

UNOFFICIAL ENGLISH TRANSLATION

COURT OF APPEAL OF S-HERTOGENBOSCH (13 APRIL 2022)

Tax law team

Multiple Tax Chamber

Numbers: 19/00771 and 19/00779

Judgment on the appeal (No 19/00779) brought by**[interested party],**

established in [place of establishment],

hereinafter referred to as the 'interested party',

and the appeal (No 19/00771) lodged by**the inspector of the tax authorities,**

hereinafter referred to as: the Inspector,

against the judgment of the Zeeland-West Brabant District Court (hereinafter: the District Court) of 11 November 2019, number BRE 17/4994, in the proceedings between the interested party and the Inspector.

1 Origin and course of the proceedings*(Huygens: procedural part omitted/not related to transfer pricing)***2 Facts***General*

2.1. The interested party is part of the [group] (hereinafter: the [group]). [F International] (hereinafter: [F International]) is the top holding company. The [group] is mainly active in the sale and production of fertilisers and fertilisers products. In [report 1] the business activities are described as follows:

'(...) [group] is a company that focuses on the production, distribution and sale of nitrogen chemicals. The main application is fertilizers, while industrial uses are an important and faster growing segment. [group] employs its scale, flexibility and global presence to deliver reliable supplies of mineral fertilizer and related industrial products to customers worldwide. (...)'

2.2. As a parent company, the taxpayer is part of a fiscal unity for corporation tax (hereinafter: the fiscal unity) with several subsidiaries, including the intermediate holding company [H BV] (hereinafter: [H BV]) and the production company [E BV] (hereinafter: [E BV]).

2.3. In respect of 2012, the interested party filed a corporation tax return on 30 April 2014 for a taxable amount of € 29,430,045 (hereinafter: the 2012 corporation tax return).

2.4. On 19 November 2016, an assessment was imposed on the interested party to a taxable amount of € 162,506,660. The simultaneous tax interest decision was for an amount of € 8,152,328. The assessment included the following corrections to the declared taxable amount:

Declared taxable amount	€ 29,430,045
-------------------------	--------------



Attributing interest to a permanent establishment [country 1] (object exemption)	€ 14,277,000
Provision for levy interest	€ 101,000
Provision for tax damage	€ 419,000
Iron stock system	€ 19,050,304
Hedging ASA	€ 13,339,000
Coherent valuation of dollar positions	€ 43,047,165
Profit transfer to [J AG]	€ 42,843,146
Determined taxable amount	€ 162,506,660

2.5. The taxpayer filed an objection to the assessment and the tax interest ruling. By ruling on the objection on 20 July 2017, the Inspector declared the objection unfounded and upheld the assessment and the tax interest decision.

2.6. On 11 July 2017, the taxpayer lodged an appeal against the failure to timely render a decision on the objection. The district court upheld the appeal, overturned the ruling on the objection, reduced the assessment to a taxable amount of € 107,724,357, reduced the tax interest decision accordingly, ordered the inspector to pay the costs of the objection and the proceedings before the district court of, in total, € 4,088, and ordered the inspector to reimburse the interested party for the court fee of € 333. The district court calculated the taxable amount as follows:

Declared taxable amount	€ 29,430,045
Attributing interest to a permanent establishment [country 1] (object exemption)	€ 12,430,000
Provision for levy interest	€ 101,000
Provision for tax damage	€ 419,000
Iron stock system	€ 19,050,304
Hedging ASA	€ 13,338,129
Coherent valuation of dollar positions	-/- € 9,887,267
Profit transfer to [J AG]	€ 42,843,146

(Huygens: part omitted to the extent not related to transfer pricing)

Unreasonably high profit [E BV]

2.27. [E BV] produces ammonia, urea and fertiliser products on a large scale.

[E BV], like the other manufacturing companies, sells the products it produces to affiliated sales organisations. These sales are based on the [group master distribution agreement]. The prices and other inter-company conditions applied to these sales are laid down in the [group-Transfer Pricing Master File] (hereinafter: [group-



Transfer Pricing Master File]). The [group-Transfer Pricing Master File] should be seen in conjunction with the Country Specific Files. In [group-Transfer Pricing Master File] and the Country Specific Files it is stated that producers, such as [E BV], are remunerated on the basis of the 'Comparable Uncontrolled Price Method' (hereinafter: the CUP method).

2.28. The 2012 corporation tax return is based on the transfer prices resulting from [group-Transfer Pricing Master File].

2.29. In the objection phase, the interested party took the position that application of the transfer prices as they follow from [group-Transfer Pricing Master File] leads to a non-arm's length high profit for [E BV].

2.30. In support of this position, the interested party referred to the report prepared by [W] for the [group] ('the W report'). The [W] report comprises a 'European Manufacturing of Fertilisers - Analysis of Comparable Data 2010 - 2012' and a 'European Distribution of Fertilisers - Analysis of Comparable Data 2010 - 2012'. The report of [W] was sent to the [group] on 26 February 2014 with an accompanying memo (hereinafter: the memo of 26 February 2014). The memo of 26 February 2014 includes, inter alia, the following:

Comparability Analysis Manufacturing

(...) The following table provides a summary of the benchmarking results of unadjusted operating margin for companies comparable to [group PU] for the years 2010-2012.

(...)

The benchmarking results of the unadjusted operating margin for 2012 gives an arm's length interquartile range from 2.13% to 5.99% with a median of 4.31%. The weighted average interquartile range for years 2010-2012 is from 2.72% to 6.31% with a median of 5.07%.

The table below presents the unadjusted operating margins for [group PU] for years 2010-2012:

(...)

The 2010-2012 weighted average operating margin of 10.9% falls above the upper quartile of 6.31% and falls slightly above the overall range from -2.41% to 10.69%. It can be seen that the unadjusted operating margins in years 2010 and 2011 fall within their respective full ranges but that the margin of 9.5% in 2012 falls slightly above its established Maximum value of 9.01%.

(...)

Two of the PUs reported an operating margin during 2010 - 2012 above the full range:

- E BV]

(...)

(...)

According to group management, the transfer pricing methodology is applied consistently throughout the [group] System, and all PUs are subject to similar terms and conditions in their intercompany transactions. Therefore, differences in operating margin may, according to management, be attributed to a specific plant's productivity and efficiency or other plant specific factors unrelated to transfer prices. Generally, the PUs operating margin is driven by the risks they assume and each plant's ability to consistently deliver as a low cost producer. As reflected in the above table, and based on comments from group management, the operating margins realized by the PUs may vary from plant-to-plant and year-to-year due to, among other factors, materialization of market risks assumed by the PUs, market



conditions in the regions where they sell, the plant's product mix, and the fact that production problems and maintenance and/or inspection shut-downs do not occur in all plants at the same time.

The above comparability analysis shows that the transfer pricing methodology applied generally leaves the PUs with an arm's length, or better than arm's length, operating margin.

(...)

Conclusion

(...)

The results of the study show that [group PU] ' weighted average operating margin of 10.9% for 2010-2012 falls above the benchmarked upper quartile of 6.31% and falls slightly above the overall range from -2.41% to 10.69% The operating margins in years 2010 and 2011 fall within their respective full ranges but that the margin of 9.5% in 2012 falls slightly above its established Maximum value of 9.01%.

(...)

The fact that all but one [group PU] , and all of the SUs, operating margins fell within or above their respective interquartile range indicates that prices were at arm's length'.

Supply agreement

2.31. In 2008, [E BV] decided to invest € 400,000,000 in a new factory, [the factory], in which ammonia is converted into urea and fertiliser products. [E BV] financed this investment entirely with internal loans. The construction of [the factory] is related to a covenant concluded by the [group] with the Dutch government. [The factory] was put into operation at the beginning of September 2011. [The factory] enables [E BV] to produce more urea and fertiliser products than before. The excess is hereinafter referred to as the surplus. The surplus amounts to 39% of [E BV's] total production.

2.32. On 14 September 2011, [E BV] and [J Ltd] (hereinafter: [J Ltd]) entered into the Supply Agreement (hereinafter: Supply Agreement). [J Ltd] is an undertaking affiliated with the interested party and [E BV] within the meaning of Article 8 of the Corporation Tax Act 1969 (hereinafter: 1969 Corporation Tax Act). The shares in [J Ltd] are held 100% by [H BV].

2.33. In the Supply Agreement [E BV] and [J Ltd] agreed that [J Ltd] is obliged to purchase the surplus. In the Supply Agreement the parties also agreed that the transfer price would be the cost price increased by a surcharge of 5%. On the basis of the Supply Agreement, [E BV] invoices [J Ltd] monthly for 39% of the produced goods at cost price plus a surcharge of 5%. Unless terminated earlier, the term of the Supply Agreement is five years, on the understanding that the term thereafter, unless otherwise notified, is tacitly extended by one year. After the aforementioned five-year period, the term will in any case be tacitly extended once.

2.34. In the Supply Agreement [E BV] and [J Ltd] agreed inter alia as follows:

PREAMBLE

WHEREAS:

(A) [E BV] operates production facilities for the production of certain chemical substances called urea solution as well as endproducts on the basis of urea solution ("Products");

(B) In order to continue the local permits required for operating its production facilities, [E BV] has been forced to take certain measures to reduce the transportation overseas of excess ammonia (NH₃). NH₃ serves as raw material for the production of urea solution. One of the measures aimed at reducing



the excess-volume of NH₃ has been to increase the capacity for upgrading NH₃ into urea solution. In Q3 of 2011, the production capacity for urea solution will be increased to 1,225 kton per year. This corresponds with an increase of 482 kton compared to the old capacity as based on the actual production of 2010;

(C) [E BV] wishes to operate the additional production capacity for urea solution, e.g. 39% of the total production capacity after the increase, to manufacture Products on a risk-free basis;

(D) [J Ltd] operates a trading business. This trading business includes the Products, as well as NH₃ (ammonia);

(E) [J Ltd] wishes to secure the supply of Products;

(F) [E BV] and [J Ltd] therefore desire to enter into an agreement pursuant to which [E BV] will supply a certain volume of Products to [J Ltd].

(...)

2 SUPPLY OF PRODUCTS

2.1 Subject to the terms and conditions set forth in this Agreement, [E BV] agrees to sell and supply the Products to [J Ltd] meeting the Product Specifications, which sale and supply of Products [J Ltd] agrees to accept.

2.2 [J Ltd] commits to pay to [E BV] the agreed Product Price for the supply of the Products.

3 MANUFACTURE OF PRODUCTS

3.1 The Parties will from time to time agree on the Product Specifications. Any changes in the Product Specifications will have to be approved before the actual implementation thereof.

3.2 [E BV] undertakes to manufacture the Products in its own facilities, as far as the Parties do not agree differently in writing for particular cases.

3.3 Upon reasonable notice and during [E BV] 's regular hours of business, [J Ltd] (or its representatives) shall have the right to:

a) inspect work in progress to determine the adequacy of production methods and equipment employed by [E BV]; and

b) conduct on spot inspections of the Products to verify that the Products have been manufactured in accordance with good manufacturing practices and the Product Specifications. All representatives of [J Ltd] conducting such inspections shall comply with all applicable safety and security rules of [E BV].

3.4 All Products will be tested and released by or on behalf of [E BV] in accordance with procedures established by the Parties to this Agreement from time to time.

3.5 Any complaints in respect of the quality of a Product and/or the nonconformity of a Product to the Product Specifications, will be lodged to [E BV] no later than forty (40) working days, after delivery of the relevant Products. If [J Ltd] has not given written notice within forty (40) days, the Products are considered to be accepted, unless such failure could not reasonably have been detected by visual inspection upon receipt of the Products.

3.6 In case of any dispute regarding the quality of a Product and/or conformity to the Product Specifications, the Parties agree to have the Product tested by an independent first class laboratory, to be appointed in mutual consultation, the findings of which shall be treated as conclusive and the



cost incidental to the analyses carried out by said laboratory shall be borne by the Party found to be in error.

3.7 In the event that Products do not meet the appropriate quality and/or the Product Specifications, [E BV] will offer adequate compensation to [J Ltd].

3.8 Title and risk of loss to all Products shall pass from [E BV] to [J Ltd] upon issuance of the invoice for those Products by [E BV] to [J Ltd].

3.9 [E BV] shall source all raw materials and other materials necessary to manufacture the Products.

4 SUPPLY VOLUME/DELIVERY

4.1 Parties agree that for each month during the term of this Agreement the volume of Products to be supplied by [E BV] to [J Ltd] will be equal to 39% of the actual volume produced by [E BV], which percentage corresponds to the increase in production capacity for urea solution realised by [E BV] prior to the conclusion of this Agreement.

4.2 In principle, the supply volume agreed in Article 4.1 will apply to each of the Products specified in Schedule 1. Parties may however agree for a certain period to vary the supply volumes per individual Product, provided that the aggregate volume of Products supplied to [J Ltd] remains equal to 39% of the actual volume of Products produced.

4.3 Before the commencement of each calendar year, [E BV] shall deliver to [J Ltd] the Production Budget, setting forth the estimated production volume for that particular calendar year, to be approved by [J Ltd] in accordance with Article 5.1. If the actual production volume will deviate more than 20% from the estimated production volume, hence also causing deviation of the actual supply volume to [J Ltd] from the estimated supply volume with more than 20%, [J Ltd] and [E BV] may in all reasonableness agree that such excess deviation results in an adjustment of the supply rate as specified in Article 4.1.

4.4 [E BV] shall use its best efforts to supply all Products in accordance with the volumes determined in accordance with Articles 4.1 through 4.3 and will maintain an appropriate level of raw materials and other materials required to manufacture the Products.

4.5 [E BV] is responsible for adequate storage of the Products. [E BV] represents that it has all necessary permits in relation to the storage according to this Agreement. [E BV] may propose a local service provider for the storage and logistics of the Products.

5 REMUNERATION

5.1 The Product Price shall be calculated as set forth in Schedule 2 to this Agreement and shall be invoiced to [J Ltd] on a monthly basis.

(...)

6 WARRANTIES AND LIABILITIES

6.1 [E BV] represents that the Products have been manufactured in accordance with good manufacturing practices and the Product Specifications.

6.2 [E BV] is responsible for the adherence to all applicable laws and regulations, in particular also to environmental protection laws, in the course of the manufacture of the Products.

6.3 [E BV]'s liability shall be expressly limited to its remuneration hereunder for the quantity of Products in respect of which any claim is made. Furthermore, [E BV] shall only be liable for special, incidental,



indirect or consequential damages (including but not limited to loss of profits, revenues, etc) incurred by [J Ltd] or any third party, to the extent such damage is covered by its insurance.

6.4 Prior to each year, [E BV] will duly inform [J Ltd] about the scope of its insurance coverage. (...)'

2.35. [E BV], [J Ltd] and various affiliated sales organisations referred to as 'Distributor' concluded the Distribution Service Agreement on 14 September 2011. As far as relevant in these proceedings the Distribution Service Agreement reads as follows:

'(...) **PREAMBLE**

WHEREAS:

(a) In connection with the increase of the production capacity of [E BV] , [J Ltd] and [E BV] have concluded a Supply Agreement (Schedule 1), pursuant to which [E BV] , as manufacturer, supplies a certain volume of products (the "Products0, as defined in that Supply Agreement) to [J Ltd] ;

(b) [E BV] and Distributor are parties to the [group-Master Distribution Agreement] (Schedule 2; the "**Distribution Agreement**"), pursuant to which [E BV] has assigned certain distribution rights to Distributor:

(c) [J Ltd] wishes the Products to be distributed by Distributor, under similar conditions as applicable between [E BV] and the Distributor under the Distribution Agreement;

(d) Distributor wishes to distribute the Products under similar conditions as applicable under the Distribution Agreement;

(e) Parties acknowledge that the most efficient way to process distribution of the Products by Distributor would be to include the Products in the scope of the Distribution Agreement;

(f) For efficiency purposes, Parties wish to Include the Products in the Distribution Agreement, provided that each Party will bear its own risk and its own costs;

(g) [J Ltd] Is willing to pay a fee to [E BV] for the handling services thus rendered.

NOW, THEREFORE. PARTIES AGREE AS FOLLOWS:

1. DISTRIBUTION OF THE PRODUCTS

The Products, as defined in the Supply Agreement included in Schedule 1 to this Agreement, will be included in the scope of the Distribution Agreement included as Schedule 2 to this Agreement.

2. DELIVERY

In connection with inclusion of the Products in the scope of the Distribution Agreement, [E BV] will deliver the full volume of products, i.e. including the Products, to Distributor. [J Ltd] consents with this direct delivery.

3. PAYMENT BY DISTRIBUTOR

Distributor will make a direct payment to [E BV] for the full volume of products delivered under the Distribution Agreement, i.e. including the Products. The payment terms for the full volume will be as defined in the Distribution Agreement.



4. PAYMENT BY [E BV]

will make monthly payments to [J Ltd] of the full amounts received from Distributor in connection with delivery of the Products to Distributor.

5. INDEMNITY

[J Ltd] fully indemnifies [E BV] against all liabilities and damages arising under the Distribution Agreement, to the extent such liabilities and damages relate to the Products.

6. SERVICE FEE

[J Ltd] commits to pay a service fee to [E BV] as remuneration for the services rendered by processing distribution of the Products through the Distribution Agreement. This service fee shall be calculated as set forth in Schedule 3 to this Agreement.

The service fee will have to be paid within seven (7) days from the Invoice date. In principle, [E BV] will issue monthly invoices. (...)

2.36. Schedule 3 to the Distribution Service Agreement states the following:

'Service Fee

The service fee for product handling as referred to in Article 6 will be calculated as follows :

Planned costs per month according to cost centre report Loading Department HASSD5600 x (actual volume/planned volume) x 1.05 (i.e. application of a 5% mark-up). Each year for the month of December this calculation will be adjusted for the difference between planned and actual costs incurred/ volumes loaded. (...)

2.37. According to the Inspector, the transfer price used with regard to the surplus in combination with the invoicing between [E BV] and [J Ltd] as it follows from the Distribution Service Agreement results in a monthly, non-arm's length transfer of profit from [E BV] to [J Ltd]. This resulted in a correction of the taxable amount declared by the interested party of € 42,843,146.

2.38. At the request of the interested party, [Y] prepared the "[report 2]" (hereinafter: the transfer pricing report of [Y]). The transfer price report from [Y] is dated October 2011. In this report, [Y] concludes that the sales price included in the Supply Agreement (cost price plus 5%) is in line with the sales prices applied by comparable companies. This conclusion is stated as follows in section 6.2 of [Y]'s transfer price report:

6.2 Results comparables search / conclusion

For the 13 comparable companies found in the comparables search, the Return on total costs was first calculated for the last 5 available years. Then the average of these 5 years was calculated for each company. Finally, the inter-quartile range of these averages was calculated. The results of these calculations, as well as the statistical analysis thereof can be found below. For a more detailed overview, we refer to Appendix C.

The Lower Quartile of the results from the tested parties is determined at 2.6% (i.e. 25% of the tested parties had an average Return on total costs below 2.6%). The Upper Quartile of the results is determined at 8.3% (i.e. 75% of the tested parties had an average Return on total costs below 8.3%). The 5 year median value is determined at 5.0%. The median value is the value upon which 50% of the comparable companies use this value or a lower value. For making a comparison, the median value is more appropriate than the average value. Thus, from this analysis it can be concluded that a Return on total costs of 5.0% is in line with the margin made by comparable companies.



The abovementioned results are summarised in the table below.

Results comparable search	
Lower Quartile	2.6%
Median	5.0%
Upper Quartile	8.3% '

3 Dispute and claims of the parties

3.1. The dispute concerns the answer to the following questions:

(Huygens: part omitted to the extent not related to transfer pricing)

3. Was the profit of [E BV] and thus of the interested party (deliberately) set too high?

4. Did the Inspector rightly make an adjustment of €42,843,146 in connection with the Supply Agreement concluded between [E BV] and [J Ltd]?

3.2. Both the interested party and the Inspector claim that the judgment of the district court should be set aside.

4 Grounds

On the dispute

(Huygens: part omitted to the extent not related to transfer pricing)

Question 3: Was the stakeholder's profit (deliberately) set too high?

4.38. Interested party takes the position that using the transfer prices that follow from [group-Transfer Pricing Master File] leads to an unnecessarily high profit for [E BV] and thus for the interested party (the fiscal unity of which the interested party is the parent company).

The interested party did not take the position that the applied transfer prices for [E BV] led to a profit that was not commercially viable until it filed an objection to the tax assessment for the 2012 financial year. With this position, the interested party explicitly wants to deviate from the 2012 corporation tax return that it submitted.

4.39. The interested party referred to the report of [W] in support of its position. See in this respect what is stated under 2.30.

The report of [W] essentially concerns two reports, namely a report comparing the results of the production companies¹⁴ and a report comparing the results of the sales organisations¹⁵. Both reports are summarised in the memo dated 26 February 2014. The Court considers the reports and the memo of 26 February 2014 as one coherent whole. Hereinafter 'the report of [W]' refers to the report in which the results of the production companies are compared with each other.

4.40. On the basis of the report by [W], the interested party concludes that an operating profit of 6.31%, expressed as a percentage of the operating income, constitutes an arm's length remuneration for [E BV]. However, the remuneration realised by [E BV] amounts to 27.4% and is therefore 20.1% too high, according to the interested party. Given the fact that the interested party and its shareholder were familiar with the report by [W], according to the interested party this was a consciously non-arm's length profit allocated to [E BV]. According to the interested party, this non-arm's length remuneration has resulted in € 203,167,984 too much profit being attributed to [E BV] in the 2012 financial year.



For the period 2010 to 2015, [E BV] would have been allocated approximately € 950,000,000 too much profit.

4.41. The interested party substantiates its point of view that too much profit has been allocated to [E BV] by making a comparison with two competitors of the interested party, namely [C BV] in [town 1] (hereinafter: [C BV]), a producer of artificial fertiliser, melamine and ammonia, and [D BV] in [town 2] (hereinafter: [D BV]), a producer of fertilisers. According to the interested party, the margins it achieved are significantly higher than those of [C BV] and [D BV].

4.42. If it must be assumed that the remuneration attributed to [E BV] falls outside the range and the interested party cannot explain this deviation in a reasoned way, according to the interested party, a (negative) correction must be made. The interested party refers in this regard to the Dutch transfer pricing decree of 22 April 2018¹⁶.

4.43. With some surprise, the Court has taken note of the argument of the interested party that in the years preceding the financial year 2012, in the financial year 2012 and the financial years thereafter, it would have systematically declared (much) too much profit. Furthermore, the amount of the over-reported profit - in 2012 an amount of more than € 203,000,000 - is striking.

It should be borne in mind that transfer pricing is about the allocation of group profits. If and in so far as too much profit was allocated to the party concerned, too little profit was allocated to other parts of the group. The foregoing means that tax authorities of various states would have been confronted over a number of years with incorrect profit figures (read: understated profit figures). It should also be borne in mind that the [group] is a large, international, listed company that may be assumed to be fiscally 'in control' and also wants to be, i.e. it has a so-called 'tax control framework'¹⁷. The assumed desire to be fiscally 'in control' is not compatible with the fact that (very) large amounts of profit have been incorrectly allocated to various group entities.

The fact that the group to which the interested party belongs has a set of processes and internal management measures at its disposal is evidenced by the presence of [group-Transfer Pricing Master File] in which transfer prices and other intercompany conditions are documented throughout the group. According to the Court of Appeal, [the Transfer Pricing Master File] has been used for a long series of years.

4.44. With regard to the division of the burden of proof, the following applies. The interested party claims, with reference to the report of [W] among others, that [E BV] received a (high) remuneration for the supplies it made to group companies. With its argument, the interested party argues for a deviation from the prices and conditions agreed at group level in the [Group-Transfer Pricing Master File], and thus a downward correction of the taxable profit stated in the 2012 corporation tax return. Since the interested party argues that the actions should be in deviation of that which has been laid down in the [Group Transfer Pricing Master File], the Court of Appeal is of the opinion that the interested party is best placed to furnish proof thereof.

4.45. Insofar as the position taken by the interested party above means that the difference between the remuneration actually obtained from group companies and, according to the interested party, an arm's length remuneration for the intercompany transactions, is to be regarded as an informal capital contribution, the burden of proof also lies with the interested party. In that regard, the Court of Appeal refers to the Supreme Court ruling of 15 March 2019¹⁸ in which the Supreme Court ruled that if the taxpayer is of the opinion that an advantage received by him does not belong to the profit, because it is to be regarded as an informal capital contribution, the taxpayer has the burden of proof to state the facts and circumstances that may justify such a conclusion, and to make these facts and circumstances plausible in the event of a substantiated dispute by the Inspector. Such a challenge has been made in the present case.

4.46. In the opinion of the Court of Appeal, the interested party wrongly draws the conclusion from the report of [W] that it received a non-arm's length remuneration. The Court of Appeal will explain below the grounds on which it arrived at this opinion.



4.46.1. The memo dated 26 February 2014, addressed to [F International] , states in the 'Introduction', as far as relevant here, the following:

' [group] engaged [W] to update the previous performed comparability analysis for the purpose to test the arm's length nature of the transfer pricing applied to the intercompany sale for fertilizers by [Group] producers to [Group] sales companies.

Two previous performed searches were updated: (i) to identify independent companies that perform similar manufacturing functions and assume similar risks as the [group] production units in Europe (hereinafter "PUs") and (ii) to identify independent companies that perform similar distribution functions and assume similar risks as the [group] sales units in Europe (hereinafter "SUs").

The objective of this memo is to summarize the results of the analyses and provide a comparison to the results achieved by the [group PU] and SUs. (...)

We have performed two benchmarking studies of comparable companies for the years 2010-2012. The following provides an overview of the benchmarking results. Please refer to the [Transfer Master File] and [Country-Specific Documentation] for further details regarding the [Group] , the industry of operation, the functional analysis, and a description of the transfer pricing method applied.

4.46.2. From this 'Introduction' the Court of Appeal deduces that [W] annually¹⁹ draws up one or more reports for the benefit of the group management (the report is addressed to the top company of the group), so that the group management gains insight into the performance of the production companies and the sales organisations, can make a comparison with somewhat comparable independently operating production companies and sales organisations and can check whether intercompany transactions can be considered to be at arm's length.

The memo of 26 February 2014 concludes that:

The fact that all but one [group PU] , and all of the SUs, operating margins fell within or above their respective interquartile range indicates that prices were at arm's length'.

4.46.3. Contrary to the apparent view of the interested party, the [W] report does not reveal that major profit shifts are taking place within the group and that transactions are not at arm's length, nor was the [W] report drawn up with the intention of making the group management aware of this. There is nothing in the report to indicate this; on the contrary, the conclusion drawn in the memo is that the prices applied can be regarded as at arm's length. The report by [W] has more the character of a global analysis, an instrument with which the group management can assess, among other things, whether the group is fiscally 'in control' in the area of transfer prices.

The Court of Appeal furthermore points out that the global character of [W]'s report can also be derived from the reference in the memo to [group-Transfer Pricing Master File] and the Country Specific Files in which further (detailed) information regarding the [group] has been gathered. Information necessary to make a proper comparison, such as a description of the activities, a functional analysis and a description of the transfer pricing method(s) applied, is lacking.

4.46.4. In the event that the report of [W], in deviation of the considerations in 4.46.3, should be interpreted as defended by the interested party, i.e. that it is a transfer pricing report from which it follows that a (much) too high profit was attributed to [E BV] in the 2012 financial year, the report must be assessed substantively, all the more so because the Inspector disputes the conclusions drawn by the interested party from the report. More specifically, the Inspector argues that the report of [W] does not contain the correct and complete documentation necessary to draw conclusions regarding the transfer prices applied.



4.46.5. Within the [group], use has been made for many years of [group-Transfer Pricing Master File]. This File concerns an extensive settlement documentation which applies to the entire group and which is updated annually. With regard to the Dutch activities, the Country Specific File - The Netherlands is also important.

Section 1.1 of [Group Transfer Pricing Master File], as far as relevant here, states:

The purpose of this report is to document how the related party transactions are conducted within the [Group] - hereinafter commonly referred to as '[group]' or the [Group] ' - and how the transfer prices have been determined.

Furthermore the report will describe how the applied transfer prices relate to the arm's length principle. The document is intended to provide the reader with sufficient information and understanding of the business to make their own assessment in regards to the arm's length nature of the conducted transactions.

[Z] specify that the prices set for intercompany transactions should be based on the arm's length principle. In essence, the results of the transactions between related parties should be consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances.

This document is structured so as to be used as a basis for compliance with the transfer pricing documentation requirements under the law of the different countries where [group] operates. The information contained in this report has been prepared based on the requirements described in [Z]. Furthermore, the Master File is believed to be aligned with the requirements of the EU Transfer Pricing Documentation (EU TPD). The Master File as presented will be completed with separate Country Specific Files , in order to comply with local transfer pricing rules and regulation.

The [Transfer Pricing Master File] contains descriptions of the [group], its activities and its fertiliser business, descriptions of the main internal transactions, the group guidelines, the transfer pricing methods and the transfer prices used. Important internal agreements and various cost calculations are included as annexes to [group-Transfer Pricing Master File].

4.46.6. In the opinion of the Court of Appeal, [group-Transfer Pricing Master File] should be regarded as the official transfer pricing documentation of the [group]. As mentioned in section 1.1 of the [group-Transfer Pricing Master File] (see 4.46.5), the group companies have to conform to the guidelines formulated in the [group-Transfer Pricing Master File], the aim of the [group-Transfer Pricing Master File] is to act in accordance with the [Z] and the [group-Transfer Pricing Master File] is considered to function as a basis for compliance with the laws and regulations in the various countries in which the group companies operate. The file provides no indications that the [group] has taken a different course in the financial year 2012 and the years thereafter and that it has distanced itself from the contents of the [group Transfer Pricing Master File]. This means that also in the financial year 2012, [group-Transfer Pricing Master File] is applicable to [E BV]/interested party.

It has neither been established nor has it become apparent that the profit of [E BV]/interested party has not been determined in accordance with the guidelines of [group-Transfer Pricing Master File].

4.46.7. In view of the considerations in 4.46.6, the question is to what extent the report of [W] justifies deviating from the guidelines as stated in [group-Transfer Pricing Master File] when determining the profit of [E BV] / the interested party, and that the report of [W] replaces the guidelines as stated in [group-Transfer Pricing Master File], as apparently defended by the interested party.

In the opinion of the Court, there is no reason to do so.

4.46.8. In the first place, in the opinion of the Court of Appeal, it cannot be derived from the report of [W] that the profit of [E BV] has been determined at a level higher than arm's length. As mentioned in 4.46.3, in the



opinion of the Court of Appeal, the conclusion can in no way be drawn from the report of [W] that certain group companies, among which [E BV], are remunerated in an improper manner. On the contrary, as mentioned in 4.46.2 the memo of [W] concludes that within the group at arm's length prices are being used.

The report by [W] also mentions the difference in performance by the various group companies, without questioning whether the prices realised are at arm's length. For example, an explanation is given for the differences in operating margins between the various group companies:

'As reflected in the above table, and based on the comments from group management, the operating margins realized by the PU's may vary from plant-to-plant and year-to-year due to, among other factors, materialization of market risks assumed by the PU's, market conditions in the regions where they sell, the plant's product mix, and the fact that production problems and maintenance and/or inspection shut-downs do not occur in all plants at the same time.'

4.46.9. Secondly, contrary to what the interested party (supposedly) asserts, the report by [W] cannot, in contrast to [the group-Transfer Pricing Master File], be regarded as a transfer pricing report. The Court of Appeal considers the report of [W] as no more than a benchmark report. Essential information, such as a comparability analysis, a functional analysis and a substantiation of the chosen transfer pricing method, is missing.

In the opinion of the Court of Appeal, the report of [W], which cannot be regarded as a transfer pricing report, cannot replace the transfer pricing documentation ([group-Transfer Pricing Master File]) which has been used within the [group] for a long series of years, is updated annually and is reviewed annually by the auditor of the [group].

4.46.10. Thirdly, in the opinion of the Court of Appeal, the companies with which [E BV] is compared in the report of [W] are not comparable with [E BV] / interested party for several reasons, or it is insufficiently clear that they are comparable.

For example, the turnover of the interested party in 2011 was almost € 1 billion, while the turnover of the companies compared to the interested party ranged from a few million euros to € 30,000,000. In a sector such as that of the interested party, scale is essential. For that reason alone, companies that realise a turnover that is (much) more than 30 times lower than the turnover realised by the interested party cannot be compared to the interested party.

Furthermore, the Inspector stated without contradiction that, on the basis of public information, the product range of the companies with which the interested party was compared was not (properly) comparable to the product range of the interested party. In addition, with regard to the differences in the product range, the consequences for the transfer prices to be applied have not been described and, according to the inspector, companies compared with the interested party supply a different target group than the interested party does. Examples mentioned by the inspector are²⁰:

- companies that produce fertilisers as part of a wider range of agricultural and horticultural products, such as seeds and pesticides;
- companies that supply a whole range of gardens to local consumers and shops;
- companies that produce organic fertilisers;
- Companies that trade in fertiliser without producing it themselves;
- companies that buy raw materials and blend them into fertiliser products;
- an enterprise producing soil improvers on the basis of peat, and



- a company that has no fertiliser-related activities at all, but trades in pesticides.

The above confirms the view of the Court of Appeal that the report of [W] is no more than a very general, somewhat sector-oriented, comparison in which almost no attention is paid to the specific characteristics of both [E BV] and the companies compared with it. On the basis of such a report, it cannot be concluded that transfer prices within the [group] were not at arm's length, nor that on the basis of the report of [W] one should deviate from the guidelines mentioned in [group Transfer Pricing Master File].

4.47. Insofar as the interested party argues that on the basis of a comparison with [C BV] and [D BV], it can be concluded that too much profit has been attributed to [E BV], because the margins achieved by [E BV] are much higher than those achieved by [C BV] and [D BV], the Court of Appeal rules as follows.

4.47.1. The Court of Appeal points out that a comparison with [C BV] and [D BV] is difficult, because the turnover as well as the average operating profit during the period 2012 up to and including 2015 of [C BV] and [D BV] differ greatly from each other. For example, the turnover of [C BV] in those years varies from over € 943,000,000 to over € 1.2 billion and that of [D BV] from over € 106,000,000 to over € 140,000,000; the average operating profit expressed as a percentage of the turnover of [C BV] in the mentioned period is 12.7% and that of [D BV] is 1.7%.

In view of the crucial importance to be attached to scale, [D BV] cannot be regarded as an undertaking comparable to the interested party.

With regard to the average operating profit of 12.7% achieved by [C BV], the Court points out that this percentage is also well above the percentage of 6.31% that, according to the interested party, should be regarded as an arm's length payment based on the report by [W].

4.47.2. The Court of Appeal considers a comparison between [C BV] and [E BV], solely on the basis of a percentage of the profit, insufficient to reach the conclusions drawn by the interested party. Before comparing those percentages, the degree of comparability should be determined. This requires a functional analysis, an analysis of the economic circumstances, the business strategy, the exact nature of the goods and services, the contractual conditions, the risks assumed and the specific and unique characteristics of the companies being compared. For example, the Inspector argued at various points during the proceedings that [E BV] is the best performing company within the [group], achieving a high capacity utilisation rate through cost-efficient production and thus achieving relatively high results and profit margins. For a comparison with another company, such as with [C BV], it is necessary to have insight into the extent of the comparison. The interested party has not provided this information. In the opinion of the Court of Appeal, it cannot be concluded that the profit of [E BV] was uncommercially high only on the basis of the higher profit margins realised by [E BV]. The mere difference in profit margins does not constitute a ground to correct the profit of [E BV] / interested party in a negative sense.

4.48. Question 3 should be answered in the negative.

Question 4. Did the Inspector rightly make an adjustment of €42,843,146 in connection with the Supply Agreement concluded between [E BV] and [J Ltd]?

4.49. In determining the profit, the interested party took into account the 39% surplus (see section 2.31) at a transfer price consisting of the cost price plus a mark-up of 5% (hereinafter: cost plus 5%), based on the Supply Agreement concluded between [E BV] and [J Ltd] (see section 2.33). For the remaining 61% of the supplies, [E BV] used transfer prices based on [Group Transfer Pricing Master File] (see section 2.28). For the year 2012, the Inspector has corrected the transfer prices used by the interested party regarding the 39% surplus with an amount of € 42,843,146 to the transfer prices as these result from the [Group Transfer Pricing Master File].



The correction made by the Inspector is in dispute between the parties. The essence of the dispute is whether, given the facts and circumstances, 39% of the production capacity of [E BV] (the surplus) can be exploited for the account and risk of [J Ltd] and [E BV] can in that capacity act as a contract manufacturer for [J Ltd] at a cost plus 5%, as argued by the interested party. The inspector takes the view that the exploitation of the 39% surplus, in addition to the other 61% of production, is also the full responsibility of the interested party, in accordance with its own transfer pricing documentation used for many years, and that the contractual transfer of part of the product risk (the part relating to the 39% surplus) is contrary to the historical, economic and actual reality.

Before dealing with the substance of the dispute, the Court will first determine on which party the burden of proof rests (in the first instance).

4.50. With regard to the transfer prices applied in respect of the 39% surplus, the district court ruled as follows:

'4.3.3. The inspector argued - without being contradicted - that [company location]²¹ had sold products to [country 2]²² in previous years at prices based on [group transfer pricing master file] and that [company location] had also sold its products in the current year to other affiliated sales organisations at prices based on [group transfer pricing master file]. In the court's opinion, it is then up to the interested party to make it plausible that there is a business reason to sell the surplus to [country 2] at prices that deviate from those based on the [group transfer pricing master file]. After all, for a long time the interested party itself was of the opinion that the prices based on [group transfer pricing master file] were commercial and - in relation to other affiliated sales organisations - still are. The court notes that the production process, the logistics process, the administrative actions and the production costs related to the 39% surplus do not differ from those of the other 61% of the production. If a different (transfer) price is calculated for that part, an explanation is required'.

4.51. In the opinion of the Court of Appeal, the district court correctly and with good grounds ruled that the burden of proof lies with the interested party regarding the question whether the transfer prices used by the interested party regarding the 39% surplus can be considered at arm's length. Therefore, the Court of Appeal has adopted the considerations set out above.

4.52. During the course of the proceedings, the interested party brought forward at various times various grounds for the transfer prices it had applied with regard to the 39% surplus. From the large quantity of documents, the Court distilled the following grounds put forward by the interested party.

4.52.1. The inspector wrongfully ignores the Supply Agreement. Such an agreement concluded between parties must, in principle, be respected and accepted by the inspector, unless the parties were aware of its impracticability at the time of entering into the agreement.

4.52.2. [E BV] / interested party is only an 'executive' producer and does not have the tools to perform certain important functions or manage certain risks. In support of its position, the interested party submits inter alia that natural gas, a raw material of great importance to production, is not purchased by the interested party, but by a group company, and that the control of the supply and demand process is managed by [AA] (hereinafter: [AA]) and [J Ltd]. It is further submitted that the management of the price risk belongs to the core business of [J Ltd] and that [E BV] does not have the knowledge to manage such a risk. Given the limited function of [E BV] / the interested party, it is, according to the interested party, not unreasonable and not unusual that the production risk in respect of the 39% surplus was transferred to [J Ltd].

4.52.3. That the transfer prices used by the interested party in the determination of profits are correct follows from, or is confirmed by, the transfer price report of [Y].



4.52.4. By correcting the transfer prices used by the interested party, the inspector is violating the principle of equality, because the inspector is not adhering to the policy as formulated in the Starbucks, Nike and Apple cases.

4.52.5. The interested party further argues that agreements such as the Supply Agreement are also concluded with third parties. The interested party mentions an agreement which [B NV] concluded with a third party. The interested party further submits that in later years contracts similar to the Supply Agreement were concluded by the [group] in which a third party performs the production function. In this context, the interested party described the agreement between [U group] and [CC] ('CC'), under which the production activities of the [U group] ammonia plant were fully outsourced to [CC] and [CC] received a fee based on its costs, as well as a fee of GBP 4,000,000. The third party also described the joint venture between [group F 1] [group F 2] and [EE] (hereinafter: [EE]) whereby the ammonia plant would be fully managed by [EE] and whereby [EE] would receive a fee for its activities consisting of its costs as well as an annual fee of USD 1,626,000.

4.52.6. In addition to the abovementioned arguments in support of the claim that the transfer prices used by the interested party with regard to the 39% surplus are correct, the interested party also argues that, if there is a profit transfer at all, taxation should have taken place in 2011, being the year in which the Supply Agreement was agreed. In that case, the net present value that [E BV]/the interested party would have forgone would have had to be taxed as profit in 2011.

4.53. The inspector has refuted all the grounds put forward by the interested party. The inspector's view can be summarised as follows.

4.53.1. According to the Inspector, the Supply Agreement can be ignored, because this agreement ignores the actual transfer price documentation that has been followed by the [group] for years. Application of the Supply Agreement in combination with the Distribution Service Agreement implies a continuous acting on non-arm's length basis because every month in retrospect a part of the profit already realised by [E BV]/interested party is given away for the benefit of [J Ltd], according to the inspector.

4.53.2. Unlike the interested party, who considers [E BV] to be a contract manufacturer of [J Ltd] with regard to the 39% surplus, the inspector considers [E BV] to be a 'fully fledged' manufacturer, who bears all risks related to the production function and to whom the full residual profit accrues for that reason. By allowing [J Ltd] to receive the 39% surplus and rewarding [E BV]/interested party with a cost plus 5%, the inspector believes that the 'arm's length' principle has been violated.

4.53.3. The inspector disputes the conclusions drawn in the transfer price report by [Y]. According to the inspector, the transfer price report from [Y] does not contain a proper substantiation of the cost plus remuneration for the transactions between [E BV] and [J Ltd], there is no proper functional analysis, the findings in the transfer price report from [Y] are not compared with the results of other transfer price documentation available within the [group], and the companies included in the report (hereinafter also referred to as 'comparables') are not comparable with [E BV].

4.53.4. Furthermore, the inspector contests acting in conflict with the principle of equality, because in the present case he would deviate from the policy formulated in the Starbucks, Nike and Apple cases. According to the Inspector, the Starbucks, Nike and Apple cases are not comparable with the facts and circumstances in the case of the interested party.

4.53.5. In his response to the interested party's assertion that agreements such as the Supply Agreement do occur in practice, the Inspector states that he does not dispute that in third-party relationships there may be a situation in which a client of a contract manufacturer buys a relative part of the production. However, the Inspector considers it implausible to find a comparable third situation in which a 'fully fledged' manufacturer such as [E BV] would be willing to give up its relatively high profits for part of the production activities in return for a relatively low cost-plus fee.



4.53.6. Finally, the Inspector is of the opinion that, on a monthly basis, the profit of the interested party should be corrected by the amount that was forgone in favour of [J Ltd]. Contrary to the interested party's claim in 4.52.6, there is therefore no question of foregoing the net present value in 2011, but of a monthly/annual correction of the profit during/from 2012 and the years thereafter, according to the inspector.

4.54. The court of appeal will give its opinion on the grounds put forward by the interested party, item by item.

Was the inspector wrong to ignore the Supply Agreement (4.52.1 and 4.53.1)?

4.55.1. When assessing whether a transfer price between related parties is at arm's length, the terms of the related transaction(s) should be compared with the terms agreed between unrelated companies, the so-called comparability analysis. For such an analysis, contractual agreements between parties, such as the Supply Agreement, are the starting point. However, it is essential that the agreed legal conditions are consistent with the actual economic transaction(s). In the opinion of the Court of Appeal, this applies in particular to transactions in which the allocation of risks plays an important role, as in the present case. The allocation of risks must be rational from an economic perspective. The party to whom the risks are allocated should have the knowledge to manage the risks and the financial capacity to bear the risks. Whether a particular risk, such as in this case part of the production risk, can be transferred therefore requires an economic analysis.

4.55.2. With due observance of the above, the Court of Appeal considers the position, as taken by the interested party under 4.52.1, that an agreement concluded between the parties must, in principle, be respected and accepted by the Inspector, unless the parties were aware of its uncommercial character at the time when the agreement was concluded, to be correct as a starting point. However, the factual conduct must not be disregarded in this respect. If the 'legal reality' (what has been contractually agreed) does not correspond to the economic reality, the inspector will not be bound by the contractual conditions and may subsequently attach other tax consequences to the transaction(s) arising from the agreement.

4.55.3. To what extent the contractual arrangements established reflect economic reality is essentially the issue of the present dispute. The question whether or not the Inspector was right to ignore the Supply Agreement, i.e. right to attach other tax consequences to the transaction(s), depends on the conclusions drawn in the following.

Can the production risk be partially transferred to [J Ltd] (4.52.2 and 4.53.2)?

4.56.1. As also mentioned in section 2.31, it was decided in 2008 to invest € 400,000,000 in the construction of a new factory, [the factory], in which ammonia can be converted into urea and fertilizer products. As a result of the arrival of the new factory, more can be produced than before (the "surplus" mentioned several times) which amounts to approximately 39% of the total production of [E BV].

4.56.2. On 14 September 2011, the interested party contractually transferred the production risk relating to the 39% surplus to [J Ltd] by means of the Supply Agreement and the Distribution Service Agreement. By means of these agreements, the interested party intended to have [E BV] act as a contract manufacturer for [J Ltd] with regard to the surplus and [E BV] receives a cost plus 5% remuneration for these activities. The financial effect of the contractual transfer of the production risk with regard to the 39% surplus is (very) large. If the Supply Agreement with [J Ltd] had not been concluded, [E BV]/interested party would have realised (expected) a total of over € 135,000,000 more profit in 2012 up to and including 2019. This higher amount of profit would have manifested itself in all years²⁴, except for 2018 in which year the presence of the Supply Agreement would have resulted in no loss.

The fact that the profit based on the cost plus 5% remuneration, as agreed in the Supply Agreement, would be (much) less than the profit to be realised on the 39% surplus seems to have been foreseeable. After all, in 2002 up to and including 2011 (2011 being the year in which the Supply Agreement was agreed upon), the return was in most years much higher than a cost plus 5% reward²⁵. In 2002 up to and including 2011, the



EBIT percentage²⁶ was namely 2002: 19.1%, 2003: 19.6%, 2004: 30.8%, 2005: 24.7%, 2006: 12.5%, 2007: 23.6%, 2008: 28.5%, 2009: 3.6%, 2010: 23.3% and 2011: 29.1%. The likelihood that these percentages could still be improved for 2012 and the following years was considerable, given the increased scale, which is of great importance for cost-efficient production. The Court considers it unlikely that in non-affiliated relations an entrepreneur such as [E BV]/interested party, given the realised EBIT percentages in the ten previous years, would exchange the profit on a part of the production for a risk-free return of 5%, even though [E BV]/interested party is active in a volatile market. The differences between the EBIT percentages realised in the past and a risk-free return of 5% are too great for that.

4.56.3. In the grounds of its appeal the interested party states that the [group] decided that [E BV] would operate the production of the 39% surplus on a risk-free basis for it and that in order to cover the market and price risk the Supply Agreement was concluded between [E BV] and [J Ltd] for a period of five years²⁷. No record of the decision to transfer the production risk relating to the 39% surplus to [J Ltd] has been made in the documents before the Court.

With the (group) decision that the production risk with regard to the 39% surplus would be transferred to [J Ltd], both the negative risk, such as price and market risk, and the positive risk, namely the profit that could be made with the surplus proceeds, were removed. With the benefit of hindsight, it can be determined that without the transfer of the production risk, the profits of [E BV] / Interested Party would have been much higher and that in this sense, again with the benefit of hindsight, the Supply Agreement did not serve the business interests of interested party.

However, also at the time of the decision to transfer the production risk to [J Ltd], there are, in the opinion of the Court of Appeal, strong indications that the Supply Agreement was against the business interests of [E BV] / the interested party and that such a decision would not have been taken in unrelated circumstances. After all, [E BV] ran the risk of the € 400,000,000 investment in [the factory] and was dependent on the return on production in order to be able to meet the interest and repayment obligations. For years [E BV] had been the largest and best performing group company within the [group]. The group management's decision to transfer a substantial part of the production yield to [J Ltd] largely deprived [E BV] of the opportunity to achieve a good return. The probability that a good return would be achieved, or at least a better return than on the basis of the cost plus 5%, must be considered very realistic. The returns of [E BV] / the interested party were already very well²⁸ and with the investment in the new factory, resulting in an increasing production volume, the expectation was that it would be possible to produce even more cost-efficiently, and thus even more profitably.

In this context, it is noteworthy that the Supply Agreement was concluded shortly after [the factory] had become operational, namely on 14 September 2011. That this decision had already been taken (much) earlier has not been argued or shown. The investment decision, which was taken in 2007, and the obligations arising therefrom will, as may be assumed, have been taken on the assumption that the entire production capacity would be used to realise the necessary return expectations.

That the business interests of [E BV]/interested party seem to have been of minor importance also follows from the fact that after expiry of the Supply Agreement, after five years, without any form of communication, the Supply Agreement was tacitly renewed. From the perspective of [E BV]/interested party this can also be considered remarkable. After all, at the end of those five years, on balance approximately € 118,600,000 profit, on average more than € 23,700,000 per year, had flowed from [E BV]/interested party to [J Ltd] as a result of the Supply Agreement. It is expected that, in a non-affiliated relationship, [E BV] / the interested party would have entered into a discussion about whether or not to continue the Supply Agreement, as well as the conditions under which, given the results of the past five years. This did not happen, as follows from a response from the interested party dated 2 October 2020 to a question letter from the Inspector dated 17 July 2020²⁹. That response refers to a statement by Mr [A] dated 28 September 2020, which states as far as relevant:

'(...)



iii. In 2016 [court the year in which the five years expired], the board of directors of [interested party] consisted of [FF] , [GG] , [HH] and me. All directors had a joint authority to represent [interested party], together with all the other board members.

i. On 14 September 2011, [E BV] and [J Ltd] A.G. entered into a supply agreement ("**Supply Agreement**") for an initial period of 5 years, commencing on 1 September 2011.

iv. When the expiry date of the initial term of the Supply Agreement approached (being 31 August 2016) [E BV] did not take any action to terminate the Supply Agreement. Neither did [J Ltd] A.G.

v. As a result, the Supply Agreement has been automatically renewed in in 2016 for a period of 1 year (based on article 10.1 of the Supply Agreement) from 1 September 2016 up to and including 30 August 2017.

vi. In my role as Tax Director and board member of [interested party], I have not advised, let alone directed, [E BV] in renewing the Supply Agreement in 2016. Also, none of my team members have been involved, in any way, in the decision to renew the Supply Agreement in 2016.

At the hearing of the Court of Appeal, [A] answered a question of the Court of Appeal as to whether, in view of his position as Tax Director of the interested party and the responsibility he had towards [E BV], it would not have been obvious that he would have assessed whether extending the agreement was in the (business) interest of [E BV], by saying that the group was not tax-driven and that less attention had been paid to the consequences of the Supply Agreement. Furthermore, he stated that he had not been involved in the conclusion of the Supply Agreement.

4.56.4. With due observance of the considerations set out in 4.56.2 and 4.56.3, the Court concludes that when the Supply Agreement was concluded and extended, the commercial interest of [E BV]/interested party was insufficiently taken into account, contrary to what would have happened in unrelated circumstances. The transfer of the production risk with respect to the 39% surplus was not in the interest of [E BV]/interested party, certainly not in view of the € 400,000,000 investment in the new factory and the risk that, as a result of that transfer, the investment could not be recouped.

4.56.5. The interested party also argued that [E BV] /interested party could only achieve the high returns because it was enabled by [AA] and [J Ltd] to make optimal use of its production capacity. The interested party also argued that there was a commercial risk that the 39% surplus could not be fully utilised, that some of the production capacity might have to be used for the production of a product that would yield less profit (UAN), and that managing this risk was one of the reasons for concluding the Supply Agreement.

4.56.6. The Court of Appeal does not consider it plausible that the production capacity of the interested party would not be used optimally, or at least that this would depend on [AA] and [J Ltd]. In the opinion of the Court of Appeal, the interested party is the preferred producer within the group, as the interested party itself writes³⁰:

'4.2.18. Within Europe, [E BV] as a Production Location has a preferential position, because the other European Production Locations are used as swing producers due to their size and age. If there is a decline in demand for Basic Products or if there is a surplus of Basic Products in the market, the [AA] determines that these swing producers must (temporarily) reduce their output, so that [E BV] does not have to reduce its output.

The preferential position of [E BV] stems from the good reputation that has been built up over the years within the group³¹, its scale and its cost-efficient production. This preferential position was only strengthened with the investment in [the factory]. Given the undisputed contribution that [E BV]/interested party makes to the group, it is only fair to think that the capacity utilisation of [E BV] is optimised. The same applies to having to use part of the production capacity for the production of less profitable products. This will also be avoided as much as possible; it may be assumed that [E BV] will also be deployed as effectively as possible in this respect.



However, should there be temporary under-utilisation or should a less profitable product be temporarily produced, then [E BV] must be considered to be able to absorb such a setback with its, on average, high yield.

4.56.7. For the question of whether the production risk in respect of the 39% surplus can be transferred to [J Ltd], it is important to establish which functions are performed by [E BV] and [J Ltd] and whether, in view of those performed functions in non-affiliated relations, a transfer, as shaped in the Supply Agreement, could take place.

4.56.7.1. Before dealing with the functions performed by [E BV] and [J Ltd], the Court will first consider the manner in which the Supply Agreement was fulfilled.

4.56.7.2. Just as it did before the commissioning of the new factory, [E BV] sells the fertiliser products it produces to affiliated sales organisations on the contractual terms and conditions as included in [Group Master Distribution Agreement]. This Master Agreement, with all related documentation, has been in use throughout the group for many years, is reviewed annually for acceptability and is part of the transfer pricing documentation to substantiate the arm's length nature of related transactions. The Supply Agreement entered into by [E BV] and [J Ltd] has not resulted in any change to the terms and conditions contained in [Group Master Distribution Agreement].

Furthermore, there has not been any change in the management of [J Ltd] since the conclusion of the Supply Agreement. No functions have been transferred to [J Ltd] or to other group companies as compared with the situation before the Supply Agreement. Neither the production process nor the logistical process has undergone any change. Nor did [J Ltd] perform any functions for the production or logistical process or make any investments in [E BV] after the conclusion of the Supply Agreement.

4.56.7.3 The considerations in 4.56.7.2 mean that [E BV], just as before entering into the Supply Agreement, continued to sell the entire fertiliser production under exactly the same conditions and at market prices to the sales organisations³². No distinction is made between the sale of the 39% surplus and the remaining 61%. Also, just as before entering into the Supply Agreement, the sales organisations also pay directly to [E BV] for the products which are part of the 39% surplus³³. What is new, after entering into the Supply Agreement, is that [E BV] makes a monthly payment to [J Ltd] for the amounts that it has received from the sales organisations and that relate to the 39% surplus³⁴. Also new is that [J Ltd] subsequently undertakes to pay a 'service fee' to [E BV] as remuneration for selling the 39% surplus to the sales organisations³⁵.

4.56.8. Interested party argues that [E BV] is functionally comparable with a 'contract manufacturer', as follows for instance from what is mentioned in 5.4.2 of the reply:

' (...)

The claimant considers that [E BV] is functionally similar to a contract manufacturer, because its functions are highly routine.

As already explained, [E BV] contractually bears the risks for its own part of the production activities with regard to, for example, the market prices of fertiliser products, the market prices of natural gas, the availability of raw materials and the production capacity risk. However, [E BV] does not have the relevant functions to control those risks.

Based on the Supply Agreement and the Distribution Service Agreement, these contractual risks are allocated to [J Ltd] to the extent that they relate to the Surplus. On the basis of the Supply Agreement and the Distribution Service Agreement, [E BV] acts towards [J Ltd] as a contract manufacturer, so that the contract and the functionality match. (...).'



Rather than regarding [E BV] as a 'key value driver', the interested party argues that the 'key value drivers' are the parts of the group that coordinate and control supply and demand and that purchase the main raw material (natural gas) for the production of [E BV], [J Ltd] , [AA] and the [department]³⁶.

In support of its claim that [E BV] should be regarded as a contract manufacturer, the interested party referred to the transfer pricing report prepared by [Y], which showed that [E BV] was only an 'executive' producer with a very limited business risk. The [Y] transfer pricing report will be discussed below (section 4.57 et seq.).

4.56.9. The Inspector takes the position that [E BV] is a 'fully fledged' producer and that the production function of [E BV] is (one of) the most important 'value driver(s)' within the [group]. According to the Inspector, in the case of [E BV] there is a complex core function which determines the success or failure of the company as a whole.

4.56.10. For many years, the [group] has had extensive transfer pricing documentation, which is updated and checked annually. The TP Master File referred to above is used as the basis, together with the Country Specific Files. The purpose and use of the [group-Transfer Pricing Master File] is described in Introduction and Scope of [group-Transfer Pricing Master File] , Sections 1 - 3:

The purpose of this report is to document how the related party transactions are conducted within the [Group] - hereinafter commonly referred to as "[group]" or the "[Group]" - and how the transfer prices have been determined. Furthermore the report will describe how the applied transfer prices relate to the arm's length principle. The document is intended to provide the reader with sufficient information and understanding of the business to make their own assessment in regards to the arm's length nature of the conducted transactions. [Z] specify that the prices set for inter-company transactions should be based on the arm's length principle. In essence, the results of the transactions between related parties should be consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transactions under the same circumstances.

This document is structured so as to be used as a basis for compliance with the transfer pricing documentation requirements under the law of the different countries where [group] operates. The information contained in this report has been prepared based on the requirements described in [Z]. Furthermore, the Master File is believed to be aligned with the requirements of the EU Transfer Pricing Documentation (EU TPD). The Master File as presented will be completed with separate Country Specific Files , in order to comply with local transfer pricing rules and regulation.

The Court of Appeal understands that the purpose of the [Group-Transfer Pricing Master File] is to arrive at arm's length transactions between affiliated parties in accordance with the guidelines given by the [Z] and that the documentation, together with the Country Specific Files, forms the basis for complying with the requirements set by the countries, including therefore also the Netherlands, where the [group] is active. The Court of Appeal considers [Group-Transfer Pricing Master File] and the Country Specific Files to be of crucial importance for the determination of the function(s) and the related remuneration of [E BV].

4.56.11. Section 3, 'Industry description' of [group-Transfer Pricing Master File] contains an extensive description of the market in which the [group] is active. It describes the market in general, the pricing of the various products, the products and value configuration, the key value drivers, the competition, the market conditions, the dynamics and trends and the risks.

Section 3 is summarised as follows:

'3.7. Summary of Industry Description

The industry description has addressed several issues which may impact the transfer prices of the companies in the industry and which are therefore relevant to [group]'s transfer pricing setup.



The understanding of volume as a key driver of profitability is important in this regard. The companies are dependent on large volumes as the economies of scale are considerable in the industry.

In addition, being aware of the volatility of the fertiliser prices is important. The industry analysis showed how the prices fluctuate depending on a range of factors (e.g. cost of raw material and grain prices). Transfer prices in the industry should take into account these price fluctuations. The seasonal fluctuations in the sales are also important, and affect the price attained for the fertilizer sold.

Cost efficiency and innovativeness was mentioned as critical success factors in the industry.

Differences in these factors between companies must be taken into account when considering the arm's length nature of the transfer prices.

High transportation costs and differing market conditions are also important to keep in mind. Although companies like [group] operate on a global basis, a world fertiliser market with one price does not exist. The prices differ from region to region depending on transportation costs from nearest producer and the market conditions in the region.

For a producer such as an interested party, volume and scale are essential, and cost-efficient and innovative production are critical success factors. Raw material prices are volatile, which means that this must be taken into account when determining (transfer) prices.

4.56.12. Section 4A Sale of finished fertiliser' of [group-Transfer Pricing Master File] details the sales of the producers, such as [E BV] , to the affiliated sales organisations. In 4.3.4 of 'Section 4A', the functional analysis is included. With respect to the production function, the following is determined:

The functional analysis is developed to understand the distinctive contribution of each of the parties in relation to the transaction under review. This section focuses on the functions, assets and risks that are relevant to the transaction under analysis. The purpose of the functional analysis is to give an understanding of the key processes, and risks related to these processes, as well as the assets used during the process. The below functional analysis is relevant for all fertilizers covered in this report which are produced and sold by [group].

(...)

4.3.4.1.1 Seller's activities:

The production plants are responsible for developing and producing finished fertiliser products from natural gas or intermediate products. In order to do this, the following functions are performed:

Research and Development

R&D and technology activities are undertaken to generate innovations that form the basis for new products, product improvements, and advancements in manufacturing processes and distribution systems.

As innovation and product and process development is important in order to remain competitive in any industry, R&D functions are necessary. Production-related R&D costs are the responsibility of Seller. These R&D costs are however limited compared to the costs related to the core functions of the Seller, i.e. the manufacturing process. Market-related R&D costs are the responsibility of the Buyers

Raw Material Purchasing

Purchasing activities relate to the sourcing of raw materials and includes activities such as identifying new suppliers, evaluating current suppliers, qualifying new and current suppliers, negotiating purchase



terms, and setting quality standards for input purchases. All plants are responsible for their own purchasing but are supported in this function by the Central Sourcing Department. The costs associated with the Central Sourcing Department are accumulated and shared amongst the production plants based on production volumes. The sourcing of ammonia, one of the key raw materials of fertilizer production, is performed by the Ammonia Trading and Shipping (AT&S) business unit which is part of the legal entity [J Ltd]. This unit ensures that the "consuming plants" always have sufficient ammonia in stock for the production of finished fertilizers. The functions and transfer pricing methodology applied to the internal sale and purchase of ammonia between the production plants and AT&S are described in detail in the Ammonia transactional file.

Manufacturing Activities

In the basic process to produce nitrogen fertilizers, nitrogen is extracted from the air and combined with natural gas to form ammonia. In turn, ammonia forms the basis for urea, nitrate and other fertilizers. The manufacturing process is relatively capital intensive. All aspects related to manufacturing are the responsibility of the Seller.

On-site storage

All plants have storage capacity, although the capacity varies from plant to plant. This function is important in order to handle demand fluctuations. Reducing the effect of demand fluctuations is one of the key success factors of the industry. Therefore, this function is considered to add considerable value to the transaction.

Sales and Logistics

The Seller is responsible for sales and logistics activities in relation to selling the products to the Buyer. As mentioned previously, all internal sales are in practice facilitated by the [JJ] ([JJ]). The functions of the [JJ] were described above under Business Strategies (4.3.3).

Transportation

As a rule, the fertilizers covered in this report which are sold in Europe and Asia are sold CFR, which entails that the Seller is responsible for arranging and paying for transport to the port of destination (first leg). In those cases, the transportation costs are added to and absorbed in the final transfer price charged to the Buyers. Fertiliser sales to USA and Africa by contrast, are usually made on a FOB basis, but transportation may be practically arranged (albeit not paid for) by the Seller.

(...)

4.3.4.2 Risks

All risks related to purchasing of raw materials are assumed by the production plants (Sellers). Typical risks related to the purchasing function are:

Fluctuations in raw material prices

Late or no delivery

Product quality

The risk of fluctuations in raw material prices is one of the key risks of the fertilizer industry. The cost of natural gas accounts for as much as 70 - 90 % of the total cash cost (i.e., costs of production, excluding such items as depreciation, corporate overhead and debt service) of ammonia production.

**Risks related to manufacturing:**

All risks related to the production function are assumed by the Sellers. Important risks in this regard are:

Insufficient volumes / Excess capacity

Risk of environmental damage during production

Defective equipment

Product quality

The risk of insufficient volumes, and consequently excess capacity at the production sites, is particularly important. There are considerable fixed costs related to running the production plants, and the economies of scale are considerable. Therefore, capacity utilization is a critical success factor for [group].

Inventory risk:

Inventory risk relates to the potential for losses associated with carrying product inventory. Losses include obsolescence and quality loss such that products are only sellable at prices that are inadequate to cover the costs. All inventory risk related to storage of finished fertilizer at the plants, including the risk for price reductions, obsolescence and quality loss during storage is assumed by the Seller.

Market risk

The risk of decreasing market demand and an overall reduction in market prices for finished products due to imbalance in the supply/demand relationship, applies to both parties to the transaction. As the pricing methods applied are directly linked to the external market prices, this risk also affects the production plants, as a drop in the market price will translate to a drop in revenues for the plant. This is also applicable for a drop in the volume sold. Although this will affect both parties as well, reductions in volumes will, if the Production plant is not able to sell these volumes elsewhere, affect the production plant most, as the plant is a substantial financial investment. Reduced volumes will therefore translate to a lower contribution to the Seller's costs.

Foreign Exchange Risk:

The fertilizer products are sold in either Euro or USD depending on the country the Buyer operates in. When products are sold in Euro, the price is calculated into Euro according to the Euro/USD exchange rate on the day of the sale, due to the price reference being in USD. The production plants will further incur operating expenses in Euro or other local currency. As such, the production plant in principle assumes the risk of the USD depreciating relative to the Euro/local currency.

[group] has however implemented a system for monitoring and managing this currency risk, and attempts to mitigate the risk by keeping the exposures within defined limits through financial hedging. This function is performed by [group]'s centralized finance organization and substantially reduces the foreign exchange risk related to the transaction.

Risk related to R&D activities:

The Seller carries the risk of production-related R&D results not materializing. This risk however is relatively limited.

(...)



4.3.4.3.1 Seller's assets

The Sellers utilize advanced equipment and manufacturing facilities when producing the products sold. The plants require substantial capital investments and are the most valuable asset applied in this transaction. In addition, the sellers also apply relevant technology in the manufacturing process.

The functional analysis concludes with the following summary, where relevant:

4.3.4.4 Summary functional analysis

Based on the above functional analysis the parties to the transaction can best be characterized as follows:

For the purpose of this transaction, the Sellers may be characterised as fully-fledged manufacturers.

4.56.13. The Court of Appeal understands the functional analysis in the sense that the [group] sees the manufacturing entities, such as [E BV], as fully fledged manufacturers³⁷. This results from the *functions performed* by the manufacturer (research and development, purchase of raw materials, production, storage, internal sales and related logistics and transport), the *risks assumed* by the manufacturer (price fluctuations, risks related to supplies of raw materials, risks related to the quality of raw materials, utilisation risk, machinery failure, risks related to the quality of the manufactured product, market risks, currency risks, and risks related to research and development activities) and the *assets used* (use of (highly) capital-intensive production facilities and machinery).

4.56.14. In 4.4 of 'Section 4A' of [group-Transfer Pricing Master File] the 'transfer pricing method' is described:

'This section describes the specific fertiliser products sold within the [Group] , as well as the transfer pricing method applied for each product.'

In 4.4.1 of 'Section 4A' of [Group-Transfer Pricing Master File], it is stipulated that the producer, such as [E BV], is remunerated on the basis of the CUP method, except insofar as it concerns the delivery of the products AN and CAN for which the 'Resale/Market Minus method' is used:

As mentioned previously, [group]'s transfer pricing policy is based on the premise that, when identifiable comparable market prices are available, these are used as a basis for internal pricing purposes.

Except AN and CAN, which are priced based on the Resale/Market Minus method, all the other products covered in this report are priced according to the Comparable Uncontrolled Price Method (CUP).

The CUP in most cases uses an international published market price as a basis. This basis is then adjusted to reflect the internal terms and conditions. The adjustments aim mainly at establishing an import parity price i.e. the price that the sales unit would have been required to pay if they had to purchase the product in the chosen trading location and import it into their domestic market. The CUP is therefore adjusted by adding to the international published market price any applicable duties (Common Customs Tariff- CCT) and a freight advantage charge. To this adjusted CUP, estimated freight charges are then added if the product is sold on a CFR basis.

Products whose CUP is based on an international published market price are in most cases calculated according to the following formula:



International published market price

+ CCT (if applicable)

+ Freight advantage fee

= Adjusted CUP

The above Adjusted CUP is then increased with estimated transportation costs to the market if the product is sold on a CFR basis.

The CUP method compares the price charged for goods or services transferred or provided in a corporate transaction with the price of goods or services transferred or provided in a comparable free market transaction under similar circumstances.³⁸

The prices charged by the producer when selling to the related sales organisations are thus derived from market prices. These market prices and the other conditions to which the producers and sales organisations are bound are laid down in [Group Master Distribution Agreement].

4.56.15. The mere fact that [E BV] is remunerated for certain functions and risks assumed does not mean that certain (supporting) services cannot be outsourced, internally or externally. This is even provided for in [Group Transfer Pricing Master File]. For example, a role has been assigned to [JJ]³⁹ ('JJ'), as follows from section 4.3.3 'Business strategies' of 'Section 4A':

'Although the above holds true for all products, a comment must be made here regarding Nitrate products such as AN and CAN for which the market is sufficiently developed leaving the sales units with limited room to further drive the prices. The market for these two products (which is essentially European) is considered to be a very mature market. As such, the sales units cannot do much to further influence the price and their activities are mostly limited to performing routine distribution functions. This, in combination with the fact that no comparable published price exists, is the reason why [group] uses the Resale/Market Minus method on the internal sale of these two fertilizer products.

In order to facilitate efficient and optimal allocation of products to the sales units, [group] has an central planning group referred to as the [JJ] ([JJ]). The [JJ] contributes to achieving [group]'s business strategy by implementing [group]'s global transfer pricing policy and ensuring that [group] sells products to the best markets. The [JJ] further ensures that the company utilizes distribution opportunities as they arise. They do this by matching the production volume, timing and product allocation of the Sellers with the sales activities of the Buyers. Due to the seasonality of fertiliser sales within a given geographical market, the balancing of the demand in order to allow for maximum capacity utilization at the plants is of critical importance.

The [JJ] annually collects and reviews information about sales plans, production plans and prices for the next year. Based on this information, a recommendation as to allocation of products to the different business units is made. Once approved by the plants, this Business Plan is meant to ensure that the company as a whole is selling product to the best markets.

In addition, the [JJ] sends out a price and volume commitment sheet monthly to the Buyers. On this worksheet, the sales units input the volumes that they would like to purchase and provide information with regard to the market price and any relevant factors affecting the transfer price. This allows the [JJ] to monitor the various world markets to ensure that [group] is selling into the best markets when product is in short supply. The costs associated with the [JJ] are accumulated and shared equally amongst Sellers and Buyers based on production volumes and sales volumes respectively.



Also the research and development activities are not carried out by the producers themselves, like [E BV], but are outsourced to [group] Technology Center through a cost sharing agreement. The costs of the Technology Center are divided among the producers within the group according to a certain ratio, increased by a surcharge of 5% ('Section 4D Research and Development Activities', part 4.4 Description of transfer pricing method of [group-Transfer Pricing Master File]):

According to the relevant Cost Sharing Agreement, the costs related to the R&D activities are covered by the members, taking into account that each member's share in the overall contribution must be consistent with that members' share of expected benefit.

Based on the above principle, [F International] pools all costs and revenues related to R&D activities covered by the Cost Sharing Agreement.

Pooled expenses include:

► Payments for services and R&D projects, related to R&D activities provided by the members, by [F International] , by other group companies or by third parties,

Payments for licensing in or purchase of technology from third parties. Pooled revenues include payments from licensing out or sale of technology to third parties.

When [group] entities ([including group]) perform R&D services on behalf of the pool, these services are remunerated on a Cost plus 5% basis. A mark up of 5 % is therefore added on the cost of the services before the costs are allocated to the Members. No additional markup is applied to external services purchased.

The net cost is allocated annually to each member based on produced tonnage of each member compared to total produced tonnage of all members;

Net Cost x (Member production volume / total CSA member production volume)

The method chosen is an indirect method based on costs. The costs of the pool are the costs of the R&D service providers including the 5% mark up on internal services. Production tonnage is used as an allocation key in order to allocate the appropriate share of the costs to each participating member.

The foregoing does not alter the fact that the risks relating to, for example, production (plans) and research and development are ultimately borne by the producers, such as [E BV], and that the remuneration awarded to the producers must therefore be sufficient to actually cover those risks should they arise.

Summary and conclusion on the transfer of production risk

4.56.16. The [group] has for many years had extensive transfer pricing documentation, which is used within the group to allocate profits to the various group units and on the basis of which it is defended externally, including vis-à-vis the Dutch Tax Administration, that profits are allocated in accordance with the [Z]. The application of the Supply Agreement deviates from the transfer pricing documentation.

According to the transfer pricing documentation, [E BV] is a 'fully fledged' manufacturer, which means that it is functionally fully equipped for the entire production process, has all the necessary tangible and intangible assets and can control and bear all the risks arising from the production functions. [E BV] produces (mainly) fertiliser products for the sales organisations of the [group] at market prices entirely on its own account and at its own risk.

The risks that [E BV] runs are great. In particular, the commodity market is extremely volatile. The documents in the proceedings show that the EBIT in the period from 2002 to 2016 fluctuated between 3.6% for the year 2009 and 30.8% for the year 2002, due to strongly fluctuating raw material and fertilizer prices. Another risk



concerns the investment of € 400,000,000 by [E BV]/interested party in [the factory]; this investment was fully financed with internal loans. However, over the years [E BV] has proven to be able to manage these risks well. Two factors are essential in this respect, namely production volume and cost-effective production. As a result of the commissioning of [the factory] in 2011, the production volume increased by 39%. This increase in volume makes a major contribution to (even more⁴⁰) cost-efficient production.

4.56.17. The Court of Appeal is of the opinion that the production of artificial fertiliser products for affiliated sales organisations by [E BV] at market prices, taking into account the functions performed by [E BV], the risks it assumed and the assets it used, can be considered to be at arm's length. After all, for a number of years, this was also the starting point for the interested party and the inspector. The question is whether the transfer of a part of the production and market risk to [J Ltd], namely the 39% surplus, at a cost plus 5%, is in accordance with the 'at arm's length' principle. The Court of Appeal is of the opinion that this is not the case for the reasons stated below.

4.56.18. In the opinion of the Court of Appeal, it would be inconceivable in non-affiliated relations for [E BV] to transfer an important part of the return to be achieved by it from the investment in the [the factory], namely the return to be achieved with the 39% surplus, to a third party for a cost plus 5% fee. All the more so because it concerns a return that results from the functions performed by [E BV], the risks to be run and the investments made. In this respect it should be taken into consideration that after the conclusion of the Supply Agreement, nothing has (virtually) changed with regard to the functions performed and the investments made. [E BV] continued to perform exactly the same functions as before; no functions were transferred to [J Ltd], nor were new functions created at [J Ltd] in order to fulfil the Supply Agreement. Neither has there been any change with regard to the capital investment; [E BV] runs its business with exactly the same assets as before the conclusion of the Supply Agreement. Except for the production risk related to the 39% surplus, the production risk itself has not changed either. [E BV] assumes exactly the same production risk with regard to the 61% production as it did before entering into the Supply Agreement. All other risks, such as capacity utilisation risk, calamities, damages, risks relating to the quality of raw materials, machine failure, currency risks, risks relating to research and development activities, etc., have also remained the same.

In an unrelated relationship, [E BV] would never exchange the return to be realised from the functions it performs, the risks it assumes and the investments made for a risk-free return of 5%, because history has shown that, given the cost-efficient way in which it is able to produce large volumes, it is able to achieve a much better return than a risk-free return of 5%. Of course, market conditions can lead to a lower, even negative, return during a year, but [E BV] has proven in recent years to be able to beat the market every time and to achieve a (very) high return in good years. By transferring (part of) the production risk related to the 39% surplus, [E BV] is essentially affecting its own earnings model, as it is able to increase its return more than proportionally as scale/volume increases.

The Court of Appeal is therefore of the opinion that it must be considered contrary to the 'at arm's length' principle that [E BV] (contractually speaking) transferred part of its production risk to [J Ltd]. This is a case of attributing profits from [E BV] to [J Ltd] purely on the basis of contractual conditions, without this agreement leading to net added value for [E BV].

No such agreement would have been reached between independent third parties.

Does it follow from the transfer pricing report of [Y] that the transfer prices used are correct (4.52.3 and 4.53.3)?

4.57. Subsequently, the Court of Appeal will assess whether the conclusions from [Y]'s transfer pricing report give cause to reconsider the considerations in 4.55 and 4.56.

4.57.1. The transfer pricing report from [Y] focuses on the surplus production activities carried out by [E BV] on behalf of [J Ltd] and looks for an at arm's length remuneration for the (production) functions carried out by [E BV] in that context. In that context, [E BV] is considered to be the 'tested party'. In transfer pricing doctrine,



the 'tested party' is the affiliated company that performs the least complex functions and that does not possess any valuable intangible assets and, for that reason, can best be compared to similar companies. In the search for comparable companies, a benchmark research was performed in a transfer pricing database⁴¹. The benchmark research resulted in 13 'comparable companies'. The study carried out by [Y] resulted in an interquartile range⁴² of 2.6% to 8.3%, with a median of 5%, whereby the return is expressed as a percentage of the total costs.

The transfer pricing report of [Y] concludes that a cost plus 5% remuneration for the production activities of [E BV] is in line with the 'at arm's length' principle.

4.57.2. In the transfer pricing report of [Y], it is assumed that [E BV] bears no risk or a very limited risk for the production activities carried out for the benefit of [J Ltd] (the 39% surplus); however, [E BV] continues to bear such a risk with regard to the original production capacity (the remaining 61%). See in this respect p. 6/20 of the transfer pricing report of [Y] :

AG⁴³ and BV⁴⁴ entered into an agreement regarding the increase of sales of urea based products (the **Supply Agreement**). Pursuant to the Supply Agreement, BV will operate on a risk-free basis in respect of the increase on production capacity to manufacture urea based products and will supply a certain volume of urea based products to AG. This volume will be equal to the increased production volume of BV. BV is going to continue at its own expense and risk to manufacture the original capacity for the production of urea solution. (...)'.

4.57.3. The absence or insignificance of risk is substantiated extremely briefly by the functional analysis. For example, no market risk is identified and no operational risk and product liability risk are considered present, because this would be covered by insurance. This analysis deviates significantly from the functional analysis that has been included in TP Master File and the Country Specific Files for years, without including an explanation for this difference. For reasons of procedural economy, the Court will ignore the functional analysis and will focus in the first instance on the comparability analysis.

4.57.4. The 13 'comparable companies' mentioned in 4.57.1, as well as some financial data, are included in Appendix C, which is part of [Y]'s transfer pricing report. There is hardly any information or explanation of these 13 'comparable companies' in [Y]'s transfer price report to test whether there is actually any comparability. However, it can be established that on one crucial point the companies compared with [E BV] are not comparable. [E BV] has a turnover of almost € 1 billion. The companies compared with [E BV] only have a turnover of a few millions up to € 30,000,000. This means that [E BV] is (at least) ten times larger than the companies compared with it. In an industry where scale and cost efficiency are essential, there is not a matter of comparable companies.

4.57.5. From the above the Court of Appeal concludes that it does not follow from the transfer price report of [Y] that the transfer prices used therein are correct and that the conclusions drawn in that report do not constitute a reason to reconsider the considerations in 4.55 and 4.56. The Court of Appeal considers the incomparability of the companies compared with [E BV] to be decisive in this respect. But that is not all. The Court of Appeal is also of the opinion that the artificial separation that the transfer price report of [Y] makes between the 39% surplus (no risk) and the original production capacity of 61% (risk) cannot be justified. Moreover, the functional analysis included in [Y]'s transfer price report (i.e., that there is no risk) contrasts sharply with the functional analysis included in the transfer pricing documentation used within the [group], in which [E BV] is described as a fully fledged company which assumes all kinds of risks, without any explanation being given for this difference. Finally, in the opinion of the Court of Appeal, [E BV] was wrongly regarded as the 'tested party'. Unlike the interested party apparently thinks, the Court of Appeal is of the opinion that [E BV] / interested party is a complex company with many functions and a high and diverse risk profile.



Is the inspector acting contrary to the principle of equality (4.52.4 and 4.53.4)?

4.58. The next question the Court of Appeal will examine and answer is whether the Inspector acted contrary to the principle of equality, because in the present case he would deviate from the policy formulated in the Starbucks⁴⁵, Nike⁴⁶ and Apple⁴⁷ cases, which is argued by the interested party and contested by the Inspector.

4.59. The interested party has argued in this respect that the cases mentioned in 4.58 show that the Inspector does not comply with the transfer pricing policy that applies when determining the Dutch taxable profit of a company, as expressed several times by the State Secretary of Finance. According to the interested party, pursuant to that policy, the arm's length Dutch taxable profit is determined on the basis of (1) the functions performed in the Netherlands, the assets used and the risks assumed, (2) the agreed contractual relationships and (3) the benchmark analyses carried out. In the case of the interested party, the tax inspector deviated from this policy by ignoring the contractual relationships, failing to take into account the functions performed, assets used and risks assumed in the Netherlands and not accepting the benchmark analyses, with the result that the interested party received worse tax treatment than a party such as Starbucks. The Starbucks case is a good example of a producer not bearing the price risk, according to the interested party.

4.60. The principle of equality requires equal treatment for equal cases and unequal treatment for unequal cases according to the degree of their inequality. The burden of proof that the principle of equality has been breached rests on the interested party.

4.61. In the opinion of the Court, the interested party does not substantiate, or substantiates in far too general a manner, that the case of the interested party can be equated with the Starbucks, Nike and Apple cases. The mere fact that the interested party, according to the interested party, benefits from a better remuneration than Starbucks, and that the State Secretary of Finance has defended the APAs⁴⁸ of Starbucks and Nike vis-à-vis the European Commission, does not mean that the State Secretary of Finance is pursuing a policy whereby activities such as those of [E BV] / the interested party can be (partly) rewarded with a cost-plus. The at arm's length remuneration depends on the functions performed, the risks assumed and the assets used. The interested party has not provided any insight into the extent to which the situation of the interested party in this respect is comparable to the Starbucks, Nike and Apple cases. The argument put forward by the interested party that the tax inspector deviates from the transfer pricing policy by ignoring the contractual relationships, failing to take into account the functions performed, the assets used and the risks assumed in the Netherlands, and not accepting the benchmark analyses, cannot be accepted in the opinion of the Court of Appeal. The inspector does take into account the relevant functions, risks assumed and assets used of [E BV] / interested party (and of [J Ltd]), but does not share the conclusion drawn by the interested party that the interested party fulfils a routine function. The Inspector concludes that there is a fully fledged operation, a conclusion that is endorsed by the Court of Appeal (see the considerations under 4.56). The remuneration awarded for the routine functions in the Apple case cannot be compared to the remuneration awarded to fully fledged companies such as that of [E BV]. Also, in the opinion of the Court of Appeal, the benchmark analysis presented by the interested party was rightfully rejected (see the considerations under 4.57).

4.62. The Court does not consider the principle of equality to have been violated.

Should significance be attached to agreements concluded by the [group] with third parties which are closely linked to the Supply Agreement between [E BV] and [J Ltd] (4.52.5 and 5.53.5)?

4.63. In its 10-day submission, the interested party argued that, in practice, agreements such as the Supply Agreement are also concluded between third parties. In this context, the interested party mentions that in 2011 it negotiated with [B NV] about the takeover of the fertiliser activities of [B NV] by the interested party. As the sale ultimately did not go ahead, the interested party does not (any longer) have the tolling agreement at its disposal. Moreover, the interested party was aware that other companies in the chemical industry had set up



similar arrangements, in which connection reference is made to a Supply Agreement between [X AG] ([country 2]) and Y B.V. (Netherlands).

In later years the [group] entered into similar contracts whereby a third party performs the production function for a cost plus remuneration. Mention is made of the agreements between [group U], a sales organisation, which concluded an agreement with [CC] under which [CC] manages a factory belonging to [group U] in return for remuneration of the costs incurred by [CC] as well as a remuneration of GBP 4,000,000. Also referred to is an agreement between [group F 1]⁴⁹ and [EE]. Under this agreement, the ammonia plant is fully managed by [EE] and [EE] is responsible for the production risks. For this purpose [EE] places employees at the disposal of [group F 1]. For its work, [EE] receives remuneration for the costs it has incurred in carrying out the work, as well as a fixed annual fee of USD 1,626,000.

4.64. The Court of Appeal has ignored the examples concerning the agreement with [B NV] that was ultimately not concluded, and the Supply Agreement between [X AG] and Y B.V. It is not to be tested whether, and if so, to what extent, these cases are (somewhat) comparable to the relationship between [E BV] and [J Ltd] and what has been agreed between them. It is not known who the anonymised party and Y B.V. are, nor is there clarity about the functions, risks assumed and assets used of both the 'toll manufacturer' and the 'manufacturing principal'.

4.65. As regards the agreements between [group U] and [CC] and [group F 1] and [EE], the Court of Appeal ruled as follows.

The relationship between [group U] and [CC] is incomparable with that between [E BV] and [J Ltd]. The most obvious difference is that [E BV] owns both the factory and the fertiliser products, whereas in the [U group] / [CC] relationship the factory is owned by [U group] and production is carried out by [CC]. Furthermore, the detailed conditions agreed in the contract between [group U] and [CC] differ to a large extent from the conditions agreed between [E BV] and [J Ltd], which appear to have the sole purpose of contractually transferring part of the risk from [E BV] to [J Ltd]. As the Court of Appeal has ruled in 4.56 this is not in accordance with the 'at arm's length' principle.

The relationship between [F 1 group] and [EE] is also very different from that between [E BV] and [J Ltd]. The [F 1] group and [EE] have entered into a partnership in which both have invested in a factory. For the purposes of the partnership, services are provided on both sides on the basis of the joint need for ammonia. The performance and remuneration must therefore be viewed against the background of the common interest and the relative equality of the parties. The relationship between [E BV] and [J Ltd] is fundamentally different. [E BV] is the sole investor in the factory operated by itself. As a fully fledged company, it performs most functions itself. A limited number of functions (provision of services) are performed by group entities. One of those entities is [J Ltd]. Unlike in the case of [the F 1 group] and [EE], there is no question of a common purpose and (relative) equivalence.

4.66. In view of the considerations under 4.64 and 4.65, the Court is of the opinion that the four examples given by the interested party are not comparable with the relationship between [E BV] and [J Ltd]. Therefore, as far as the assessment of the Supply Agreement is concerned, there is no reason to attach significance to the agreements concluded between third parties mentioned by the interested party or to reconsider the considerations under 4.55 and 4.56.

If there is a profit transfer, should it have been taxed in 2011 (4.52.6 and 4.53.6)?

4.67. Finally, the interested party also argued that if there is a profit transfer, taxation should have taken place in 2011, being the year in which the Supply Agreement was drawn up. The profit to be declared in that year would then consist of the net present value that [E BV]/the interested party would have foregone. According to the interested party, if no profit was taken into account in 2011, no profit could be (further) taken into account in later years.



4.68. In the opinion of the Court, the argument put forward by interested party under 4.67 is not correct. The presence of the Supply Agreement is a fact that cannot be ignored. In case the execution of the Supply Agreement should be considered as non-arm's length - which is the opinion of the Court of Appeal - such non-arm's length action should, pursuant to the provisions of Article 8b of the 1969 Corporation Tax Act, be corrected in such a way that a result is achieved in which the fiscal profit is comparable to the profit that independent companies would achieve under comparable circumstances with comparable transactions. In unrelated relations the Supply Agreement would not have been agreed upon and the monthly profit transfer from [E BV] to [J Ltd] would not have taken place. The (monthly) non-business dealings must be corrected on a monthly basis.

Contrary to the interested party's assertion, therefore, the profit should not be corrected when the Supply Agreement was concluded in 2011, but from month to month, in the month in which the non-arm's length conduct occurred. Since the interested party did not raise any other objections to the amount of the correction of € 42,843,146 applied by the tax inspector in this respect, this correction will be upheld.

4.69. Question 4 should be answered in the negative.

Interim conclusion

4.70. In conclusion, the appeal filed by the interested party with number 19/00779 is well-founded and the appeal filed by the Inspector with number 19/00771 is unfounded. The assessment must be reduced to a taxable amount of EUR 95,039,363, on the understanding that this taxable amount is based on the following calculation:

Declared taxable amount	€ 29,430,045
Attributing interest to [K CV].	€ 1,847,000
Provision for levy interest	€ 101,000
Provision for tax damage	€ 419,000
Iron stock system	€ 19,050,304
Coherent valuation	€ 1,348,868
Profit transfer to [J Ltd]	€ 42,843,146
Total	€ 95,039,363

(Huygens: procedural part omitted/not related to transfer pricing)

5 Decision

The court:

- Dismisses the appeal lodged by the interested party under reference 19/00779 as well-founded;
- Dismisses the appeal lodged by the Inspector with reference number 19/00771 as unfounded;
- Annuls the judgment of the court, with the exception of the decision on the court registry fee and the (legal) costs;
- upholds the appeal to the court against the decision on the objection;



- Annuls the decision on the objection;
- reduces the assessment to a taxable amount of € 95,039,363;
- shall reduce the decision on tax interest accordingly;
- orders the Inspector to reimburse the interested party with the court fee of €519 for the appeal proceedings before the Court of Appeal;
- orders that a court registry fee of EUR 519 be imposed on the inspector;
- order the inspector to pay the costs of the proceedings before the court in the amount of EUR 5,313.

This judgment has been issued by P.A.M. Pijnenburg, chairman, T.A. Gladpootjes and L.B.M. Klein Tank, in the presence of J.M.A. van Rooij-Beckers, as registrar.

The decision was delivered in public on [date] and copies of the judgment were sent to the parties by registered mail on that date.

1) R.o. 4.1.7 to 4.1.9.

2) R.o. 4.6.

3) Parliamentary Papers II 2011/12, 33.003, no. 3, p. 96, where it is stated: In Article 15e, sixth paragraph, of the Corporate Income Tax Act 1969 is determined in which manner the profit to be allocated to a foreign company (permanent establishment) must be determined for the application of the second paragraph, part b. It therefore concerns the allocation of profits in non-treaty situations. The text of this paragraph has been derived from the most recent text of the OECD model treaty, as concluded in the update of 2010. This text ensures that in non-treaty situations the profit is allocated according to the most modern OECD approach.

4) OECD, *Report on the attribution of profits to permanent establishments*, 22 July 2010.

5) Decision of 15 January 2011, no. IFZ2010/457M, Government Gazette 2011, 1375.

6) See, among others, OECD, *Report on the attribution of profits to permanent establishments*, 22 July 2010, paras 118 and 156.

7) OECD, *Report on the attribution of profits to permanent establishments*, 22 July 2010, at 121.

8) OECD, *Report on the attribution of profits to permanent establishments*, 22 July 2010, at 124.

9) Supreme Court 8 February 2019, ECLI:NL:HR:2019:199.

10) See, among others, Supreme Court 10 April 2009, ECLI:NL:HR:2009:AZ7364.

11) Hoge Raad 16 november 2007, ECLI:NL:HR:2007:AZ7371.

12) Supreme Court 21 March 2014, ECLI:NL:HR:2014:635.

13) Supreme Court 23 January 2004, ECLI:NL:HR:2004:AI0670.

14) European Manufacturing of Fertilisers - Analysis of Comparable Data 2010-2012.

15) European Distribution of Fertilisers - Analysis of Comparable Data 2010-2012.

16) Decision of 22 April 2018, No 2018/6865, Government Gazette 2018, 26874.

17) A tax control framework can be described as a set of processes and internal control measures designed to ensure that the tax risks within the taxpayer's business operations are known and controlled.

18) Supreme Court 15 March 2019, ECLI:NL:HR:2019:355.

19) The report speaks of 'update' and of 'previous performed comparability analysis'.

20) Notice of appeal of 7 May 2020, pp. 101-102.

21) Court of Justice: means [E BV].

22) Court: means [J Ltd].

23) Production risk can include (among others): capacity utilisation risk, efficiency risk, price risk and market risk, such as the cost of raw materials such as the price of natural gas.

24) More profit 2012: € 42,843,146, 2013: € 15,457,904, 2014: € 17,916,008, 2015: € 29,793,071, 2016: € 12,617,000, 2017: € 7,414,000, 2018: -/- € 8.449.000, 2019: € 17.424.000. From: Memorandum from [Y] dated 12 August 2020, [stakeholder] - explanation calculation IRR.

25) The cost-plus 5% also takes place at EBIT level. See note 11.

26) EBIT means earnings before interest and taxes. EBIT % is EBIT expressed as a percentage of net turnover. See for the percentages: Inspector's defence document, p. 42 and 43/107.

27) Grounds of appeal, p. 12/50, at 83.

28) See also the EBIT percentages for the years 2002-2011, mentioned in 4.56.2.

29) Annex 14 to the Inspector's rejoinder of 21 October 2020.

30) See statement of reply of 13 August 2020, section 4.2.18.

31) See in this respect the press releases (in particular Annexes 3 and 4 to the statement of rejoinder) in which is mentioned that the team of [the factory] plant 'has got that plant running one hundred and twenty percent above design capacity' and that the [plant] plant 'is



- not the largest urea plant in the world, but we have run the highest production in the world with it'. Those press releases further refer to efficiency by stating that the plant has not experienced a single major malfunction in five years and thus no start-up of the immense plant.
- 32) See 2. Delivery of the Distribution Service Agreement.
 - 33) See 3. Payment by Distributor of the Distribution Service Agreement.
 - 34) See 4. Payment by [E BV] of the Distribution Service Agreement.
 - 35) See 6. Service Fee of the Distribution Service Agreement.
 - 36) [AA] and [division] are parts of [group] Belgium.
 - 37) Also in the Country Specific Files, section 5.2.1, of [group] Transfer Pricing Documentation 2012 - Section 5 the Netherlands, [E BV] is referred to as 'fully fledged manufacturers'.
 - 38) Paragraph 2.14 of the [Z] for Multinational Enterprises and Tax Administrations (2017).
 - 39) Later called [AA].
 - 40) Within the group, [E BV] was already considered particularly cost-efficient.
 - 41) The search was conducted in the Orbis database. This database was published by Bureau van Dijk and contains financial information on more than 2,500,000 European companies.
 - 42) The interquartile range eliminates the highest and the lowest 25% of observations found.
 - 43) Court: [J Ltd].
 - 44) Court: [E BV].
 - 45) General Court of the European Union 24 September 2019, Starbucks, ECLI:EU:T:2019:669.
 - 46) General Court of the European Union 22 November 2019, Nike, T-648/19 (not yet a final decision).
 - 47) General Court of the European Union 15 July 2020, Apple, ECLI:EU:T:2020:338.
 - 48) Advanced price agreement.
 - 49) [group F 1] is a joint venture between ([group]) [site 3] [group F 2] and [EE]. In this joint venture, the [group] has an interest of 68% and [EE group] an interest of 32%. [group F 1] operates an ammonia plant in [site 3] , Texas.
 - 50) Appeal bearing the number 19/00779: notice of appeal (1 point), reply (0.5 point) and appearance at the hearing (1 point). Appeal bearing the number 19/00771: statement of defence (1 point).

