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The Newly Updated Dutch Transfer Pricing Guidance, Part 3: Intangibles

By Monique van Herksen and Clive Jie-A-Joen[*]
Simmon & Simmons LLP
Amsterdam

INTRODUCTION

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

While the most material change or update in the new TP Decree is the inclusion of extensive guidance on transfer pricing for financial transactions, it also reiterates in detail what the applicable rules are for intangibles.

Payments for the use or transfer of intangibles between associated enterprises have been a popular audit item in the Netherlands, in particular in light of the OECD Transfer Pricing Guidelines' (OECD TPG)[3] elaboration on the so-called "DEMPE" functions — the Development, Maintenance, Protection and Enhancement functions related to intangibles. Paragraph B.2 of Chapter VI of the OECD TPG on intangibles lists the DEMPE functions and underscores the importance of appropriate compensation to be allotted to these functions when performed by members within a multinational enterprise (MNE) group. The new TP Decree explicitly incorporates the OECD TPG in this respect.

In this third part of our five-part series,[4] the authors discuss the new TP Decree and position of the Dutch Tax Authorities (DTA) on intangibles.

INTANGIBLES

The new TP Decree reiterates what was already included in the former decree, that a transfer of intangible assets from one group entity to another will not be considered arm's length if the transferee cannot perform certain relevant functions with respect to such intangible assets.

The above assumption is anchored in the axiom that associated enterprises are deemed to aim at maximizing their profit.

According to the DTA, unrelated parties normally will enter into a transaction with respect to an intangible asset only if both expect an increase of their (individual) profitability to result from it. That is considered possible only if there is an expected increase of

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[*] Monique van Herksen is a partner and Clive Jie-A-Joen is counsel in the Financial Markets practice group of Simmons & Simmons LLP with a focus on transfer pricing controversy.

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

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

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

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

profit for seller and buyer jointly, and the buyer adds value somehow. The latter would be possible only if the buyer has the required functionality to add value and can also control related risk, according to the DTA.

The DTA maintains that the offering price of a prospective buyer will be lower than the asking price of the potential seller in the absence of an expected increase of joint profit post-transfer of the intangible asset. The position of the DTA is that the transfer of an intangible asset would in that case not seem commercially rational, also considering that a transaction will include a certain amount of transaction costs. Therefore, such a transaction between associated enterprises will not be considered as meeting the arm's-length principle.

In addition to the targeted increase in joint profit, the new TP Decree lists that the options realistically available for the seller and buyer will need to be considered. It would appear that the realistically available and more attractive option is to not enter into the transaction, if combined total operating profit of the parties will not increase as a result of the transfer of the intangible asset. If you also add in the transaction costs in that scenario, the expected operational result after the transfer will be lower than before the transfer.

The argument that the buyer of an intangible asset being located in a low-tax jurisdiction contributes to the increase of joint profit, will not be accepted if such buyer does not also possess functionality related to the intangible asset. While reduced (tax) costs may be beneficial, that benefit alone will not be sufficient to maintain that there is an increase of profit for the seller and buyer jointly.

Furthermore, if in that same scenario the seller retains and continues to perform the relevant functionalities after the transfer of the intangible, the buyer will be considered dependent on the seller for future development of the value of the intangible and the exploitation thereof. According to the DTA, in an unrelated-party setting, such a buyer would not expect operational profit. As a result, the buyer would not be able to benefit from the lower tax rate for arm's-length purposes.

The DTA position is that the difference in profit (be it upward or downward) resulting from conditions that deviate from those that unrelated parties would have applied at arm's length must be eliminated from the taxable income of the Dutch transferor. This is essentially the difference in profit resulting from the transfer as compared to without a transfer. Reference is made to example 1 in paragraph 1.148[5] and the example in paragraphs 9.122–9.124 of the OECD TPG. The example in paragraph 1.148 is about a transfer of future intangibles to be developed in the next 20 years for a lump-sum payment to an associated party, without any reliable means to determine whether the payments reflect a proper valuation. The example concludes that the structure and form of payment can be modified and should be based on economically relevant characteristics, functions performed, assets used and risks incurred of the commercial/financial relations of the associated enterprise. The example in paragraphs 9.122–9.124 regards a business restructuring where legal ownership of trademarks, trade names and other intangibles are transferred to a newly incorporated entity in exchange for a lump-sum payment, while post-transfer, the transferor continues to perform the exact same (DEMPE) functions as before the transfer, but now for a (cost plus) service fee. Upon accurate delineation, this is (re)characterized as a funding transaction rather than a restructuring. According to the new TP Decree, a close review of the commercial reality of the transaction is required in situations like this.

Depending on the circumstances, a weighting of the DEMPE functions will be required related to the relative importance of such functions. The DTA take the position that of the respective DEMPE functions, Development and Enhancement are generally considered to ''weigh'' more than Maintenance, Protection and Exploitation. While this is not a new position, there is no formal (OECD TPG or other) rule in this respect, and taxpayers should consider themselves apprised of this DTA position.

Therefore, taxpayers are advised to substantiate the performance of DEMPE functions by identifying them, where possible, in the value chain analysis that is considered for transfer pricing purposes and also applying a RASCI analysis as to who is responsible, accountable, supporting, consulted and informed with respect to the development, enhancement, maintenance, protection and exploitation of the intangibles.

HARD-TO-VALUE INTANGIBLES

There are intangibles and there are Hard-To-Value intangibles (HTVI). The latter are not defined in the new TP Decree, which only references the relevant paragraphs (6.186–6.195) of the OECD TPG. We repeat the definition of HTVI provided in the OECD TPG, below:

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[5] The new TPG Decree references example 1 of paragraph 1.145 but since that paragraph/example does not include a transfer of intangibles and paragraph 1.148 does, we have assumed paragraph 1.148 is intended to be referenced here.

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HTVI are defined as intangibles or rights in intangibles for which, at the time of the intragroup transfer, (i) there are no reliable comparables and (ii) the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, therefore, it is hard to predict the success of the intangible at the moment of the transfer of the intangible.

Indicative features that HTVI may exhibit are as follows:

(1) The intangible is only partially developed at the time of the transfer.

(2) The intangible is not expected to be exploited commercially until several years following the transaction.

(3) The intangible does not itself fall within the definition of HTVI but is integral to the development or enhancement of other intangibles which fall within that definition of HTVI.

(4) The intangible is expected to be exploited in a manner that is novel at the time of the transfer, and the absence of a track record of development or exploitation of similar intangibles makes projections highly uncertain.

(5) The intangible, meeting the definition of HTVI under paragraph 6.189 of the OECD TPG, has been transferred to an associated enterprise for a lump sum payment.

(6) The intangible is either used in connection with or developed under a Cost Contribution Arrangement or similar arrangement.

HTVI present a host of challenges for tax authorities. Determining an arm's-length price for a transfer of intangibles at a time when their value is highly uncertain is difficult due to insufficient information on the future benefits and risks related to the intangibles being available. However, the tax authorities want to make sure that the intangibles are not transferred for low value yet end up being highly profitable for the transferee. In the event unrelated parties would have included a price adjustment clause in their purchase agreement in such situations, the revenue service should be able to do the same, according to paragraph 6.185 of the OECD TPG. The DTA similarly take the position that no fixed price can be determined in case of a transfer of intangibles at the time the value is highly uncertain. In that case, the agreement between the associated enterprises ought to include a price adjustment clause through which the price is also dependent on benefits generated by the intangibles in the future.

When hard-to-value intangibles are transferred or licensed, determining the value of the transfer or license is complicated due to the uncertainty of the future value development of the intangibles. The so-called ''HTVI-regime'' allows the DTA to use the realized results from exploitation of the intangibles when determining the arm's-length nature of the price applied to the transaction.

According to the new TP Decree, the DTA is authorized to adjust the transfer price applied at the time of the transaction based on the actual realized results in two scenarios:

(1) There is a significant deviation (i.e., 20% or more within a five-year period) between the realized results and the expectations and prognoses that formed the base of the pricing at the time of the transaction; and

(2) This deviation cannot be explained by facts and circumstances that occurred after the date of the price determination.

Thus, the HTVI regime considers *ex-post* outcomes as presumptive evidence about the arm's-length nature of the *ex-ante* pricing arrangements adopted for intragroup transfers or licensing of HTVI and the presence of uncertainty at the time of the transaction. This authority to use *ex-post* results to measure a valuation based on *ex-ante* projections is conceptually worrisome. *Ex-post* results will always differ from *ex-ante* projections, since the *ex-post* actual results are a single realization of all potential risk outcomes, whereas *ex-ante* projections reflect the average of all potential risk outcomes. It is therefore an extraordinary measure that provides the DTA with extraordinary authority to adjust *ex-ante* pricing arrangements.

BUSINESS RESTRUCTURINGS INVOLVING INTANGIBLES

In the event of a purchase of shares of an unrelated company followed by a business restructuring in which the intangibles of that unrelated company are transferred within the group, the transfer price for the transferred intangibles will need to be determined. In this scenario it is relevant to determine whether — in addition to the legal ownership — the functionality and risks related to the intangibles are also transferred (as was addressed earlier above).

The arm's-length price for shares of an acquired entity provides relevant information on the valuation of the enterprise of the entity. Profitability and the separate business line profit margins that result from intercompany transactions, will likely be based on benchmark reports prepared for transfer pricing purposes. The purchase file of the buyer is therefore considered by the DTA as an essential part of the documentation

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that a taxpayer must provide to support the transfer price for transferred intangibles. Also to be considered are the allocation of synergy benefits and the so-called control premium, the valuation of remaining routine functions considering the assets used and risks incurred, and the effect of taxes.

While the eventual price paid for the acquired shares will be at arm's length since the seller is an unrelated party, this does not imply that the value of the shares is equivalent to the transfer price. The buyer will proceed with the purchase only if it expects the acquired entity to generate more value than the price paid. The value the buyer attributes to the intangible assets in the acquired entity can be a good indication of the price that the buyer would minimally want to receive in case these assets would be transferred.

According to the new TP Decree, a seller of the intangible assets will generally want to obtain sale proceeds that match the value attributed to the intangible assets topped up with the taxes due with respect to a potential book profit.

In the event that entrepreneurial functions and associated intangibles of an acquired entity are transferred to another group entity and the transferor merely performs routine functions after the transfer, taxpayers sometimes determine the transfer price based on the difference between the restructured entity's discounted cash flow (DCF) before and after restructuring based on infinite life. In such a case, the DTA will take the position that the DCF of the (restructured) entity post-restructuring cannot be based on perpetual cash flows, since the routine functionality can easily be replaced with other contracts pursuant to which similar functions are rendered and which usually have a short-term time frame. The DTA position will generally result in a lower value for the (restructured) entity post-restructuring and therefore to a higher transfer price (i.e., compensation due to the restructured entity because of the restructuring).

It is quite common for taxpayers to determine the remuneration for the use of intangibles based on publicly available databases. The new TP Decree makes clear that the DTA questions whether these databases provide information that is sufficiently detailed to provide for reliable comparables. The OECD TPG observe that in many cases the comparability analysis will show that no comparable uncontrolled transaction can be found. The DTA in practice consistently critically reviews the use of such databases and rejects the proposed comparables.

The use of a residual income analysis — an approach in which the least complex entity (that does not own any intangibles) is the tested party and whose arm's-length margin is determined while the remaining profit is allocated to the intangible assets together with the related functions performed — is considered acceptable provided all other related functions are sufficiently remunerated. However, this one-sided approach based on the resale price method, the cost-plus method and the transactional net margin method does not serve to directly determine the value of the intangible, according to paragraph 6.141 of the OECD TPG.

SUMMARY FINDINGS: DELINEATE DEMPE FUNCTIONS, SUBSTANTIATE TRANSFER PRICING OF INTANGIBLES

While the new TP Decree does not materially change the DTA position set forth earlier as regards intangibles and transfer pricing, it does underscore that the DTA will continue to closely scrutinize intangibles transactions from a transfer pricing angle. It also foreshadows that adequate substantiation of the transfer pricing used for intangibles may prove to be a complex exercise. Carefully delineating the (location of the) DEMPE functions will be crucial to support the allocation of remuneration for the exploitation of intangibles. Doing so early on when analysing the value chain for transfer pricing purposes and identifying the value drivers will go a long way in supporting transactions down the road.

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