Decision") and amends it with respect to certain points.

This decision replaces the decision of 16 August 2004, No. IFZ2004/653M. The latter apparently contains two inaccuracies. The first is found in section 2, "Support" services, third paragraph, second sentence, under i). The word "and" placed between the two conditions mentioned there is used incorrectly for "or". In addition, in the fifth paragraph, first sentence, under i), the word "or" has been incorrectly used for "and". The decision of 16 August 2004, No. IFZ2004/653M is therefore revoked.

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**1. Intra-group services and shareholder activities**

Section 6 of the Transfer Pricing Decision states that under the arm's length principle an intra-group service is rendered when an activity that adds economic or commercial value is performed on behalf of one or more group members and for which the group member or members would normally be prepared to pay. Activities performed in the capacity of a shareholder are not covered by this definition.

The activities listed below are considered to be performed in the capacity of a shareholder and are therefore not considered to be intra-group services. The taxpayer should not charge other group members a fee for such activities. Each category contains examples of the type of activity that falls within the category.

### **List of shareholder activities**

1. Activities relating to the company's own legal structure
  - 1.1. Compliance with Book 2 Civil Code requirements
    - organization, preparation and holding of the shareholders' meeting
    - activities involved in the preparation and approval of the annual accounts and their deposit with the Chamber of Commerce
    - activities of the supervisory board to the extent the activities involve the execution of its statutory supervisory tasks
    - Works Council activities
  - 1.2. Compliance with the General State Taxes Act (Algemene Wet inzake Rijksbelastingen - AWR), to the extent this involves the company's own tax obligations
    - the keeping of accounts
    - compliance with the obligation to retain records
    - the filing of tax returns
    - compliance with the duty of disclosure
2. Activities relating to the placing/issuing/splitting of the company's own shares or similar securities in the capital markets and activities involving applying for/holding a (foreign) stock exchange listing for the company itself
  - compliance with admission requirements for the stock exchange
  - activities relating to the listing on the stock exchange, for example filling in the forms that have to be provided to the American SEC in order to be listed on the exchange, provision of the annual accounts and annual report (for free), etc.
  - membership in the associations and other organizations that represent the stock exchanges
3. Activities relating to the adoption and enforcement of the statutory rules on the supervision of share transactions
  - adoption and maintenance of a system of registration under the Securities Transactions (Supervision) Act 1995 (Wet Toezicht effectenverkeer 1995)
  - the notification of share transactions carried out by the company's personnel under the above law.

4. Activities relating to the adoption and enforcement with statutory rules and rules of conduct with regard to “corporate governance” by the company itself or the group as a whole <sup>1)</sup>
  - the introduction of corporate governance supervision as required by legislation and regulations, including the incorporation of a section on this topic in the annual report
  - reports/communications on environmental policy, social policy and policy with regard to sustainable business practice

1) The group as whole consists of the company itself and direct and indirect subsidiaries.

5. Activities relating to reporting to various interested parties with regard to the company itself or the group as a whole
  - press conferences and other expenditure for communication with the shareholders and other interested parties, such as financial analysts, to the extent the communication has to do with the company’s own external reporting, financial results and future expectations or those of the group as a whole

The above list is not exhaustive. This means that - in accordance with section 6 of the Transfer Pricing Decision and Chapter 7 of the OECD Guidelines - a determination will have to be made in each case for activities not included on this list whether intra-group services or activities carried out in the capacity of a shareholder have been rendered. Mixed activities are also possible. “Mixed activities” refers to activities that are carried out by a division or some other group of persons operating within the MNE group that can partially be characterized as intra-group services and partially as shareholder activities. Consolidation activities, activities in the field of mergers and acquisitions (M&A) and activities of the supervisory board are examples of mixed activities. In addition, the characterization of the activities as intra-group services or shareholder activities can be made on the basis of every method that leads to a result that is in accordance with the arm’s length principle.

The following examples serve to illustrate situations in which there can be said to activities with a mixed character.

*Example of consolidation activities*

1. An MNE group uses a management information system in which the results of all of the group members are included. The information is used both for budgetary decisions, management and evaluation of the respective group members and for drawing up the quarterly, bi-annual and annual consolidation reports that form the basis for the annual accounts. Intra-group services are rendered in setting up and maintaining the management information system and the processing of information for the management of the group members. With respect to the final drawing up of the periodical consolidated accounts of the (intermediate) holding company based on the information obtained, there can be said to be activities carried out in the capacity of a shareholder.

*Examples of M&A activities*

2. A division of the European headquarters of an MNE group is involved in mergers and acquisitions. The MNE group needs an additional location for production in Europe and the division making an analysis of companies in various European countries that might be suitable for a potential acquisition. The European headquarters will make the acquisition. The analysis of the M&A division is an activity that is carried out in the capacity of a shareholder and therefore no consideration should be charged to the group members with respect to this activity.
3. The M&A division of the previous example is making an analysis of which companies in continent X (not being Europe) might be suitable for a potential acquisition in order to increase market share in that continent. The analysis leads to the acquisition of a company by the regional head office in continent X. An intra-group service on behalf of the regional head office in continent X has been rendered. An arm's length consideration has to be charged for this activity.
4. A division of an MNE group is involved in mergers and acquisitions and is assisting an acquired company with the legal implementation of the acquisition (for example, taking the shares off the market), with making adjustments so that it fits in the group's system and house style and with setting up and implementing a personnel plan. Economic and commercial value is added to the acquired group member as a result of this assistance for which in a comparable situation a third party would be prepared to pay. An intra-group service has been rendered for the group member. An arm's length consideration has to be charged for this activity.

*Certainty in advance*

If desired, certainty can be obtained from the inspector on whether there is an intra-group service on behalf of group members or whether there is an activity carried out in the capacity of a shareholder. Such requests will be considered to be requests to which the Instelbesluit Coördinatiegroep Verrekenprijzen, decision of 11 August 2004, No. DBGB2004/1339M, is applicable. Should the taxpayer want certainty on both the characterization of the activities and the arm's length nature of the transfer price, it may request an Advance Pricing Agreement (see the decision Procedure voor een behandeling van verzoeken om zekerheid vooraf ten aanzien van in grensoverschrijdende transacties te hanteren verrekenprijzen (advance pricing agreements) of 11 August 2004, No. IFZ 2004/124M).

## **2. "Support" services**

Section 6 of the Transfer Pricing Decision states that as a matter of principle there can only be said to be an arm's length consideration for intra-group services rendered if a

suitable profit mark-up is taken into account when the consideration is determined. In practice, such an arm's length consideration for intra-group services is generally determined on the basis of the cost-plus method (in other words, the mark-up is a percentage of the costs) with a cost base made up of the (estimated) direct and indirect costs. In principle, a cost-plus mark-up allows overhead costs to be covered as well as an appropriate profit mark-up to be made.

The basic principle of an arm's length consideration with an appropriate profit mark-up remains applicable. Using a cost-benefit analysis in accordance with sub-section 7.37 of the OECD Guidelines, the Tax Authorities have looked at the intra-group services for which, in principle, the Tax Administration does not have to make an adjustment where the taxpayer chooses to charge all relevant actual costs instead of an arm's length consideration.

The conclusion is that in general services with respect to book keeping, legal affairs, tax matters and personnel may be considered to be such support services. An adjustment will, however, be made in these cases if the Tax Administration makes a reasonable case that i) activities are rendered that make up or which add more than marginal value to the primary business operations or ii) the respective services are performed on behalf of non-associated parties on a more than an incidental basis.

It is conceivable that a cost-benefit analysis in accordance with sub-section 7.37 of the OECD Guidelines might justify the charging of all relevant actual costs instead of the determination of an arm's length price for support services other than the ones mentioned above. Given the complexity of the way in which multinational enterprises are organized, the various ways in which such enterprises are structured and the way they have set up their business operations, it is not possible to make a general statement on which other services could be considered "support" services.

In addition to the above, I therefore permit the Tax Administration, in accordance with sub-section 7.37 of the OECD Guidelines, to allow, at the taxpayer's advance request, all relevant actual costs to be charged instead of an arm's length consideration for support services other than the ones mentioned above, provided the taxpayer substantiates the fact that the activities i) do not make up or add more than marginal value to the primary business operations of the MNE group and ii) are not rendered to third parties on a more than incidental basis. Such requests are considered to be requests to which the Instelbesluit Coördinatiegroep Verrekenprijzen, decision of 11 August 2004, No. DBGB2004/1339M, is applicable.

The Tax Administration decides whether there can be said to be primary business operations based on the standard of the total business operations, whereby the following elements play a role:

- *what is the nature of the activities?*

In general, the following activities are primary business operations: production, purchasing, sales, marketing, product development and other research and development.

- *what is the proportion of the activities within the MNE group?*

The proportionate size of the activities is evaluated on the basis of the scope of similar activities and activities that are directly related to the respective activities performed within the MNE group as a whole. Relevant in this regard are the number of employees involved, the costs involved in the activity, the amount of investment related to the activity (equity and loan capital), or a combination of these factors.

- *what is the added value of the activities?*

#### *Relevant actual costs*

Direct costs and indirect costs relating to the respective support services as well as the overhead costs are among the relevant costs that may be charged. Financing expenditure and extraordinary expenditure (such as severance payments, reorganization expenses and wages in kind) therefore fall under the relevant costs. Which of these expenditures are relevant follows from the functional analysis on which the taxpayer's transfer pricing system is based.

#### *Separate legal entity*

The above holds regardless of the legal entity that performs the support services within the MNE group. This means that no adjustment will be made both in the case all relevant costs are charged for support services rendered within an entity whereby other activities are also performed, and in the case where the support services are rendered by a separate legal entity (in such cases there may be, for example, what is known as a shared service centre).

The following examples serve to illustrate the above.

#### *Examples*

5. An MNE group is involved in the area of providing legal services to third parties. An employee of one of the companies in the MNE group gives advice on local legal aspects to a foreign group member that is engaged in advising a client on an international transaction. With regard to this activity the group member must charge an arm's length consideration because the activities are part of the MNE group's primary business operations. Moreover, the services involved are rendered on a more than incidental basis to non-associated parties.
6. A bank's legal department is closely involved in the structuring of a bank product that will be offered by another group member. The legal department's activity is an activity that adds more than a marginal value to the MNE group's primary business operations. For this reason an arm's length consideration will have to be determined and charged to the other group member. Charging all relevant actual costs will not be sufficient here.
7. A help desk department does nothing more than answer questions of staff members of various group members on how the computer system works, the

software used, and on how to solve minor user problems. The taxpayer must substantiate the fact that these activities are not part of the MNE group's primary business operations on the basis of the nature of the activities, the relative scope of the activities within the MNE group and the value added by the activities and it must also substantiate the fact that the activities do not add more than marginal value to the MNE group's primary business operations. At the taxpayer's request, the Tax Administration will allow all relevant actual costs to be charged instead of an arm's length consideration.

8. An MNE group operates an international chain of hotels. One of its divisions is involved in the setting up and maintenance of a computer application within the MNE group to automate the reservation system, the invoicing and the inventory system. The division's activities are probably not part of the MNE group's primary business operations but certainly do add more than a marginal value to the MNE group's primary business operations. The taxpayer must determine and charge an arm's length consideration for the activity.
9. A company is involved in the manufacture of semi-finished products ("contract manufacturer") under the instructions and for the risk of another group member. These kinds of production activities are, by their very nature, generally part of an MNE group's primary business operations. In addition, the activities, along with similar activities or activities that are in line with them (such as, for example, the principal's production activities) are in general a relevant part of the MNE group's total activities, in both absolute and relative terms. That the added value of the activity may in itself be marginal is thus not a sufficient reason to consider the activity a support service. The taxpayer must determine and charge an arm's length consideration for this activity.

### **3. Contract research**

In certain situations in which a group member A (production company) makes a contract with a group member B (principal company) and develops intangible fixed assets under the contract at the expense and the risk of group member B ("contract research") a consideration using the cost-plus method may be considered to be an arm's length consideration. This is the case if group member A carries out the research activities and group member B manages the research activities, bears the costs and risk and becomes economic owner of the assets developed. Each case must be determined according to the facts and circumstances.

In deciding which company is managing the research activities, the following factors play a role: the decision-making process, planning, budgeting, performance evaluation, consideration, the adaptation/redefinition of spheres of work, the determination of commercially valuable fields and the assessment of the likelihood of the research being successful or unsuccessful. In deciding who bears the risk, the contractual terms will, in

principle, be followed, unless the risk is not apportioned in line with the functions performed (for example, the principal does not have the expertise to manage the risk that the contractual terms assign it by means of management or the principal has too little equity capital to bear the financial risk the contractual terms assign it) or it is evident that the contractual terms are not in accordance with the functions actually exercised. In any case the company's consideration must be determined in each individual case on the basis of the functions performed, taking into account the risk borne and the assets used. Moreover, attention must be given to whether the principal company is financially able to bear the risk and whether it has the expertise to adequately manage such risk. The following examples serve to illustrate this.

### *Examples*

10. An MNE group has its headquarters in country X. The MNE group is involved in the production and sale of consumer goods. In order to maintain and, if possible, improve its market position, on-going research is being carried out on how to improve existing products and develop new products. For this reason the MNE group has two R&D centres, in a separate company, established in country X (R&D X, as part of the headquarters) and in the Netherlands (R&D NL). The research programmes for the MNE group as a whole are – after strategic decision-making by the MNE group's management – are set up by R&D X. R&D NL is then put to work – on the basis of separate contracts – to carry out part of the research programme. R&D NL has to present the detailed plans for projects with respect to its share in the research activities to R&D X. R&D X has approval of the plans and the budgets for them. Even when R&D NL has suggestions with respect to changes in the research programme and/or plans for projects that have already been approved, its suggestions must be explicitly presented to R&D X. R&D NL reports back regularly to R&D X on its progress with regard to the research and whether the budgets have been used up. If the budgets are exceeded, R&D NL has to ask R&D X for additional financial resources. Not every research activity is successful. The contractual terms between R&D X and R&D NL provide that all risk related to R&D NL's development activities are at the expense and risk of R&D X. R&D X is the economic owner of all legal and economic rights arising from the research. R&D X has sufficient equity capital to bear the financial risk that is connected to the research. R&D X pays R&D NL a fee that is determined on the basis of the cost-plus method.

*Conclusion:* R&D NL's functions are limited to carrying out R&D activities. These activities are carried out on the instructions and under the management (including control and decision-making) of R&D X. The risk related to the R&D activities is borne by R&D X. R&D X is financially capable of bearing and managing the risk and it has the expertise to do so. The activities of R&D NL are correctly considered to be contract research. In this case application of the cost-plus method results in an arm's length consideration.

11. An MNE group has its headquarters in country X. The MNE group is involved in the production and sale of consumer goods. In order to maintain and, if possible improve its market position, on-going research is being carried out on how to improve existing products and develop new products. The R&D activities with respect to the A line of products are conducted in the Netherlands in a Netherlands company (R&D NL). The European headquarters and sales activities also take place in this Netherlands company. R&D NL operates completely independently, within the framework of the strategic decision-making of the management of the MNE group.

Company Y is also part of the MNE group. Company Y is established in country Y. Company Y has two employees, both of whom have an administrative and financial background.

R&D NL and company Y have made a contract for an indefinite period of time with respect to R&D NL's R&D activities. Not all of the research activities are successful. The contractual terms between company Y and R&D NL provide that all risk related to R&D NL's development activities are at the expense and risk of company Y. Company Y is the owner of all legal and economic rights arising from the research. Company Y has sufficient equity capital to bear the financial risk related to the research. Company Y pays R&D NL a fee that is calculated on the basis of the cost-plus method.

*Conclusion:* the functions of R&D NL include the whole of the R&D activities (from decision-making on the research to be done to the carrying out of the actual research itself). R&D NL thus independently manages the R&D activities. The contractual terms provide that the risk related to these R&D activities is to be borne by company Y. Company Y does not, however, have sufficient expertise to manage the risk that it has to bear. In actuality R&D NL manages the risk, meaning that the risk also has to be attributed to R&D NL. Therefore, based on the factual circumstances, it cannot be said that R&D NL is conducting contract research activities, and consequently in this situation the application of the cost-plus method to determine the consideration for R&D NL does not result in an arm's length consideration.

#### **4. Cost Contribution Arrangement (CCA)**

Section 7 of the Transfer Pricing Decision has given cause for discussions on whether this section is in accordance with Chapter 8 of the OECD Guidelines (CCAs). In order to prevent the possibility of a lack of clarity and of misunderstandings, Section 7 of the Transfer Pricing Decision is hereby revoked. Instead, guidance should be sought with respect to CCAs in the arm's length principle as elaborated in the OECD Guidelines and in particular Chapter 8 of the OECD Guidelines. The arm's length principle entails that the consideration must be in relation to the functions performed (taking into account the risk borne and the assets used). This means that the amount of the consideration for

participants in a CCA may not (in essence) be different from the consideration that the enterprises in question would receive if they were to cooperate in a non-CCA framework, with the exception of the possible synergetic advantages that they achieve through their CCA cooperation.

Chapter 8 of the OECD Guidelines prescribes that the proportionate share of each participant in the overall contributions to a CCA must be consistent with the proportionate share of the overall expected benefits. In practice, whether this is the case has to be determined on a case-by-case basis. In the Netherlands view, the arm's length principle entails that both the proportionate share of each participant in the overall contributions to a CCA and the proportionate share of that participant in the overall expected benefits are determined on the basis of the market value. Nevertheless, if it can be shown that the average proportionate added value of the individual contributions that the various participants make to the CCA is about the same, it is consistent with the arm's length principle to use the cost price of the contributions as starting point in determining whether each participant's share in the overall expected benefits is in accordance with each participant's share in the contributions. On this point, see example 16 below. If the interested parties choose to allocate the expected benefits on the basis of the cost price of the contribution, this will have to be substantiated, in order to show that the average proportionate added value of the participants' contributions is the same.

The final paragraph of section 7 of the Transfer Pricing Decision dealt with the situation in which some countries do not accept the charging of a profit mark-up, although they do accept the charging of remuneration for the capital used for those activities. Both methods can lead to the same result. Although section 7 of the Transfer Pricing Decision has been revoked, it is acceptable for Netherlands tax purposes to choose a method based on the acceptability for certain countries of the amounts charged, provided the result is in accordance with the OECD Guidelines.

Below a number of examples of CCAs with respect to R&D activities are given to illustrate the above premises<sup>1)</sup>.

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1)

For simplicity's sake, no account is taken in the examples of the differences in timing of the contributions of each participant. In a business relationship, when determining the valuation, account would be taken of such differences, to the extent relevant for the value of the contribution. This means that in practice attention has to be paid to this aspect in the determination of an arm's length price where a CCA is agreed between associated parties.

### *Examples*

12. The headquarters of group member A is located in continent A and the headquarters of group member B is located in continent B. Both are involved in the production and sale of group member products. Both have an R&D centre. The MNE group decides to do research on the development of a new product. The market outlook for the product is good, but major research has to be conducted before the product is ready to be produced and sold. The product has market potential in continent A and in continent B.

Group members A and B agree to conclude a cost contribution arrangement on carrying out the necessary research. A provides research capacity and the initial development results and B provides knowledge, know how and researchers. A and B agree on a number of points in time at which group members A and B will make decisions together on the next phase of the project. The ratio of the market value of A's contribution to that of B is 1:1. The overall expected value of the product development is the same in continent A as in continent B. A and B agree that each of the participants will bear the costs of its own contribution. In addition, group member A will be both legal and economic owner of the product development with regard to continent A, and group member B will be legal and economic owner of the product development with regard to continent B. The strategic planning of the project and the management (including control and decision-making with regard to the project) will take place on the basis of equality.

*Conclusion:* The cost contribution arrangement leads to an arm's length result. Both A and B can be considered to be participants in the CCA because in exchange for their contribution both participants receive an interest in the rights that are developed, an interest, moreover, that they can exploit (see sub-section 8.10 of the OECD Guidelines). Finally, the proportionate share of both participants in the contributions is equal to the proportionate share of the expected overall benefits (in other words, in the rights to be assigned to the participants).

13. Group member A is involved in the development, production and sales of consumer goods in continent A. Group member A has conducted the initial research on the feasibility of developing a new product. Its 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 markets in continents B and C. Group members B and C are involved in developing, producing and marketing similar products for markets in continent B and C.

Group members A, B and C decide to conclude a cost contribution arrangement in order to carry out the research needed to develop the new product. In order to ensure that the development of the product is successful, the following is agreed:

- *all parties will make an equal contribution:* setting up a research programme and making decisions during the phases identified in the research programme to be used to check the progress of the project (strategic project planning and management (including control and decision-making)).
- *contribution by A:* Results of the initial research. Costs for the development: € 1 million. Market value of the research results: €2 million.
- *contribution by B:* capacity for development activities (personnel and fixed assets). The estimated costs with respect to the development capacity are €1.8 million. If such development capacity were to be hired from third parties on the basis of contract research, it would cost €2 million (= market value).

- *contribution by C*: liquid resources in the amount of €2 million for anticipated additional expenditure (purchase of materials from third parties and hiring of third parties).

The participants agree that each of the participants will bear the costs of its own contribution. The expected overall benefit from the product development in continent A, B and C is expected to be the same so that the value of the rights arising is expected to be the same for each of the continents. The group members agree that A, B and C will become legal and economic owners of the product development with regard to continents A, B and C, respectively.

*Conclusion*: the cost contribution arrangement leads to an arm's length result. A, B and C can all be considered to be participants in the CCA because in exchange for their contributions the participants receive an interest in the rights that are developed, rights, moreover, that they can exploit (see sub-section 8.10 of the OECD Guidelines). Finally, the proportionate share of the participants in the contributions is in accordance with the proportionate share in the expected overall benefit (in other words, the rights the participants are assigned).

14. Group member A, group member B and group member C are involved in the production and sales of similar consumer goods in continent A, continent B and continent C, respectively. Group member A has an R&D centre. Group members B and C employ a number of product specialists who are also knowledgeable about product development, but they do not have their own R&D centre. Group member A has done the initial research on the development of a new product. The market prospects for the product on continent B and C are good, but major research needs to be done before the product is ready to be produced and sold. The expected overall value of the product development is the same in continent B and in continent C. The product does not seem to be interesting in continent A.

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

- Together, B and C set up a development programme with each contributing equally to the (further) development of the product. In addition, they make the same amount of capacity available with regard to the management of the project (strategic planning and management (including control and decision-making) of the project).
- *Contribution by A*: Results of the initial research. Costs incurred for development: €1 million. Market value of the results of the research: €2 million.
- *Contribution by A*: Development capacity (personnel and capital): The R&D department of A makes a plan for the project and submits it to B and C. The R&D department of A then starts work on the research. In doing so, the R&D department of A regularly reports to B and C on its progress. The costs that are expected to be incurred for this development capacity are €1.8 million.

Market value of the development capacity if the work were done for a client: € 2 million.

- *Contributions by B and C:* each makes a payment to A in the amount of €2 million as the fee for A's contribution. In addition, each bears the burden of half of the additional expenditure paid to third parties (purchase of materials, hiring of third parties) in the amount of €2 million.
- Each of the participants bears the costs of its own contribution.
- B and C are assigned legal and economic ownership of the product development for continent B and continent C, respectively.

*Conclusion:* A is not a participant in the cost-contribution arrangement because A itself does not benefit from the product development (see subsection 8.10 of the OECD Guidelines). A actually sells the initial product development result to B and C in combination with the conducting of contract research activities for B and C. B and C may, however, be considered participants in the CCA because in exchange for their contribution (money and management) they are assigned an interest in the rights that are to be developed, rights that they, moreover, can independently exploit (see subsection 8.10 of the OECD Guidelines). A makes development capacity and the initial product development available having a total market value of €4 million and receives as consideration an amount of €4 million in cash. A consideration like this one is at arm's length. The contribution of both participants in the CCA (B and C) and the expected benefit (the rights they are assigned) are balanced. Although for A the contract cannot be considered to be a CCA, the consideration under the contract can be considered as being at arm's length for all the participants.

15. Group member A is involved in the development, production and sale of consumer goods.

Group member B employs 2 people who have an administrative and financial background. Group member A has done the initial research on the development of a new product. The market prospects are good in continent A and continent B, but extra research has to be done before the product is ready for production and sales. The expected overall value of the product development is the same for continents A and B. Group members A and B decide to conclude a cost contribution agreement under the following conditions:

- *contribution by A:* initial development results and development capacity. Total costs involved: €5 million. Total market value: €10 million.
- B pays A €5 million and 50% of the costs if these exceed the estimated costs of €5 million.
- A and B become economic owners of the product development for continent A and continent B, respectively.
- A becomes the legal owner.

In addition to the terms under the contract, A is to manage the project (including control and decision-making).

*Conclusion:* A's functions include the entire R&D activity (from making a decision as to which research will be done to the actual execution of the research itself). Moreover, A manages the R&D activity totally independently. The contractual terms provide that the risk connected to this R&D activity is 50% at the expense of B (B pays €5 million and 50% of the costs if these exceed the estimated costs and it becomes economic owner of the rights developed). B does not, however, have the necessary functional expertise to manage the risk that it bears in connection with the R&D activity. In actuality, the entire risk is managed by A, so that the whole risk thus has to be attributed to A.

The consideration A receives has to be in line with the functions A exercises and the risk involved in these functions. Because of the fee agreed under the contract with B, A – wrongly – is paid only for its development activities to the extent they do *not* involve management and the risk that management entails. The conditions in the contract between A and B are therefore not at arm's length.

16. Group member A and group member B are involved in the development, production and sale of similar consumer goods in continent A and continent B, respectively. A and B decide to develop a new product together. Their development departments are comparable, in other words the quality level (know how and experience) and the cost structure are comparable. The costs connected to the contributions during the entire development trajectory are in a ratio of 1:1. The expected benefit from the product development in continent A and continent B is also 1:1. A and B decide to enter into a cost contribution arrangement under the following conditions:

- together, A and B set up a research programme with each contributing equally to the (further) development of the product. In addition, they make the same amount of capacity available with regard to the management of the project (strategic project planning and management (including control and decision-making)).
- the participants each bear the costs of their own contribution.
- A and B are assigned legal and economic ownership of the product development on continent A and continent B, respectively.

*Conclusion:* A and B can be considered participants in the CCA because in exchange for their contribution they receive an interest in the rights developed, rights that they can, moreover, exploit (see sub-section 8.10 of the OECD Guidelines). The participants have further substantiated the fact that the average proportionate added value of the performance that they are contributing is comparable. In determining the proportion of each share in the expected overall benefit, A and B may use the cost price of these contributions as the point of departure.

If the average proportionate value added of the performance contributed by A and B were not comparable, for example because A's and B's knowledge and

experience are very different, the cost price of the contributions may not be used as the point of departure for the determination of the proportion of the expected overall benefit, but instead the market value of the contributions should be used.

The examples given above are based on an abstract description of actual situations. In practice, it will be difficult to determine the exact market value of the contributions of the participants in a CCA and to determine the exact market value of the benefits arising from the CCA. When looking at whether the proportion of the expected overall benefits from the CCA may be looked at in relation to the costs that are to be attributed to the participants instead of using the market value of these contributions, it will be difficult in practice to determine whether the contributions of both participants have a comparable proportionate added value. When assessing CCAs in particular, the Tax Administration should take into account the fact that transfer pricing is not an exact science. This does not, however, alter the fact the taxpayers may be expected to substantiate their claim that in comparable circumstances independent parties would conclude a similar agreement.

#### *Transitional measure*

Bottlenecks with respect to the application of CCAs have become evident during the Tax Administrations' control of multinational enterprises. This has led to the decision to revoke section 7 of the Transfer Pricing Decision. The tax treatment of R&D is being reviewed during the discussions on the modernization of the corporate tax and it cannot be ruled out at this point that the outcome of these discussion may have repercussions for the use of CCAs. It is expected that the modernization of the corporate tax will be given form by 1 January 2007. As a result, a situation may arise in which an existing CCA will have to be adapted on the basis of the clarifications in this decision and that this may lead to an adaptation of the conditions and/or transfer pricing system applied by an MNE group. If the corporate tax is modernized, the conditions and/or transfer pricing system used by an MNE group might have to be adapted once again.

I therefore consider it to be fair that the tax treatment of CCAs that existed on 30 March 2001 and which have been approved on the basis of the OECD Guidelines and the then valid supplementary regulations on the interpretation of the arm's length principle, or which should have been approved, will be continued until 1 January 2007. By that date the modernization of the corporate tax system will probably be given form. It goes without saying that, in accordance with the general principles of sound administration, a reasonable term will be granted, as from 1 January 2007, in which the MNE group can bring, to the extent necessary, the conditions and/or the transfer pricing system it uses in line with the regulations.

### **5. Determination of an arm's length consideration when valuation at the time of the transaction is uncertain**

In section 5 of the Transfer Pricing Decision it is stated that when intangible assets such as patents are transferred it may be difficult to determine their value at the time of the

transfer because it is not known what their value will be in the future and what risks will be faced. It is also stated that in certain situations the Netherlands Tax Administration will take the position that it is not good business practice to agree to a flat fee when the valuation at the time of the transaction is highly uncertain. An independent third party would not agree to a flat fee in a comparable situation. In such cases a price adjustment clause must be included in the contract between the associated parties whereby the price is partially made dependent on the income received later on.

To supplement to section 5 of the Transfer pricing Decision, supplementary rules will be given to deal with the specific situation discussed below. In other situations section 5 of the Transfer Pricing Decision remains fully applicable. The supplementary rules entail that where the intangible asset is transferred to a foreign group member and thereafter the intangible asset is largely (i.e. for more than 50%) licensed to the transferring Netherlands company and/or Netherlands-resident entities associated with this company, a price adaptation clause is *deemed* to have been agreed, unless the taxpayer demonstrates that i) there are business reasons for the transaction and ii) the valuation at the time of making the contract was so certain that independent enterprises would not have requested such a price adaptation clause. In other situations the rule that each individual case will have to be examined as to whether an independent enterprise would have requested a price adaptation clause in comparable circumstances remains valid. It should be noted, perhaps superfluously, that a price adjustment clause can result in both an upward and a downward adjustment of the originally agreed price.

In substance, situations in which, after the transfer of an intangible asset to a foreign group member, a Netherlands group member from an economic viewpoint actually pays for the use of the transferred intangible asset, for example where the fee is calculated in the price of a good or service, are seen as being comparable to the previous situations. As a result, the “largely” test above must be applied in the same way.

## **6. Deduction of withholding taxes**

Mixed contracts are sometimes concluded in which a fee for intra-group services and a fee for the making available of an intangible asset (royalty) are paid. In such cases, under a tax treaty for the avoidance of double taxation, the foreign tax authorities may be allowed to withhold tax on the part of the payment related to the royalties. In principle, under tax treaties for the avoidance of double taxation, such withholding tax may be deducted in the Netherlands. In most cases, however, the foreign tax authorities may not levy a withholding tax on fees for intra-group services. Should, in contravention of the tax treaty, a withholding tax nevertheless be levied, the withholding tax may not be deducted in the Netherlands.

A comparable situation occurs with regard to payments under a CCA (contributions, balancing payments and so on). Foreign tax authorities may not levy withholding tax on such payments under a CCA (see sub-section 8.25 of the OECD Guidelines). Should, in

contravention of the tax treaty, a withholding tax nevertheless be levied, the withholding tax may not be deducted in the Netherlands.

In the situations described above in which, in contravention of the tax treaty, withholding tax is levied on intra-group services or on payments under a CCA that are not deductible in the Netherlands, a mutual agreement procedure for the avoidance of double taxation may be requested if the authority involved is not willing to unilaterally step back. It should be noted that the Netherlands actively works to achieve a speedy settlement of mutual agreement procedures for the avoidance of double taxation.

## **7. Entry into force**

This decision enters into force as from today.

## **8. Revocation of decision**

The decision of 16 August 2004, No. IF2004/653M is revoked as from today.