The Netherlands: deductibility of payments to related companies

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A recent court case demonstrates that contemporaneously written contractual agreements are of the utmost importance

The Amsterdam Court of Appeal recently decided on a case involving the deductibility of damages paid by a Dutch limited liability company ("Dutch BV") to its sister company.[1] The court decided that Dutch BV had not sufficiently made it clear that there was a legal obligation to award damages and consequently denied the deduction of the damages paid to the sister company. There has been little case law in the Netherlands regarding the deductibility of the payment of damages to a related company. This decision shows that in order to benefit from a deduction, contemporaneously written contractual agreements are of the utmost importance. After discussing the decision of the court we will further analyse the role of the arm's length principle in situations where either no written contract is present or where a written contract is incomplete (if there is a gap in the contract). The article argues for a more economical approach to transfer pricing cases where contracts are absent or incomplete.

I. Background facts of the Court decision

The taxpayer in this case, Dutch BV, is a member of a Dutch group that is involved in trading cheese and poultry products.[2] The sister company of Dutch BV, C&D B.V. ("C&D"), exploits a wholesale business in cheese.[3]

On April 25, 2001, Dutch BV entered into a distribution contract with a third party company that owned a chain, which was anticipated to grow to about 800 shops (the "Customer"). The distribution contract determined that Dutch BV was obliged to deliver various cheese products and poultry products to a distribution centre belonging to Customer. Furthermore, the Customer was obliged to purchase a certain minimum amount of Dutch cheese (i.e., 2,590 tons) and poultry products (i.e., 3,560 tons) from Dutch BV each year.[4] The contract determined that damages had to be paid where the Customer did not meet its minimum purchase requirement. Each year it would be evaluated whether the Customer had satisfied this requirement. If not, then the Customer would commit itself to pay Dutch BV an amount of damages equal to 20 percent of the average net purchase value of the not purchased quantity.

Dutch BV did not produce the cheese and poultry products itself, but had agreed with its sister company, C&D, that C&D would deliver the cheese products to the Customer.[5] Dutch BV did not possess the logistical, administrative and internal organisation to meet the demand of the Customer. In addition, Dutch BV did not have sufficient purchasing power in the cheese market to guarantee purchase of the requested specialities at a sufficiently competitive price. Therefore, Dutch BV approached C&D to jointly make the offer to the customer, whereby C&D assured the purchase and made available sufficient logistical and other capacity to adequately supply the Customer.

The Customer intended to sell the cheese and poultry products to shoppers in its sales outlets. The Customer was in the course of a reorganisation of its shops and expected that the demand for cheese and poultry products would grow substantially. During the course of the second half of 2001, it became clear, however, that the Customer was not able to fulfil its

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obligation to purchase the minimum amount of cheese and poultry products. Under the distribution contract with Dutch BV, the Customer would have to pay damages to Dutch BV if it were not able to satisfy the minimum purchase requirement.

Following this, Dutch BV and C&D drew up a written document (dated December 28, 2001) which determined that C&D would be entitled to certain damages to be paid by the Customer. Simultaneously, it was laid down that C&D would – against a one-off compensation of €1,815,120 to be paid by Dutch BV – relinquish its claim to its share of the damages from the Customer. Dutch BV would therefore take over C&D's claim on the Customer against this one-off compensation of €1,815,120.

II. The issue

As a result of its obligation of €1,815,120 towards C&D following the written document of December 28, 2001, Dutch BV deducted the same amount as (extraordinary) business expenses in its tax return. The question was raised whether Dutch BV could deduct this amount.

The Dutch tax inspector took the view that Dutch BV had no legal obligation towards C&D as a consequence of the breach by the Customer of its minimum purchase obligation. The tax inspector argued that C&D was in fact not entitled to the damages to be paid by the Customer. According to the tax inspector, a prudent business person would not grant the damages to C&D so quickly. Hence, Dutch BV should not have agreed to pay any amount to C&D. According to the Dutch tax inspector, Dutch BV had accepted to make the payment to C&D not on the basis of sound business motives but on the basis of shareholder's motives. Since Dutch BV had been profitable in the past, whereas C&D had carry forward losses, it would, from the perspective of the group as a whole (i.e., the ultimate shareholder's interest), be more tax efficient if C&D instead of Dutch BV would benefit from the damages as it would enable C&D to effectively use its carry forward losses. Thus, the tax inspector argued that the amount to be paid by Dutch BV to C&D should not be deductible at the level of Dutch BV.

According to Dutch BV, it was in particular C&D that had suffered losses as a consequence of the fact that the Customer had not satisfied its minimum purchase obligation. Dutch BV argued that similarly, like the minimum purchase obligation of the Customer in its relation to Dutch BV, there was a minimum purchase obligation of Dutch BV in its relation to C&D. Such minimum purchase obligation between Dutch BV and C&D did not stem from a written contract, but was based on an oral agreement. According to Dutch BV, it is customary in the cheese business community to work with oral agreements.

The Amsterdam Court of Appeal (the "Court") decided that Dutch BV was not able to demonstrate that such minimum purchase obligation existed towards C&D. The position of Dutch BV, that it is customary in the cheese business community to work with oral agreements, did not convince the Court. The Court therefore decided that there was no obligation on Dutch BV to pay any amount to C&D. Furthermore, no justification for awarding the damages had been demonstrated by Dutch BV according to the Court. Hence, the award of the damages by Dutch BV to its sister company C&D was considered to be in conflict with the arm's length principle and the payment should be qualified as a distribution of profits, a so-called constructive dividend. Consequently, the payments of the damages to C&D were not deductible for corporate income tax purposes at the level of Dutch BV.

III. The deductibility of damages

A. The deductibility of damages under Dutch tax law

There is not much case law in the Netherlands regarding the deductibility of the payment of damages. As a general principle, in determining the taxable profit of a taxpayer, the costs borne by the taxpayer are deductible.[6] The deductibility of costs cannot be denied by a tax inspector on the grounds that such costs are excessive or could have been avoided. The tax inspector may not interfere with the business decisions of the taxpayer, even if such decisions are unwise. However, if costs are not borne in the interest of the business of the taxpayer, but in the interest of a related person (i.e., a group company or the (indirect) shareholder of the group or a family member of the (indirect) shareholder) then such costs will be non-deductible as a consequence of the arm's length principle.[7] Payments in relation to such costs are considered either a constructive contribution (where the costs are borne in the interest of a lower tier company) or as a constructive dividend (where the costs are borne in the interest of an upper tier company or the ultimate shareholder or its family members). Where a payment by a company to its sister company is considered outside the scope of the company's business interests, then such payment will be treated as a constructive dividend distribution up the chain (from the company up to the ultimate parent company), followed by a constructive capital contribution down to the sister company.

The above also applies to the deductibility of damages paid. In principle, such costs will be deductible (the legislation does not contain a special provision which excludes the deductibility of damages), even if the amount of damages paid may seem excessive or if the payment of damages could have been prevented. If damages are not paid in the interest of the business of the taxpayer, however, but in the interest of a sister company, then such payment of damages is treated as a series of constructive dividend distributions, followed by a series of constructive capital contributions.

B. The relevance of written contracts without gaps

In principle, one might be inclined to think that the relevance of written contracts is limited in order to benefit from a deduction of costs as long as it can be demonstrated by plausible economic reasoning that the costs are made in the interest of the taxpayer and not in the interest of a related party. If such costs are connected to the business activities of the taxpayer

and not to the activities of another company, the deductibility of such costs should not be an issue. However, it appears that, in practice, tax courts attach great weight to proper written contracts which describe in clear terms the responsibilities of the parties.[8] Basically, the tax courts take the view that there is no legal obligation to make payments in the absence of written contractual obligations. Therefore, without proper contracts, the risks of adverse tax consequences (e.g., the non-deductibility of payments made to a related entity) are high.

Very recently for example, in its decision of May 9, 2008 the Supreme Court decided on a case where a loan had been granted by a company to one of its shareholders without a written contractual loan agreement. Subsequently, the company was faced with the non-recoverability of that loan.[9] The Supreme Court decided that to the extent the company granted the loan funds on terms that a third party would not have assumed, the company assumed risks with the intent to serve the interests of its shareholder. The relevant circumstances in order to reach the conclusion that too much risk was assumed by the creditor were the lack of a proper loan contract with its shareholder and consequently the lack of a redemption period and the lack of securities for the company. The Supreme Court held that in those circumstances and to that extent, a loss incurred on a loan is not a business cost; therefore, the loss on the loan was not deductible at the level of the company.[10]

"The "freedom of contract" principle is not unlimited"

C. Gaps in contracts from a civil law perspective

The question arises whether it is correct if the tax courts indeed assume that there is no legal obligation to make payments in the absence of a written contractual obligation. In general, this cannot be correct, since written contractual provisions do not provide all the contract duties: even in the absence of written contractual obligations, legal obligations may still be present under Dutch civil law.

It has to be realised that all contracts contain some gaps. We speak of a gap when the text of a contract addresses certain issues, but fails to address other issues that it is supposed to address. Even the most carefully drafted document rests on volumes of assumptions that cannot be explicitly expressed. The silence of a contract in a specific situation does not necessarily imply a "gap" however: the silence of the contractual provision with regard to a specific situation may imply that the contract does not aim to cover such situation (there is no gap in such situation but a conscious silence). In the Dutch civil law system, when the text of a contract is silent, and such silence is caused by a gap in the contract, then the principles of reasonableness and fairness will determine whether the gap should be filled.[11]

One must realise, however, that the filling of gaps in contracts involves a reconstruction of a private agreement. Filling gaps therefore stands in tension with the so-called "freedom of contract" principle and the related principle of legal certainty. Traditionally, the "freedom of contract" principle was the central principle of contract law. "Freedom of contract" means that the parties are free to decide for themselves to enter into a contract with whom they choose and they are also free to agree on any lawful terms in their contracts. The "freedom of contract" principle is the idea that contractual obligations should ultimately stem from the consent of the parties. Each party will strive to put contractual conditions in the contract that are most beneficial to it. This is not thought to be a problem since the other party is free to decide whether or not it will accept such contractual conditions.

However, this traditional view has been abandoned since the parties are not always so free, especially parties that are not so well informed or economically or socially "weaker" parties, since they may not be able to protect their own interest sufficiently when entering into contractual agreements. Therefore, the "freedom of contract" principle is not unlimited: courts are willing to enforce contract and extend the scope of the contract where terms are missing on the basis of the principles of reasonableness and fairness.

Courts do have to restrain themselves at the same time since far reaching gap filling would affect the legal certainty of contract parties too much. Contract parties will never be certain of their legal obligations if judges take excessive liberty in filling gaps. In determining what the principles of reasonableness and fairness require, the intent of the parties, the actions taken, the nature of the contract, good faith and the expectations of the parties all play a role in determining whether and how the gap in the contract should be filled.

D. The position of tax courts in situations where contracts contain gaps

The reluctance of tax courts to accept a deduction for business costs in the absence of a written contractual obligation is understandable in certain circumstances. For example, taxpayers may sometimes try to abuse the situation where no contract is present or where a contract contains a gap. In the occurrence of unexpected events, for which a written agreement lacks an appropriate special provision, a contract is said to contain a "gap". Taxpayers may try to abuse the conscious silence of the text in a contract; taxpayers may do this by pretending to fill the gap in the contract on the basis of the principles of reasonableness and fairness in such way that tax arbitrage benefits are obtained. For example, the silence of the text of a contract may be abused by interpreting the contract in such a way that it creates a legal obligation to make an excessive payment in such a way that profits are be shifted from a profit making (or high taxed) entity to a loss-making (or low taxed) entity; or by presenting the

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excessive payment as a business cost at the level of one party while the contractual counterparty presents the corresponding receipt as income from an exempt activity (thereby creating a loophole). In such situations the taxpayer is not really applying the principles of reasonableness and fairness in order to fill the gap in the contract. The arm's length principle aims to combat this kind of tax arbitrage.

An example of how a taxpayer dealt with a gap in a contract to take into account an unexpected event is contained in a 2004 decision of the Dutch Supreme Court. This case concerned the situation where a written contract did not provide for potential price adjustments as a result of unexpected circumstances.[12] In this case the taxpayer (a Dutch company) had concluded a written contract with its sister company regarding the sale by the taxpayer of certain participations (which qualified for the Dutch participation exemption) to its sister company. When the participations declined in value after the sale, the decline in value was considered an unexpected event and it was considered unreasonable by both parties not to adjust the price afterwards. Consequently, an amount to correct the purchase price was agreed on and subsequently the taxpayer paid such amount to its sister company. At that time, payments as a consequence of purchase price adjustments of a participation were included in the taxable profits (i.e., a payment, in case of a downward price adjustment, would in principle be deductible at the level of the seller and be taxable at the level of the buyer).[13] However, the deductibility of the payment for the downward price adjustment at the level of the seller/the taxpayer would still be denied if the payment was not motivated by the business interests of the taxpayer but by the interests of the shareholder/the sister company. If there had been a clause in the contract regarding purchase price adjustment which stipulated the payment, then the amount would have been deductible since it is in the business interest of a taxpayer to comply with his legal obligations towards his contract partners.[14] There was no written contractual legal obligation for the seller/the taxpayer to agree with a downward price adjustment (the decline in value of the participations was a consequence of disappointing market conditions which were not addressed in the contract). The taxpayer decided to present the amount paid as a regular business cost for "services" rendered by its sister company. The aim of the parties was to deduct the amount paid at the level of the taxpayer and to treat the payment as a tax free result from the participation at the level of the sister company. The tax inspector found out about this, and it was admitted by the taxpayer that in fact no services had been provided by its sister company. It was admitted that the payment was only made to correct the purchase price of the participation. The Supreme Court did not allow the amount to be deducted as a purchase price adjustment at the level of the taxpayer since an unrelated party would never have made such payment if it would not be required by a legal obligation to do so. Hence, the payment was qualified as a constructive dividend distribution up the chain to the shareholders followed by a constructive capital contribution by the shareholders to the sister company.

Although the reluctance of tax courts to accept a deduction for business costs in the absence of a written contractual obligation may be understandable in certain circumstances due to the risk of dishonest taxpayers, trying to exploit tax arbitrage opportunities, it must be realised that it is the duty of the tax courts to apply the arm's length principle as correctly as possible. Costs that are incurred by taxpayers, not on the basis of written contractual obligation but on the basis of an interpretation of a contract in accordance with the principles of reasonableness and fairness may not be denied deductibility out of fear caused by the dishonesty of a few taxpayers.

In tax cases the courts will be confronted with the question what the principles of reasonableness and fairness require in case a contract contains gaps. Since the requirements of the principles of reasonableness and fairness are, by their nature, uncertain and depending on the particular circumstances, tax courts may be inclined to take the position that taxpayers should go to a civil court with their related contract parties in order to determine what the principles of reasonableness and fairness require in case a contract contains a gap. If a taxpayer and its related contract party do not go to a civil law court in such situation, then the tax courts may, just like the Court in the case of Dutch BV and C&D, consider payments made by such taxpayer by definition not in accordance with business motives and deny the deductibility of such payments.

This is a bizarre situation: related companies, having a high level of mutual trust and a good relationship, that want to fix gaps in their contracts in a reasonable way, will be forced to sue each other or otherwise be confronted with unexpected transfer pricing issues.

In order to fix this awkward situation, relying just on the principles of reasonableness and fairness is not sufficient in case the contractual agreements contain gaps. In such situations taxpayers should not be forced to go to a civil law court in order to avoid transfer pricing problems. We argue that contracts containing gaps or oral contracts should be filled by fully reconstructing the contractual arrangement. In order to achieve this, a so-called functional analysis should be applied; a functional analysis may be used to determine how the gap would have been filled under arm's length conditions.

Hereafter, we will discuss this approach, whereby we will further elaborate on the case of the damages paid by Dutch BV to its sister company C&D.

IV. Transfer pricing analysis: reflection on OECD guidelines

In the case at hand, whereby Dutch BV made a payment to C&D, the Court ruled that the written document of December 28, 2001, (the distribution agreement) did not contain a written legal obligation for Dutch BV to pay damages to C&D as a consequence of the breach by Dutch BV's Customer of the minimum purchase requirement. C&D was not a party in the distribution agreement between Dutch

BV and the Customer. In addition, Dutch BV had not made it plausible, according to the Court, on the basis of which other legal obligation the damages had been attributed to C&D.

The Court did not explicitly refer to and apply the arm's length principle and the OECD Guidelines.[15] During 2001, the year at issue, the arm's length principle was not explicitly codified into Dutch corporate income tax law.[16] However, the arm's length principle implicitly was applicable in the Netherlands through the definition of "taxable profit" in the Dutch tax legislation.[17]

Below, the authors reflect on the case based on the OECD Guidelines.

A. Inter-company transaction at issue

From a transfer pricing viewpoint, the issue should be analysed based on the inter-company transaction between Dutch BV and C&D ("Inter-company Transaction") associated with the third party transaction between Dutch BV and the Customer. The case, however, completely ignored to discuss the inter-company transaction at issue.

The type of inter-company transaction is not clear based on the facts of the case. The following two alternatives are possible:

- inter-company sale of cheese by C&D to Dutch BV. Dutch BV subsequently resells the cheese to the Customer;
- C&D provides purchasing and logistical services to Dutch BV. Dutch BV buys directly from the suppliers.

The taxpayer argues that a minimum purchase requirement existed between Dutch BV and C&D, which corresponds to that between Dutch BV and the Customer, and that not satisfying the requirement will oblige Dutch BV to compensate the damage incurred by C&D. It seems that such a (back-to-back) damage clause is more likely where the inter-company transaction is structured as a buy-sell transaction of goods instead of as a provision of services, since the third party transaction regards a buy-sell transaction.

B.The arm's length principle: would independent parties pay damages?

The application of the arm's length principle to the inter-company transaction at issue is generally based on a comparison of the conditions of the inter-company transaction with the conditions of uncontrolled transactions between independent enterprises. Paragraph 1 of the OECD Model Tax Convention ("MTC"), which contains the following authoritative statement of the arm's length principle, may provide room for the taxpayer to argue that paying the damage to C&D is consistent with the arm's length principle:

> "[When] *conditions are made or imposed* between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Based on the arm's length principle, it is important to analyse whether paying damages to C&D is a condition, which would be made between independent enterprises. Besides the *current* transfer price, the conditions of the inter-company transaction may include, for example, payment terms, delivery terms, termination clause, and perhaps the contingency that Dutch BV may need to pay damages to C&D in case the Customer does not meet its purchase requirement. It should therefore be analysed whether a damage clause would have applied in a similar *unrelated* party setting.

Although the OECD Guidelines do not specifically address the transfer pricing issues relating to paying damages, the following extract of paragraph 1.15 is relevant in this respect:

> "Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive."

The question whether paying damages is appropriate or not should thus be analysed from the viewpoint of both Dutch BV and C&D based on the *options realistically available* to these parties. For example, would C&D have engaged in the inter-company transaction with Dutch BV if a damage clause was not part of the conditions of the transactions and C&D could have entered into other transactions?

> "Functions performed will determine the allocation of risks between the parties"

C. Written contracts

In the case at hand, Dutch BV pointed out that the obligation to pay damages on to C&D resulted from an oral agreement between the parties dated before the taxpayer was acquired by the parent company of C&D. Dutch BV also indicated that such an oral agreement is not unusual in the cheese industry. The question arises whether Dutch BV, in the absence of a written contract, could have a legal obligation to pay the damages on to C&D. In order to determine this, it should be analysed what the principles of reasonableness and fairness require in this case. The outcome of a civil law procedure would be difficult to predict and consequently the Court followed the view of the tax inspector that a prudent business person would not grant the damages to C&D so quickly and would have gone to a civil court to challenge a claim for payment of the damages.

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Thus, the Court placed high significance to a well written contemporaneously written contract. The OECD Guidelines (para. 1.28) indicate that the contractual terms of a transaction will normally describe the allocation of responsibilities, risks and benefits between the parties to the contract. Where there is no contract or other correspondence / communications between the parties, however, the contractual relationships between the parties can be derived from the *conduct of the parties* and *economic principles* which govern relationships between independent companies. In the case at hand, there was neither a written contract nor any other written communication between Dutch BV and C&D available. Hence, economic principles and conduct of parties can be used to determine the contractual relationships between Dutch BV and C&D based on the OECD Guidelines.

Before applying economic principles to determine whether a minimum purchase requirement would have existed between C&D and Dutch BV, it should be examined whether *comparable uncontrolled transactions* are available that support such a condition in the inter-company transaction.

If no reliable comparable data exist, then it can be analysed whether the assertion of the taxpayer that it is obliged to pay damages to C&D *may be expected* between independent parties. The facts of the case are too incomplete to apply economic principles. However, the functions performed, risks assumed, and assets used by the parties are relevant in this respect.[18] Where Dutch BV only orders the cheese from C&D after it gets an order from the Customer (i.e., Dutch BV has flash title), then it could be argued that a minimum purchase requirement would have existed between C&D and Dutch BV. However, where Dutch BV is a fully fledged distributor incurring market risk and inventory risk and employs personnel that can control these risks (regarding the supply of cheese products), then it could be argued that such a requirement would not have existed between C&D and Dutch BV. This also depends on whether C&D has other realistic options available.

D. Disregarding actual transactions undertaken in exceptional circumstances

By disallowing the deduction of the damages, one could consider that the Court basically disregarded one condition of the inter-company transaction between Dutch BV and C&D. The OECD TP Guidelines state that in examining a controlled transaction, the point of departure for a tax administration should be the actual transaction undertaken by the associated enterprises as it has been structured by the associated enterprises.[19] Apart from exceptional cases, the tax administration should not disregard the actual transactions or substitute other transactions for the actual transactions. The question is what constitutes exceptional cases. In this respect, the OECD Guidelines (para. 1.37) provide that there are two particular circumstances in which it may be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer when entering into a controlled transaction:

- where the economic substance of a transaction differs from its form. In such a case, the tax administration may disregard the associated enterprises' characterisation of the transaction and re-characterise the transaction in accordance with its substance; and
- while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

With respect to these two exceptional circumstances, paragraph 1.38 of the OECD TP Guidelines states the following:

> "In both sets of circumstances described above, the character of the transaction may derive from the relationship between the parties rather than be determined by normal commercial conditions and may have been structured by the taxpayer to avoid or minimise tax." In such cases, the totality of its terms would be the result of a condition that would not have been made if the parties had engaged in arm's length dealings. Article 9 would thus allow an adjustment of conditions to reflect those which the parties would have attained had the transaction been structured in accordance with the economic and commercial reality of parties dealing at arm's length."

However, paragraph 1.39 states that associated enterprises may conclude arrangements that are not often engaged in between independent enterprises because of various economic, legal, or fiscal reasons.

> "Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively. In such instances, tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm's length principle."

These paragraphs of the OECD Guidelines show that economic substance and economic / commercial reality of transactions are important issues in transfer pricing.

E. Functions

The description of the functions performed by Dutch BV is limited to the following:

- Dutch BV is engaged in trading cheese and poultry products.

With respect to the functions performed by C&D, the case provides more information:

- C&D is exploiting a wholesale business in cheese;
- C&D has available logistical, administrative and internal organisation to satisfy the need of the Customer regarding cheese;
- according to the written document of December 28, 2001, C&D guaranteed the purchase of cheese and provide sufficient logistical and other capacity to adequately supply the Customer;
- C&D has sufficient power on the cheese purchase market to be guaranteed of the demanded specialty cheese and sufficient competitive purchase prices;

- C&D has reserve capacity for about three years so that Dutch BV could satisfy its supply obligations towards the Customer; and
- it seems that Dutch BV outsourced the supply of cheese to C&D.

The description of functions performed by the parties is limited, but it seems that C&D has the organisation available in order for Dutch BV to satisfy its supply obligation of cheese to the Customer. The OECD Guidelines (para. 1.25) indicate that the functions performed will determine the allocation of risks between the parties to some extent, and hence the conditions of arm's length transactions. One of the conditions may include a damage clause. The information provided is too limited to determine the link between functions, risks and conditions in subject case. Based on the information provided regarding functions performed, however, it seems plausible that the minimum purchase requirement with respect to cheese products is a condition in the transaction agreed between Dutch BV and Customer to "compensate" C&D for guaranteeing the supply of cheese products and committing a logistical, administrative and internal organisation to meet the needs of the Customer. Dutch BV did not seem to possess the organisation to meet the demand of the Customer. In addition, Dutch BV did not have sufficient power on the cheese-purchase market to be guaranteed of the requested specialties and sufficiently competitive purchase prices. Therefore, Dutch BV approached C&D to jointly make the offer to the customer, whereby C&D assured the purchase and made available sufficient logistical and other capacity to adequately supply the Customer.

F. Economic theory

It follows from the above that the following aspects are important in applying the arm's length principle to the case at hand:

- it is important to analyse whether the conditions of the inter-company transaction differ from the conditions which *would be made* between independent enterprises. Besides *current* prices, the conditions of inter-company transactions may include other elements, such as a damage clause. Are comparable transactions available, which support that a damage clause is made between independent enterprises? If not, it could be analysed whether a damage clause would have applied in a similar *unrelated* party setting (based on a prudent business manager). Applying the arm's length principle based on actual transactions is, however, preferable;
- since a contemporaneously contract was not available, the contractual relationships between Dutch BV and C&D could be assessed based upon the conduct of the parties and *economic principles*;
- the question of whether paying damages is appropriate or not should be analysed from the viewpoint of both Dutch BV and C&D based on the *options realistically available* to these parties. For example, would C&D have engaged in the transactions with Dutch BV if a damage clause was not part of the conditions of the transactions and C&D could have entered into other transactions?[20]
- *economic substance* and *economic / commercial reality* of transactions are important to analyse whether a tax administration is able to disregard a condition of the transaction (i.e., damages paid to C&D in subject case); and
- a more detailed functional analysis is needed to determine the consequences for the allocation of risks between the parties and hence the conditions of the transactions.

Hence, economic theory will be helpful in analysing transfer pricing issues. It can assist in describing situations and forecasting how independent enterprises would have acted. In this respect game theory, which attempts to forecast the outcome of a game in which the decisions of each party will affect the decisions of other parties, can be useful in analysing the likely absence and possible amount of damages, if any, as a condition of the inter-company transaction between Dutch BV and C&D. Merely disallowing the damages may not comport to the arm's length principle and may not be consistent with what takes place between *unrelated* parties. *Contract theory*, which examines how economic actors draw up contractual agreements, usually in the presence of asymmetric information where two parties have different information, can also be helpful. A complete contract will describe the rights and duties of the parties for each and every contingency. There are no gaps in the contractual terms. However, designing a complete contract is complex and costly, which will inevitably result in incomplete contracts. In case of a dispute concerning a gap in the contract, the parties should negotiate, go to court, or the default rules in the contract may fill in the specific gap in the contract.

> "Economic theory will be helpful in analysing transfer pricing issues"

The facts of the case are too limited to build a specific economic model. However, the principle is clear: by applying economic theory to re-construct how independent enterprises would have acted, the related parties are basically regarded as hypothetical independent enterprises. This comes down to a hypothetical experiment: economic theory is used to reconstruct the missing contract or the loopholes in a contract by determining what the contractual parties would have decided if they originally had been aware of all possible circumstances that might occur during the lifetime of the contract, but if they had not been aware which party in the contract they would be. Applying re-constructive thinking using a hypothetical original position is not new; the influential political philosopher John Rawls used re-constructive thinking

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in order to determine the principles of justice for a well-ordered society.[21]

The concept of re-construction has been applied in a Dutch Supreme Court case regarding an automotive importer.[22] In this case, the court of appeal based its decision on how a fictitious independent company faced with comparable circumstances as the Dutch automotive importer would have acted.

The case concerned a Dutch taxpayer, a wholly-owned subsidiary of a Japanese parent company, that was engaged in importing and selling automobiles and other engine products (i.e. products *a*, *b*, *c*, and *d*) to independent retailers. The case concerned in particular product *a* (i.e. automobiles) which the Dutch taxpayer purchased from its Japanese parent company. It was the method of business within this multinational enterprise group that the Japanese parent company could take autonomous decisions regarding the transfer prices and the type of products to be purchased by its distributors. The Dutch tax inspector argued that the transfer price for product *a* was not at arm's length, because the import activity of this product was loss-making for the Dutch taxpayer during 1987 and 1997. A benchmarking search was also performed by the Dutch tax authorities to support its view. However, this benchmarking search was not referred to by the court of appeal presumably because secret comparables were used. The question rose whether a fictitious independent enterprise faced with the imposed method of business would have acted differently. Because the Dutch taxpayer was profitable on the entire assortment of product *a* the court of appeal determined that it was neither stated nor shown that at the onset the disadvantages of following this method of business exceed the expected advantages. Hence, the tax authorities could not prove that this method, imposed by the parent company, would have been unacceptable in a hypothetical third party situation. The court of appeal therefore decided in favour of the Dutch taxpayer. The Supreme Court upheld the decision of the court of appeal.

Re-constructive thinking using a hypothetical original position is also on its way in Germany.

In Germany's new transfer pricing regulations, the hypothetical arm's length price concept is introduced in case unqualified or qualified comparable prices cannot be identified. It is expected that the concept of a hypothetical independent enterprise will be used more often in practice by tax authorities in case good benchmarking data is not available or the analysis also concerns conditions of the transaction besides current prices.

Obviously, performing an economic analysis will increase the (administrative) burden of the taxpayer. Furthermore, economic modelling is based on assumptions, which should be substantiated. In addition, it could be argued that applying the arm's length principle based on a hypothetical enterprise (instead of actual comparables) is not appropriate, because it is not based on actual transactions. A caveat against applying economic principles is also that it may involve subjective analyses of realistic options available and the payoffs of the options by tax administrations. However, in the case at hand, Dutch BV did not have a contemporaneous contract, and as such could have benefited from providing more economic support to its claim that a minimum purchase requirement would have existed between Dutch BV and C&D (e.g., based on functions performed, risks assumed and assets used). If possible, it could also have benefited from providing more facts to support that it is customary in the cheese industry to work with oral agreements.

V. Concluding remarks

There is not much case law in the Netherlands regarding the deductibility of the payment of damages. As a general principle, in determining the taxable profit of a taxpayer, the costs borne by the taxpayer are deductible, including damages due. The decision of the Amsterdam Court of Appeal of January 30, 2008 shows that in order to benefit from a deduction for the payment of damages to a related company, contemporaneously written contractual agreements, which create a legal obligation to pay such damages, are of the utmost importance. It seems that the Dutch courts tend to presume that costs are not borne in the interest of the taxpayer's business (but made in the ultimate shareholder's interest) when such costs are paid to a related entity and when there is no contemporaneously written contractual agreement on which the legal obligation to pay damages can be based. However, legal obligations do not only stem from written contractual agreements but can just as well stem from oral agreements. Oral agreements are part of the reality of economic life, especially within groups of related entities where there is a substantial amount of mutual trust and hence less need for written contracts. In fact, one of the benefits of entering into transactions with related entities (as compared to unrelated parties) is the mutual trust and the subsequent savings of transaction costs by relying on oral agreements and mutual understanding.

The strict adherence to written contracts by the Dutch courts is not a correct way of applying the arm's length principle. If the terms of such oral contract are uncertain or incomplete, then the tax courts should not only refer to the principles of reasonableness and fairness since these principles often will not provide enough clarity; the courts should instead use economic analysis, and analyse what would have applied in a similar *unrelated* party setting. In the decision discussed in this article, the Court should have analysed, whether a damage clause would have applied in a similar *unrelated* party setting.

Closely related to the situation where no written contractual agreements are present, is the situation in which a written contract contains a gap. Gaps may create situations where one of the contractual parties may obtain an economically unjustified advantage or disadvantage. Related contractual parties may sooner than unrelated parties agree, in the presence of a "gap", the principles of reasonableness and fairness require one of the contract parties to make a payment to the other party, to settle the balance between the parties. From an arm's length perspective it would be appropriate, in our view, to accept such payment in principle as a business cost. Acting in accordance with

the principles of reasonableness and fairness by related parties should in principle be considered in accordance with the arm's length principle since unrelated parties would generally agree to avoid the situation whereby one of the parties would either obtain an unjustified advantage or disadvantage due to a gap in the contract. In practice it may be very difficult to determine for tax courts what the principles of reasonableness and fairness require. Economic theory provides a helpful tool, also for the courts, in order to determine what exactly would be appropriate between unrelated parties in such situation.

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NOTES

[1] Amsterdam Court of Appeal, decision of January 30, 2008, nr. 07/00111 (published on June 18, 2008).

[2] The Dutch BV forms a fiscal unity for Dutch corporate income tax ("CIT") purposes with its parent company. The shares of Dutch BV's parent company are owned by Beheer B.V. since May 18, 2001.

[3] Beheer B.V. holds all the shares of C&D B.V.

[4] Minimum purchase requirement generally assist in generating standardisation and efficiencies in order fulfilment (order, pick, pack and deliver the products and invoicing the customer). It will increase a company's average order size and assess the validity of a customer.

[5] The term of the distribution contract is until May 14, 2004. The contract will be automatically renewed with a period of one year, unless one of the parties cancel the contract with registered post and in writing at least six months before the end of the contract.

[6] The definition of taxable profit is laid down in article 3.8 of the Personal Income Tax Act 2001 (which also applies to corporate taxpayers): "Profit from an enterprise is the amount of the total benefits, under any name or form, which are acquired from an enterprise."

[7] The arm's length principle implicitly applies through the definition of "taxable profit" in Dutch tax legislation and is also explicitly laid down in article 8b of the 1969 Dutch Corporate Income Tax Act.

[8] M. Wallart and M. van Herksen, *Documenting and Defending Transfer Pricing Policies: The Often Underestimated Role of Contracts*, International Transfer Pricing Journal, July/August 2004, p. 182-187.

[9] Dutch Supreme Court, decision of May 9, 2008, case nr. 43849, VN 2008/23.14.

[10] For more detailed information regarding this court case, please refer to an article by Clive Jie-A-Joen and Jeroen Geevers in the January 2009 issue of this journal.

[11] See article 6:248 of the Dutch Civil Code. Besides the principles of reasonableness and fairness gaps may also be filled by means of provisions in the Civil Code or by customs.

[12] See the decision of February 6, 2004 from the Dutch Supreme Court, BNB 2004/267.

[13] This situation has been changed as of January 1, 2003, when a special rule with regard to price adjustments was introduced to the participation exemption provisions in the Dutch Corporate Income Tax Act 1969. The price adjustment rule determines that if a participation is acquired or sold and the price against which the acquisition or sale took place is adjusted, then the adjustment in the price forms part of the proceeds from the participation for both the buyer and the seller. Consequently, the price adjustment rule achieves a balanced result by symmetrically treating the buyer and the seller: in case of a downward price adjustment the seller cannot deduct the payment it makes to the buyer whereas the buyer cannot be taxed with regard to such payment it receives from the seller (or vice versa in case of an upward price adjustment).

[14] If unrelated parties would have agreed to such a clause.

[15] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, issued in 1995 with subsequent updates.

[16] Effective January 1, 2002, Article 8b Corporate Income Tax Act that codifies the arm's length principle and introduces transfer pricing documentation requirements in The Netherlands came into force.

[17] The definition of taxable profit is laid down in article 3.8 of the Personal Income Tax Act 2001 (which also applies to corporate taxpayers): "Profit from an enterprise is the amount of the total benefits, under any name or form, which are acquired from an enterprise." The Dutch Supreme Court introduced the arm's length principle on the basis of this provision in Dutch tax law with its landmark decision of 31 May 1978, nr. 18 230, BNB 1978/252. The Dutch Supreme Court decided in this case that there should be an arm's length adjustment (resulting in an imputation of interest) if a Dutch taxpayer would obtain a benefit from its shareholder in the form of an interest free loan (since such interest free loan benefit should not be considered "profit from an enterprise" but rather a constructive capital contribution from its shareholder. Therefore, such benefit should be eliminated from the taxable profit of the taxpayer by way of an imputation of interest).

[18] See Section 4.5. of this article.

[19] OECD TP Guidelines, paragraph 1.36.

[20] Paragraph 5.4 of the OECD Guidelines indicates that "The taxpayer's process of considering whether transfer pricing is appropriate for tax purposes should be determined in accordance with the same prudent business management principles that would govern the process of evaluating a business decision of a similar level of complexity and importance."

[21] John Rawls, *A Theory of Justice*, 1999, Harvard University Press. In order to determine the principles of justice of a well-ordered society Rawls sets up an imaginary experiment: he conceives of a hypothetical situation, whereby the members of society are in a so-called original position under a veil-of-ignorance. John Rawls asks us to imagine a social contract drawn up by self-interested agents in an equal position, negotiating under a veil of ignorance, unaware of their personal characteristics, their talents or status, and of their social and historical circumstances (by way of a thought experiment). They do know of certain fundamental interests they all have, plus general facts about psychology, economics, biology, and other social and natural sciences. He argues that a just society is one that these disembodied souls would agree to be born into, knowing that they might be confronted with unfortunate social or physical circumstances.

[22] Judgment of June 28, 2002, No. 36.446. Please refer to an article entitled Dutch Supreme Court Decides on Automotive Importer Case, which appeared in this journal in September 2002, Volume 3, Number 9.

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