Transfer Pricing as Frankenstein's monster

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1. The investment climate and intercompany transactions

1.1. Transfer pricing as Frankenstein's monster

In an everlasting effort to grow our economy, The Netherlands has over the last 20 years tried to position itself as the country of preference to establish a business. The government has defined scientific research as a main area for economic growth, with a focus on agriculture, industry and services. The government predominantly sees itself in a facilitating role for entrepreneurs by stimulating cooperation between researchers and entrepreneurs.
The stimulation has been done through fiscal incentives in the areas of wage tax, personal income tax[2] and corporate tax by effectively lowering the tax rate for certain activities or alternatively creating timing advantages for instance through accelerated depreciation schemes[3].
It is clear that entities that are involved in the growth motors of the economy will be confronted with transfer pricing as they either buy from or sell goods to related parties in other countries.
When looking at the current transfer pricing regulation you may wonder whether a business process redesign would be an innovative effort that could also stimulate economic growth by reducing the cost of doing business.
As a matter of principle we may ask whether also the government should apply some of the principles of innovation by looking critically at its current transfer pricing processes and see whether it can be replaced with something that achieves similar or better results at a lower cost.
Or to define it in commercial terms: can we add value by business process redesign?
In this article I will argue that the current transfer pricing system has outgrown the Netherlands. It seems like a regular monster of Frankenstein that is nurtured and kept alive by its surroundings. I subsequently will try to come up with a risk based light touch approach for transfer pricing that could be adopted as alternative.

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2 The so-called 30% ruling effectively lowers personal income tax for foreign specialists.
3 DB 2010/103M.

1.2. Business process redesign

A business process design starts with a description of the current state of affairs. I will try to give a description of the main Dutch trade flows, its legislation and administration.
Subsequently I will try to describe what factors are relevant to improve the investment climate. As a third point I will come with some suggestions for approaches for a new design.

2. The current business environment

2.1. Trading partners and economic sectors

Transfer pricing predominantly relates to the allocation of taxing rights between sovereign states.[4] Where there are no economic relations between states, transfer pricing will not be relevant and where the economic relations between states are intensive the allocation of taxing rights is of more importance.
Below you find an overview of the international trading in goods and services from the Netherlands.

2009 Dutch trading volumes in EUR*mln		
	Import	**Export**
Goods	274.020	309.359
EU	*60%*	*75%*
Germany, Belgium, UK, France	*35%*	*40%*
Services	77.994	81.924
EU	*50%*	*60%*
Germany, Belgium, UK, France	*30%*	*35%*

The Central Bureau of Statistics ("CBS") identified in 2009 the 40 most important trading partners of the Netherlands. For goods, the two most important export countries for the Netherlands are Germany (24%) and Belgium (11%). Together with France, Italy, the UK and the US they contribute to 60% of all export of goods. The other 35 countries, important as they are, are only responsible for 40% of export.
Another cut of the numbers shows that the EU contributes roughly to 75% of the export volume of the Netherlands.
Import into the Netherlands shows a much larger share from non-EU countries. Just below 60% of import comes from within the EU. Within the EU the largest importers are Germany (17%), Belgium (10%), France and the UK. The most notable import from outside the EU comes from China (10%) the US (8%) and Russia (5%).

4 Transfer pricing also applies to domestic transactions, relevancy for this article is limited.

Export of services is for 60% to EU countries, within the EU the main trading partners are the UK, Germany, France and Belgium (together 35% of the volume). The largest non-EU importer of Dutch services is the USA (9%).
Import of services comes for 50% from within the EU. The bulk also here comes from the UK, Germany, France and Belgium (together 30% of the volume). The most important provider of services to the Netherlands however is a non-EU country. The US is responsible for 15% of all imported services.
Both export from and import of goods into the Netherlands comes for more than 50% from five sectors: food and livestock, fruit and vegetables, raw materials, oil and chemicals.
When looking at cross-border services it is notable that 65% of exported services comes from transport, professional advisory services and royalties. The three main areas of imported services (that account for 60% of the total) are transport, travel and professional advisory services.

2.2. The taxpayers

Coming up with an estimate on the share of intercompany transactions is difficult without having access to detailed data of individual companies. A rough estimate of the number of taxpayers that are affected can be produced though.

Number of companies relative to the number of employees (2006)	
0 employees	413.765
1-5 employees	229.785
5-10 employees	43.100
10-20 employees	28.245
20-50 employees	18.480
50-100 employees	6.370
100-200 employees	3.225
200-500 employees	2.020
500 + employees	1.340
Total	**746.330**

It is fair to assume that companies that have no employees do not have a foreign operation and therefore no intercompany transactions. Similarly it is realistic to assume that entities that employ less than 20 people will only have a negligible foreign presence.
The group of companies that employs between 20-200 FTE may have foreign operations depending on the sector in which they operate. A construction company with 70 staff will almost certainly have no international presence. A producer of cycling training materials will surely have some sort of presence in a country with more cyclists or hills. These midsized companies obviously also include Dutch subsidiaries of foreign companies. Out of the group of midsized companies a portion therefore will have intercompany transactions.
Out of the group of companies with a size over 200 FTE a substantial number will have an international presence.

In 2006 CBS estimated there were 746.330 enterprises in the Netherlands of which around 28.000 had employed between 20-200 staff members and 3300 employed more than 200 staff members. The number of taxpayers on which transfer pricing legislation has a material impact will presumably not exceed 31.000 and will likely be somewhat less.
Large enterprises account, within the definition of the tax authorities, for around 10.000 taxpayers. This is in the same range that as the number of entities that is reported by the CBS as medium and large sized companies.

2.3. Where to expect transfer pricing issues

On basis of the above data you would expect that interpretation issues on transfer pricing will arise predominantly within the EU, with a focus on Germany, Belgium, France and the UK. In the goods area pricing of agricultural products and raw materials may be the main topic, on the services side transport, professional advisory services and royalties could well be the main areas of attention.
In 2005 the EU Joint Transfer Pricing Forum published a report upon the re-entry into force of the arbitration convention. This report contains the pending Mutual Agreement Procedures (hereafter: 'MAPs') of the Netherlands at year end 2004. For the Netherlands these MAPs were with Germany (11), France (13), the UK (5), Belgium (1) and Sweden (2). The distribution of the MAPs is in line with the trade pattern of the Netherlands (be it that it is notable that relations with Belgium hardly seem to give rise to conflicts).
No details are available of the economic sectors or activities that were underlying these MAPs.
The tax authorities do occasionally give an insight in their focus areas. This may be an indication of relevance. In the past years intra-group loans, head office costs and intangible assets were actively pursued. These focus areas look more like areas where perceived abusive transaction may take place than sectors where important economic activity occurs that require attention.
Currently a lot of effort goes into the self-assessment for tax risks. The authorities are thereby scaling down audits and are not actively involved in topical audits.

2.4. Legislation

Dutch transfer pricing rules come from domestic as well as international sources.

Domestic sources include

- Art. 8b of the Corporate Income Tax Act: this describes the arm's length principle
- Art. 10a, 10b and 10d of the Corporate Income Tax Act limit the deductibility of interest paid to related companies
- IFZ 2001/295 and IFZ 2004/680M: TP Regulations
- IFZ 2004/124M en IFZ 2004/125M: APA and ATR Regulations
- IFZ2010/457M: profit allocation permanent establishments

International sources that are applied are

- "Official" Dutch Translation OECD TP Guidelines (1996)
- EU Arbitration Convention
- Treaties for the prevention of double taxation
- OECD TP Guidelines (2010)
- Report on attribution of profits to permanent establishments (2010)

The legislation from domestic sources is limited in size. It covers a few thousand words in Dutch.
The treaties themselves do not go much beyond a standard text for art. 9 of the OECD Model Tax Convention.
The bulk of the transfer pricing legislation consists of the OECD TP reports. These reports contain hundreds of pages of text explaining all elements of transfer pricing. The material is only available in the English language with the exception of the EU arbitration convention and the translation of the 1996 (!) OECD TP Guidelines.
The size of these reports in comparison to the Dutch legislation is enormous. The Dutch Corporate Income Tax act contains around 34.000 words, the OECD TP Guidelines (2010) and the Report on attribution of profits to permanent establishments contain together around 250.000 words.
When looking at the various sources of legislation also some other aspects catch the attention. For one thing much of the legislation has the character of a principle based guidance to taxpayers and tax authorities. There are very little strict rules like "a margin of 3% is acceptable for back office support services" or "cost of management should be included in integral cost price computations". There is however an overload on principles that may be applied, the reason being that "transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer".[5]
It also should be noted that, probably with the exception of royalties, none of the sectors that were identified as relevant import and export sectors for the Netherlands are dealt with specifically in these rules.

2.5. Education

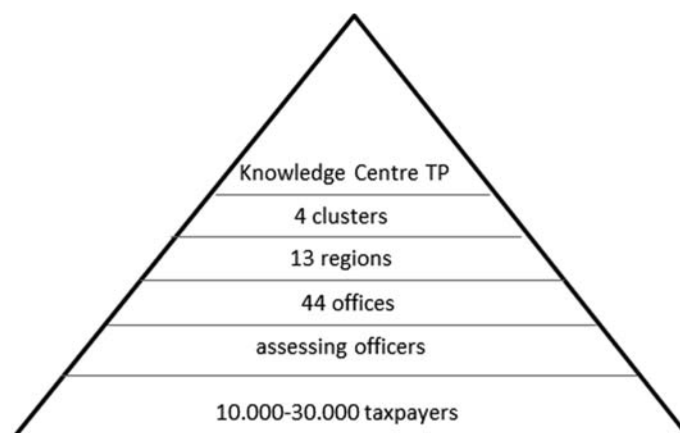
In light of the complexity of the legislation you would expect that there are ample opportunities to obtain knowledge on transfer pricing and the manner the legislation should be applied properly. The opposite is true. The principles of transfer pricing are taught as part of the International Taxation course that university students have to take for the Bachelor or Master program. The legal side of transfer pricing will usually be dealt with in lecture of a few hours. As may be clear from the sheer magnitude of the topic, these lectures will not give any in-depth knowledge. The (financial)

5 OECD TP Guidelines (2010), 1.13.

accounting side of transfer pricing is not part of the curriculum of master students in tax law.

2.6. The administration

The tax system lays the responsibility for the assessment of the taxable income with the tax inspector of the unit where a taxpayer is booked. The proper implementation of transfer pricing is therefore the responsibility of the assessing officer. The tax authorities have divided the country into thirteen regions. A region contains multiple locations. The regions are clustered into four geographic groups.
The regions and clusters do not have a formal assessing responsibility; they are used to achieve coordination within the tax service.
To ensure a coordinated application of transfer pricing rules a "knowledge"-pyramid is created. At the top of the pyramid is a dedicated TP-team. This dedicated TP team, together with representatives of each of the clusters and of the central APA-team are responsible for coordination of the TP-policy.



In order to ensure a trickling down of knowledge to the regions each cluster has at least 6 to 7 linking pins and each of the regions has at least one TP-specialist (and to the extent possible also each of the offices.
ATP-specialist is someone who has at least followed an internal TP-program within the tax administration. This is an annual transfer pricing training program of a few days for 20 inspectors/auditors offered by the central organization. For agents that have completed this training course refreshers are offered annually.

Conflicts between the taxpayer and the tax authorities on the interpretation of the law can be brought forward to the courts. In the Netherlands there are five District Courts that can hear tax cases, appeal is possible with one of five Courts of Appeal and ultimately with the Supreme Court. Judges and other legal staff involved in tax cases will most likely have a good knowledge of the tax law as knowledge of tax law is a prerequisite to be appointed. Economists cannot have become judge without also

being a qualified lawyer. The judges do not specialize in areas such as international taxation and transfer pricing. A system of permanent education requires the judiciary to keep up with developments; the training courses offered to them however do not have any focus on international taxation or transfer pricing. There is an informal knowledge sharing network in place where judiciary staff can share questions/ideas in areas such as international taxation.
The lack of knowledge in the judiciary apparatus may be the reason why there are so little court cases on transfer pricing. It appears that almost all transfer pricing disputes are solved before they come into an appeal stage. This may be a good sign, but can also the signal that taxpayers lack a proper legal protection and therefore try to solve issues out of court.

2.7. The taxpayers

Probably 20-30 Dutch taxpayers employ 1 or more staff members that are dedicated to transfer pricing. These specialists have a good knowledge of the company itself and the business sector in which it operates.

Most other taxpayers will appoint a staff member on the accounting side of the organization as responsible person. They will more likely than not have no specific knowledge of tax law or transfer pricing. These taxpayers have to obtain transfer pricing knowledge externally from one of the large accounting organizations, law firms or specialized transfer pricing boutiques.

2.8. Summary and conclusion

A group of around 10 000-30 000 Dutch companies may be engaged in intercompany transactions. The bulk of this group is medium sized (less than 200 employees). It is likely that the majority of these transactions take place within the European Union and predominantly with group companies in Germany, Belgium, France and the UK. The legislation applicable to these transactions is very complex. The total body of legislation is about 5 times the size of the Dutch Corporate Income Tax act and is to a large extent not available in Dutch. The complexity is such that it is questionable whether any but the 20 largest Dutch taxpayers will be able to apply the legislation without help from advisors.
The remainder of the taxpayers may decide to use external counsels or just take the risk.
The tax authorities have created a knowledge pyramid where on top of the pyramid there are around 10 dedicated transfer pricing specialists. The knowledge of the specialists is drilled down in the organization through internal training programs. The background of the field agents that are not fully dedicated to transfer pricing is such that it may be expected that they will not be able to apply the legislation properly.
Within the judiciary there is no dedicated specialized knowledge on transfer pricing. Judges have a good knowledge of tax law, however no mechanism is available to

develop transfer pricing knowledge. Additionally the judiciary probably lacks specialized economic knowledge to apply the transfer pricing legislation.
The Dutch schooling system does not offer any special training programs in the area of transfer pricing.
The conclusion therefore is that there is a legal system that probably is far too complex for the majority of the intercompany transactions. The legislation is so complex that it will be hard for any but the largest 20 taxpayers to apply the rules properly. At the same time also the tax authorities have far too few trained staff to apply the rules with other than real big companies. The training of judges is so weak that there is not an independent body that can decide with knowledge in case of conflicts.

3. The investment climate defined

The CBS has published a meaty study into factors that could improve the investment climate. The determinants and drivers of economic growth are probably the most important elements to ensure economic growth. Factors like available entrepreneurs, staff and capital are crucial for innovation. Government and infrastructure are according to the CBS factors that are preconditions for economic growth and innovation.[6] The existence of a well-functioning government or a good infrastructure does not create growth and innovation; a weak infrastructure or government, however, may seriously hamper economic growth. Important elements for a good functioning government are the existence of a framework in which obligations and rights are properly defined, a proper control/review of the implementation of the legislation as well as a framework to ensure legal certainty. This should be done in an efficient manner ensuring both the best interest of government and companies.[7] When looking at the infrastructure ICT-infrastructure and schooling are important elements that may be influenced by public authorities as well as private financiers.[8]

4. Transfer pricing redesign

4.1. Would a redesigned transfer pricing system improve the investment climate?

As noted above the current transfer pricing environment is not an example of "good government" because the legislation does not define obligations and rights clearly. It is extremely complex resulting in inefficiency through high costs for taxpayers (and probably tax authorities as well). Legal certainty is questionable for the majority of the taxpayers due to lack of training of judiciary, taxpayers and tax aut-

6 Figures on the investment climate in the Netherlands 2008, Statistics Netherlands, p. 13-14.
7 Het Nederlands ondernemingsklimaat in cijfers 2008, CBS, p. 234.
8 Het Nederlands ondernemingsklimaat in cijfers 2008, CBS, p. 271.

horities. In this respect an effort could be made to improve the investment climate by taking away some of the negative elements of the current system.[9]
The question I would like to raise is if we would have the possibility to overhaul the existing transfer pricing system how we should do this.

4.2. Limitation of the number of affected taxpayers through generic exemptions

One approach could be to limit the number of taxpayers that are actually affected by transfer pricing rules. I estimate that there are between 10.000 and 30.000 entities that are potentially affected. The majority of which fall in the category of small and medium sized entities.
A general threshold for transfer pricing could ensure that the majority of taxpayers will be out of scope for transfer pricing legislation. An example of a general threshold is the thin capitalization rules of art. 10d of the Dutch Corporate Income Tax act. These rules are only applicable if the undercapitalization exceeds EUR 500 000. This effectively leads to a situation that smaller taxpayers will not be affected.
A general threshold could be also structured more subtle by descoping payments made to countries where there is an acceptable tax rate. This approach is very commonly used in legislation around controlled foreign corporations.
Another alternative, as applied by India, is to allow deductions of intragroup payments up to a certain percentage of gross result (or a similar criterion). Anything above that level may be deducted but then documentation requirements apply.
These types of rules are not complex. Each of them could be unilaterally applied by the Netherlands and would potentially lead to exclusion of substantial numbers of taxpayers from the scope of the transfer pricing regulations[10]

4.3. Limitation of affected transactions through published safe harbors

The above mentioned approach is very much focused on the exclusion of taxpayers. An alternative approach is to limit the number of transactions involved by publishing safe harbors.
In the current TP Regulation (IFZ 2004/680M) the option is included to charge part of support costs without a mark-up to group companies. An option could be for the legislator to publish threshold compensation levels that are considered as acceptable transfer prices for certain services or products. As noted above guidance in the areas of transport, professional advisory services, royalties and agricultural products (and group financing) could cover a big part of the transactions between related parties.
I would expect that publication of safe harbors for intercompany loans, royalty rates, head office expenses and low added value services (for instance administration and production) would greatly help to reduce the costs of compliance and review both

9 The CBS report on the investment climate also compares the Netherlands to a peer group of OECD-countries. It is fair to say that the problems noted here for the Netherlands will largely also apply for other OECD-countries.
10 The data required to get confirmation are not in the public domain. The Ministry of Finance should be able to confirm feasibility and effects.

for the tax authorities and taxpayers. It would strengthen the legal certainty and thereby improve the investment climate.

4.4. *Limitation of affected transactions through published country agreements*

The majority of the international transactions in which a Dutch taxpayer is involved is with a limited number of countries. These are the same countries that are parties to be the bulk of the MAPs for the Netherlands. The overall efficiency and quality of transfer pricing rules could be improved if the Netherlands actively seeks to agree on accepted transfer prices with the individual treaty partners or even with the complete European Union. The transfer prices could be published as an addendum to the treaty and ensure a smooth transfer pricing system, which would greatly add to the existing Treaties for Double Taxation.
Germany and the Netherlands could for instance agree and publish a policy that a mark-up of 5% on costs would be an accepted profit margin on selling, general and administrative costs charged between the two countries.
In this light I also would like to point at the opportunity that a Common Consolidated Tax Base could bring. In the proposal as presented by the European Commission there is clarity on the factors that should be used to allocate a common tax base amongst countries in the EU as well as a relative weighting of these factors.[11]
A big advantage of a "per country"-approach is that all agreements are bilateral. Bilateral agreements are much easier to negotiate (in comparison to an OECD-agreement), are less driven by political agendas and can thus focus on the relevant countries or problem areas. Countries could almost act like normal corporations that enter into a joint venture. These corporations also would lay down how they will share the revenues before starting to collaborate. That creates certainty and in the end limits conflicts. For the taxpayer the big plus would be certainty in both countries without going to a lengthy APA-process.

4.5. *Publication of anti-abuse criteria*

A point often raised by taxing authorities when reviewing transfer pricing is the abusive use of transfer pricing by taxpayers. Taxpayers could be using transfer pricing to shift income from high-tax jurisdictions to low-tax jurisdictions. There are no published criteria for abusive behavior. This in practice creates the risk that individual tax inspectors will bring forward self-developed criteria of unwanted taxpayer behavior. These secret individual rules may be a nice and magic weapon in the hands of a tax inspector. It leads to arbitrary rules differing per taxpayer. It thereby creates uncertainty with individual taxpayers and the risk of inequality amongst taxpayers.

11 Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB)COM(2011) 121/4 2011/0058(CNS), art. 86.1 gives an apportionment. The escape clause in art. 86.2 may render art. 86.1 obsolete in practice.

I think a political discussion on the criteria and publication of them would greatly enhance legal certainty. There are obviously multiple ways to tackle anti-abusive behavior. The first step, however, needs to be a clear definition of abuse. Is every payment to a tax haven abusive? How could you define a tax haven? Is the effective tax rate paid by a taxpayer important? Do we think it is abusive to allocate income to countries where capital is employed (instead of labor)? Once the abusive behavior is defined, a next step could be to draft "legislation" or publish policies that are in the public domain.

4.6. Education

As we saw above there is serious worry whether the existing staff of the judiciary, tax authorities and taxpayers are sufficiently equipped to apply the current transfer pricing rules on the bulk of the intercompany transactions. There are full time dedicated specialists with the tax authorities and taxpayers. They seem to work only on or with large multinationals. Even within that group the building up of knowledge may be a challenge.

The knowledge of professionals working with smaller entities is available but presumably rudimentary. When looking at the judiciary it is practically speaking non-existent.

A dedicated schooling program could be a good addition to ensure that the quality of application of the law is improved. Such program could be made available as a Dutch domestic program, for instance as a Master or as an international Master's program offered in the Netherlands or abroad.

5. Conclusion

The current transfer pricing rules and their implementation in the Netherlands are a weak element when looking at the investment climate. The legislation is far too complex for the majority of the transactions it governs which leads to uncertainty when it comes to proper application. The rules also seem vague and wooly, which can lead to legal uncertainty as well.

There may be some simple domestic measures that could take away the pain. Additionally a focus on more detailed bilateral country agreements may not only take away the problem on the Dutch side of the intercompany transaction but on the side of the other treaty partner as well.

Last but not least: the availability of a dedicated schooling program for all parties involved could lead to an improved application of the law.