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The Dutch Approach to the Attribution of Profits to Permanent Establishments

In this article, the authors outline and comment on the Decree of the Dutch State Secretary of Finance on the attribution of profits to a permanent establishment, which was released in response to the 2010 amendments to Art. 7 of the OECD Model Tax Convention, as well as a recent announcement of the Dutch State Secretary of Finance regarding the Dutch tax treatment of foreign permanent establishments.

1. Introduction

The OECD Model Tax Convention (the OECD Model) is used by the Netherlands as the standard for (re)negotiating its tax treaties.[1] Art. 7 of the OECD Model addresses the attribution of profits to a permanent establishment (PE). In July 2010, Art. 7, and the commentary thereto, was amended to achieve greater consensus between the OECD Member countries on profit attribution. However, taxpayers will still be required to make a number of decisions to arrive at an arm's length attribution of profits to a PE.

These decisions may lead to uncertainty for taxpayers, as states can still apply different methods and vary in their interpretations. In an attempt to reduce this uncertainty, the Dutch State Secretary of Finance (SoF) published a decree on 27 January 2011, outlining the Dutch position with respect to the most important decisions relating to the amended Art. 7 of the OECD Model (the Decree).[2] The Decree is binding for the tax authorities but not for taxpayers. By following the preferences contained in the Decree, taxpayers reduce the risk of disputes with the Dutch tax authorities on the attribution of profits to a PE.

In this article, the authors investigate these Dutch preferences and, where applicable, place them in the context of Dutch domestic legislation and case law. They also address a recent announcement of the SoF regarding the Dutch tax treatment of foreign PEs.

2. Background to the Decree

In the past, states often expressed different views on the attribution of profits to a PE. This resulted in either double taxation or non-taxation of a PE's profits. In 1995, the OECD started a project to unify the interpretation of Art. 7 of the OECD Model. This project resulted in the Report on the Attribution of Profits to Permanent Establishments of 18 July 2008, with minor amendments published on 22 July 2010 (the Report).[3] To the extent that the conclusions of the 2008 Report were not in conflict with the existing wording of Art. 7 of the OECD Model, the Commentary to the OECD Model was amended in 2008. The second step was to amend Art. 7 of the OECD Model itself (and its Commentary) in 2010 (2010 OECD Model, with the former version of the OECD Model being referred to as the Pre-2010 OECD Model).

Following the recommendations of the OECD, as published together with the Report (the Recommendations),[4] the SoF decided to issue the Decree in order to give the Report publicity in the Netherlands in the Dutch language. At the same time, by publishing its "domestic law choices" the Dutch preferences may lead in discussions with other states (for example, through mutual agreement or arbitration procedures – see section 6. on profit attribution to a Dutch PE).[5]

3. Scope of Art. 7 of the 2010 OECD Model

The Decree begins by stating that Art. 7 of the 2010 OECD Model will, from now on, form the basis of Dutch tax treaty negotiations. This means that, in principle, it only applies to (future) treaty situations. Due to the fact that the OECD Model lacks standing and there is no direct domestic legislative reference to the OECD Model, the OECD Model, its Commentary and the Report do not have direct effect regarding the application of Dutch domestic tax law (i.e. in regard to non-Dutch taxpayers with a PE in the Netherlands) and the Dutch Unilateral Decree for the Avoidance of Double Taxation (DADT) (i.e. in regard to Dutch taxpayers with a PE in a non-treaty jurisdiction). Instead, the OECD Model only has direct effect when interpreting tax treaties concluded by the Netherlands. As a result, the PE definition under domestic tax law or the DADT may have a different meaning than the PE definition under tax treaties (although the SoF mentions that all PE provisions have the same purpose). A difference in the interpretation of the PE

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1. Which was expressly confirmed by the Dutch Ministry of Finance in its recently published 2011 Note on Tax Treaty Policies (*Notitie Fiscaal Verdragsbeleid 2011*) of 11 February 2011 (*Kamerstukken* II 2010/11, Ref. 25 087, No. 7) (Note on Tax Treaty Policy), as a result of which there is no longer a need for a separate Dutch Model Treaty (the last version dating back to 1987).
2. Decree of the Dutch State Secretary of Finance of 15 January 2011, No. IFZ2010/00457M, as published in the *Staatscourant* on 27 January 2011, No. 1375.
3. Note that any further references to the Report are to Part I of the 2010 Report (unless expressly stated otherwise).
4. Recommendation of the Council on the attribution of profits to permanent establishments (C(2008)106), as amended on 16 July 2009 (C(2009)88) and on 22 July 2010 (C(2010)105), as included in the Report on pp. 238-240.
5. See Para. 48 of the Commentary to Art. 7 of the Pre-2010 OECD Model.

provisions, and of the methods that are used to attribute profits to a PE, could result in double taxation or double non-taxation, which would contradict the purpose of these provisions. Therefore, the SoF notes that the Report and the Commentary to Art. 7 of the OECD Model are of great importance in interpreting Dutch domestic tax law and the DADT.

4. Dynamic versus Static Interpretation

4.1. In general

The general Dutch policy is to apply the arm's length principle when determining a PE's profit and to adhere to the functionally separate entity approach.[6] As such, the Decree states that Dutch policy is in accordance with the conclusions of the Report and considers these conclusions to be a correct interpretation (and clarification) of the principles of Art. 7 of the Pre-2010 OECD Model. The SoF also notes that the Netherlands applies the dynamic method for the interpretation of tax treaties when the Commentary to the OECD Model is amended. Consequently, amendments that are intended as clarification should apply to treaties that were concluded before the Commentary to the OECD Model was amended. Since the July 2008 amendment to the Commentary to the OECD Model (only) represents such clarification according to the SoF, these amendments can be applied to all existing treaties.

It is, however, not true that the amendments in Art. 7 of the 2010 OECD Model and its Commentary apply automatically to existing treaties that have been concluded with a deviating Art. 7. To remove any uncertainty as to the extent to which Art. 7 of the 2010 OECD Model and its Commentary apply to existing treaties (i.e. with a Pre-2010 OECD Model Art. 7), the SoF is willing to apply the principles of the Report to all treaties, even in cases where these principles do not serve to clarify Art. 7 of the Pre-2010 OECD Model. This commitment also applies when exempting foreign profits under the DADT or when taxing foreign taxpayers in the absence of a treaty based on domestic tax law.

4.2. The authors' comments

The option, at the taxpayer's discretion, to apply Art. 7 of the 2010 OECD Model and its Commentary to all tax treaties, contradicts the Recommendations. The Recommendations provide that the Report should only be applied to treaties drafted on the basis of Art. 7 of the 2010 OECD Model. A treaty partner may not agree to apply the Commentary to Art. 7 of the 2010 OECD Model and the Report to Pre-2010 OECD Model treaties, with the result that each state may interpret Art. 7 of the Pre-2010 OECD Model differently.[7] Moreover, the tax treaty partner may consider the Dutch approach to be an infringement of its rights under the treaty. It is, therefore, questionable whether or not the Dutch approach will result in more certainty for taxpayers.

More importantly, it is possible that the Dutch courts will not follow the dynamic approach. The Dutch courts have interpreted the Commentary to the OECD Model in both a static and a dynamic manner. As such, a taxpayer may choose to appeal its case (and the applicability of Art. 7 of the 2010 OECD Model and its Commentary) in court if a dynamic interpretation leads to an unsatisfactory result. A judge may then interpret Art. 7 and its Commentary in a static manner, as the courts are not bound by the Recommendations;[8] rather, the courts use the Commentary to the OECD Model as an important means of interpretation of tax treaties concluded based on the OECD Model.

5. Concepts regarding the Attribution of Profits

5.1. In general

The starting point, when attributing profits to a PE, is the Authorized OECD Approach (the AOA). This approach provides that the profit that is attributable to a PE is equal to the profit that the PE would have realized if it were a functionally distinct and separate enterprise, having the same or similar functions, acting under the same or similar conditions (i.e. the functionally separate entity approach).[9] The AOA identifies two steps. Under the first step, assets and risks, together with equity and debt, are allocated to the PE based on a functional analysis. Under the second step, profit is allocated to the PE based on the analysis under the first step and by applying the arm's length principle.

The Decree prefers to allocate equity to the PE based on the capital allocation approach. The SoF mentions that this method best takes into account the basic principle that a PE has the same creditworthiness as its head office. The SoF acknowledges that applying the capital allocation approach may result in a modified allocation of equity and debt, since the Dutch practice was previously to only allocate external debt to a PE if a causal relationship existed between the debt and the assets of the PE.[10] The internal comparison will only be relinquished and the thin capitalization approach applied if the entire enterprise is not financed in accordance with the arm's length principle, i.e. there is too little equity and the funding costs are too high.

6. The functionally separate entity approach had already been highlighted by the SoF in its 1998 note on Dutch treaty policy, as published in V-N 1998/22, Para. 4.1.3.
7. However, Para. 2.6.4 of the 2011 Note on Tax Treaty Policy states that *in consultation with* the treaty partners the principles of the Report are applied to existing treaties.
8. See, for more details on this topic, and an overview of Dutch court cases (divided on the basis of static and dynamic interpretation), Hans Pijl, "De financiering van de vaste inrichting: interpretatie- en dynamiekproblemen" (*The financing of a PE: interpretation and dynamics problems*), *Weekblad fiscaal recht* 6894, 17 February 2011.
9. For an in-depth discussion of the AOA see Luis Nouel, "The New Article 7 of the OECD Model Tax Convention: The End of the Road?", *Bulletin for International Taxation* 1 (2011), pp. 5-12 and Mary Bennett and Raffaele Russo, "Discussion Draft on a New Art. 7 of the OECD Model Convention", *International Transfer Pricing Journal* 2 (2009), pp. 73-80.
10. See, amongst others, the ruling of the Dutch Supreme Court of 23 January 2004, No. 37 893, BNB 2004/214, with the opinion of Advocate General Th. Groeneveld and the note by R.J. de Vries. This was also discussed in the context of attributing assets to a PE by Hans Pijl in, "Netherlands: Allocation of Assets to a Permanent Establishment and the OECD Discussion Drafts", *Bulletin for International Taxation* 8-9 (2006), p. 351-357.

Besides allocating equity, arm's length interest expenses should be allocated to the PE. The Report describes different methods, including the tracing approach and the fungibility approach. The tracing approach looks at the historic relation between debt funding that was obtained by the enterprise and the specific asset that required financing. The fungibility approach allocates a pro rata portion of the interest expense of the total enterprise to the PE. The SoF has indicated a preference for the fungibility approach, which allocates a (risk-weighted) portion of the total interest expenses of the enterprise to the PE. According to the SoF, the tracing approach takes the specific circumstances of the PE into account to a lesser extent and may, therefore, not result in an arm's length attribution of interest expenses to the PE.

In the annex to the Decree, certain remarks are made relating to the application of the capital allocation approach. First, in determining the value of the assets when calculating the relative interest of the assets of the PE, the fair market value of such assets is the starting point. Second, the determination of the relative value of the assets, in principle, has to be done annually. The SoF concludes that due to the complexity of the above, the tax authorities will be somewhat flexible in their review.

5.2. The authors' comments

There are a number of Dutch cases on the allocation of debt or equity to PEs. In most of these cases, the Dutch courts used the attribution of debt as the starting point, whereas the remainder qualified as 'free' capital not giving rise to interest expenses. In addition, the tracing method has generally been followed in Dutch case law, most recently by the Dutch Supreme Court in its decision of 25 November 2005.[11] The Decree, therefore, contradicts what was customary in the Netherlands in two respects. First, the Decree follows the AOA in stating that equity, rather than debt, should be allocated to the PE first. Second, the Decree prescribes the use of the fungibility approach, although the SoF could have chosen the tracing method in accordance with Dutch case law.

In light of the fact that the Dutch courts generally agree that the tracing method should be applied, the authors cannot comprehend the comment in the Decree that this method is not preferred, as it takes the specific circumstances of the PE into account to a lesser extent (and may, therefore, not result in an arm's length attribution of interest expenses to the PE). In the authors' view, the tracing approach does exactly the opposite. It links a specific loan to the PE if it was taken up to finance assets deemed to be owned by the PE, and thus takes note of the PE's specific circumstances. It is, therefore, likely that, where it is beneficial, taxpayers may still be able to apply the tracing method, although they will have to convince the tax authorities of the arm's length outcome of applying this method.

In regard to the thin capitalization approach, the Dutch Supreme Court ruled that it would lead to an arbitrary outcome. The Supreme Court held that referring to the debt to equity ratio of independent enterprises involved in a comparable business when determining the debt to equity ratio that should be allocated to a PE (i.e. the thin capitalization approach) would lead to an arbitrary outcome, since it depends on the specific circumstances of the case and the choice of the entrepreneur as to how to finance the business.[12] The preference of the Netherlands, as set out in the Decree, therefore, seems to be in accordance with the decision of the Supreme Court on this point. Nonetheless, the argument regarding the same creditworthiness, in the authors' view, does not hold, since, in applying the thin capitalization approach, the PE is also considered to have the same creditworthiness as the head office.

In the authors' view, the SoF has chosen the least practical approach with respect to the valuation of assets by prescribing a valuation at fair market value. The Report, which mentions the following methods for valuing assets, provides for sufficient flexibility: (1) the book value, (2) the market value and (3) the original purchase price or cost of the assets.[13] The method chosen by the SoF will impose a substantial administrative burden on taxpayers since not only does the market value of the assets of the PE have to be determined, but also that of the whole enterprise in order to determine the relative portion of the assets to be attributed to the PE. In addition, although the SoF requires that assets be valued annually, the Report only appears to require that a subsequent valuation be made when an internal dealing gives rise thereto.[14] It would have provided taxpayers with more certainty and less of an administrative burden if (1) the valuation method to be used by taxpayers was based on the book value, original purchase price or cost of the assets rather than the market value and (2) there was no requirement to value the assets each year. Even if the same method is applied for the attribution of capital in both states, double taxation may still arise if the method for valuing the assets and the moment at which (re)valuation takes place differs.

6. Elimination of Double Taxation

6.1. In general

Since the Report does not prescribe the use of a specific method, there is a risk of no taxation or double taxation if different jurisdictions allocate equity and funding costs

11. Dutch Supreme Court, 25 November 2005, No. 40 858, among others published as BNB 2007/117, wherein it held that: "As a general rule, when calculating taxable profits, only financing expenses that are subservient to the enterprise of the permanent establishment should be attributed to this permanent establishment. So-called internal loans are generally not taken into account in calculating taxable profits, except in exceptional cases where the arm's length character of the internal loan cannot be disputed, e.g. internal supplier credit (*leverancierskrediet*) and advances between divisions of financial institutions as mentioned in the Commentary to Article 7 of the OECD Model under 19. Only debt that is subservient to the enterprise of the permanent establishment should thus be attributed to this permanent establishment." (authors' unofficial translation).
12. See Para. 3.3.2 of the Dutch Supreme Court ruling of 7 May 1997, No. 30 294, amongst others published as BNB 1997/263, with the opinion of J. van Soest and the note by J. Hoogendoorn.
13. Paras. 109 and 110 of the Report.
14. See, for instance, Paras. 196-199 of the Report.

differently.[15] The Decree states that if double taxation arises as a result of a different approach to the allocation of interest expenses used by the respective tax authorities, the SoF is willing to enter into a mutual agreement procedure with another jurisdiction (with which the Netherlands has concluded a tax treaty) to attempt to eliminate such double taxation.[16]

In situations where Art. 7 of the Pre-2010 OECD Model applies, the Netherlands should follow the approach of the PE state (in accordance with Para. 48 of the Commentary to Art. 7 of the Pre-2010 OECD Model and the conditions described therein) where a different approach is used for the attribution of capital. The SoF is of the opinion that a situation where part of the profit is not subject to tax, due to different methods being used for allocating equity by the different tax authorities, should be prevented as much as possible or eliminated.

6.2. The authors' comments

By not wholly committing itself to applying a corresponding adjustment if the other state has made an initial adjustment in accordance with the principles of Art. 7(2) of the 2010 OECD Model, the SoF is in conflict with its obligations under Art. 7(3) of the 2010 OECD Model.[17]

It is unclear why the SoF is only committed to entering into a mutual agreement procedure in cases of double taxation caused by a different approach to the allocation of interest expenses by another jurisdiction (under an applicable tax treaty with that jurisdiction) and not when a different method is used for allocating equity. This seems to be based on a strict reading of Para. 49 of the Commentary to Art. 7 of the Pre-2010 OECD Model, which clearly is only meant to serve as an example. In addition, the Decree should interpret these issues based on the 2010 OECD Model, and not on the pre-2010 OECD Model and its Commentary. In this respect, the main rule of Para. 48 and the example in Para. 64 of the Commentary on Art. 7 of the 2010 OECD Model should be noted, which does not provide for such a limit.[18]

In addition, this limited commitment does not seem to be in line with the intention of the Netherlands to opt for mandatory arbitration (as laid down in Art. 25(5) of the 2010 OECD Model) in its tax treaties. Currently, the Dutch competent authority is generally not obliged to arrive at a solution for the elimination of double taxation. This would only be different if (1) a tax treaty provides for mandatory arbitration, (2) a tax treaty provides for voluntary arbitration and, upon the request of a taxpayer, both states agree to such a procedure, or (3) a case is covered by the EU Arbitration Convention. As such, this commitment does not seem to add much value.

7. SPFs versus Control

Due to the absence of legal contracts between a head office and its PE, significant people functions (SPFs) form the basis for determining the allocation of assets and risks to the PE. SPFs are functions that relate to actively making decisions with respect to assuming and managing the risks of the activities within the enterprise, specifically the day-to-day activities that play an important role in the business of the enterprise.[19]

The Decree addresses the relationship between SPFs and the term "control", which is used by the 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines) when elaborating on the arm's length principle contained in Art. 9 of the OECD Model. The Decree quotes Para. 1.49 of the Guidelines[20] from which the SoF concludes that control plays an important role in the allocation of risks between unrelated parties. The SoF concludes that although the functions of the people that have control may be somewhat different from the activities of the parties that carry out the SPFs, since they are more remote from the day-to-day activities, a significant overlap can be distinguished. Consequently, the allocation of risks to a PE is comparable to the risk allocation that would have taken place in respect of a comparable unrelated enterprise in similar circumstances.

8. Intra-Group Services

8.1. In general

The Decree refers to chapter 7 of the Guidelines regarding intra-group services: such services are to be compensated as independent enterprises would be compensated in comparable circumstances.[21] It continues by stating

15. See, for instance, the example given in Para. 55 of the Commentary on Art. 7 of the 2010 OECD Model.
16. In this regard, the Decree makes reference to a decree of 29 September 2008, No. IFZ2008/248M. This decree describes when and how a taxpayer can request the SoF's assistance in respect of a mutual agreement procedure and shows how such a procedure generally is conducted.
17. The authors refer to Para. 59 of the Commentary on Art. 7 of the 2010 OECD Model.
18. See, amongst others, Para. 64, which provides that: "[…] If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the example in paragraph 55 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention (the arbitration provision of paragraph 5 of Article 25 will play a critical role in cases where the competent authorities would otherwise be unable to agree as it will ensure that the issues that prevent an agreement are resolved through arbitration."
19. See, for further coverage on SPFs, Danny Oosterhof, "The true importance of significant people functions", *International Transfer Pricing Journal* 2 (2008), pp. 68-75.
20. Para. 1.49 of the Guidelines provides that: "In arm's length transactions it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control."
21. See Para. 7.6 of the (2009) Guidelines, which provides that: "Under the arm's length principle, the question whether an intragroup service has been rendered when an activity is performed for one or more group members by another group member should depend on whether the activity provides a respective group member with economic or commercial value to enhance its commercial position. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity inhouse for itself. […]."

that Art. 7(3) of the Pre-2010 OECD Model provides that executive and general expenses incurred for the purpose of the PE are deductible. According to the SoF, this provision should not be interpreted as a limitation of Art. 7(2) of the Pre-2010 OECD Model, but as a clarification that does not stand in the way of the arm's length principle. Nonetheless, the Decree also refers to Paras. 37 and 38 of the Commentary to Art. 7 of the Pre-2010 OECD Model, which allows expenses to be charged without a mark-up.

The Decree then describes the Dutch preferences: in treaties that are not based on Art. 7 of the 2010 OECD Model, the attribution of expenses regarding intra-group services mentioned in the Commentary to the OECD Model can be done either based on all relevant actual expenses, without applying a mark-up, or at a price that is considered suitable under the arm's length principle (i.e. all relevant actual expenses including a profit mark-up). This preference is not applicable for treaties that are based on Art. 7 of the 2010 OECD Model. In such circumstances, the arm's length principle must always be applied, including in respect of deemed intra-group services (i.e. internal dealings).

This may, however, be different in regard to specific situations that are covered under the decree of 21 August 2004,[22] which refers to Para. 7.37 of the Guidelines.[23] This decree provides taxpayers with the possibility of charging out all relevant expenses incurred for supportive inter-company services without a mark-up and naturally also applies to dealings.[24] As this decree is still valid, such internal service dealings may be charged without a mark-up, regardless of whether a treaty is based on Art. 7 of the Pre-2010 OECD Model or Art. 7 of the 2010 OECD Model.

8.2. The authors' comments

The SoF refers to the 2004 decree that (still) allows for inter-company services that have low added value and are of a supportive nature to be charged at cost, without applying a profit mark-up, which he says naturally also applies to internal dealings. Although not in line with the Report, this practical approach is welcome and should help reduce the administrative burden on taxpayers.

9. Intangible Assets

9.1. In general

The Decree describes the suggested treatment of internal royalties under Art. 7 of the Pre-2010 OECD Model by first referring to Para. 34 of the Commentary on Art. 7 of the Pre-2010 OECD Model.[25] It recognizes that this paragraph is generally interpreted as a ban on internal royalties. However, the SoF considers that this is not correct as this paragraph merely describes the complexity of internal royalties. In the SoF's view, a royalty can be charged in situations where expenses relating to the development of an intangible asset are attributable only to one part of an enterprise, justifying the assumed ownership of the intangible asset by that part of the enterprise, where another part of the enterprise makes use of that intangible asset.

The Decree proposes to use a method that results in an outcome that is in accordance with that found between independent enterprises. The attribution of both self-developed intangibles and acquired intangibles should, therefore, be made by taking the SPFs into account. The question that needs to be addressed is who is involved in the active decision making regarding the acquisition and risk management of intangibles? This means that a mere split of expenses (as suggested in Para. 34) is not suitable in cases where the arm's length principle can be followed and leads to a different outcome.

9.2. The authors' comments

There is no specific Dutch case law on internal royalties (as opposed to internal interest), which suggests that taxpayers, in practice, have found other methods of reaching an arm's length outcome. This conclusion is also recognized in the Report, which mentions that there are a number of ways to ensure a return on intangible property.[26] Moreover, this is likely one of the topics for discussion between taxpayers and tax administrations, given the complexity of allocating (sole) ownership of intangible assets and the utilization of such assets.[27] The Decree has not added any guidance to these discussions but merely summarizes the conclusions of the Report.

22. Decree of the Dutch State Secretary of Finance, 21 August 2004, No. IFZ2004/680M, amongst others published in V-N 2004 /43.10, under Para. 2 ("*Ondersteunende*" *diensten*).
23. Para. 7.37 of the Guidelines states that: "While as a matter of principle tax administrations and taxpayers should try to establish the proper arm's length pricing, it should not be overlooked that there may be practical reasons why a tax administration in its discretion exceptionally might be willing to forgo computing and taxing an arm's length price from the performance of services in some cases, as distinct from allowing a taxpayer in appropriate circumstances to merely allocate the costs of providing those services. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations where the provision of a service is a principal activity of the associated enterprise, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price."
24. The 2004 Decree mentions, amongst other things, supportive services in the area of accounting, legal, tax and HR services.
25. Para. 34 of the Commentary on Art. 7 of the Pre-2010 OECD Model states: "In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g. payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise[...]". The authors note that Para. 34 of the Pre-2010 OECD Model Commentary was not carried forward into the 2010 OECD Model Commentary.
26. See Para. 203 of the Report.
27. The Report deals, in Paras. 200 to 215, with intangible assets and repeats a number of times that this is a complex matter. For instance, Para. 206 refers to, "*Even more difficult questions* [...]".

10. Financial Transactions

10.1. In general

According to Paras. 41 and 42 of the Commentary on Art. 7 of the Pre-2010 OECD Model, there is generally a ban on internal interest (except for financial enterprises).[28] Nonetheless, there is a need to attribute equity and debt in the right proportion to a PE in order to realize an arm's length debt to equity ratio. The SoF mentions that such attribution should be made only after assets and risks have been attributed to the PE. The resulting debt allocation and subsequent interest charge then, amongst other things, determines the PE's profits.

The Decree points out that the ban on internal interest is not included either in the Report or in the Commentary to the 2010 OECD Model. It follows, however, from the position in the Report that interest dealings are only relevant for rewarding treasury functions that qualify as SPFs. The SoF explicitly does not accept the attribution of more debt to a PE than the general enterprise has borrowed from external parties, as he prefers the use of the capital allocation approach.

Since the Report emphasizes the functionally separate entity approach, the SoF recognizes that questions may arise concerning the deductibility of interest on an internal loan, trade debt or intra-group services. However, the SoF feels that this is not possible under either of the allocation methods of the Report for allocating equity and debt. Deductible interest on such items is, in the SoF's view, indirectly taken into account through these allocation methods.

10.2. The authors' comments

Internal interest has always been a controversial topic. As cash is considered the most flexible asset, it can also be considered the most feared asset used in tax planning exercises. This fear was essentially the basis for the internal interest ban under the Pre-2010 OECD Model. The Report, in principle, accepts internal interest[29] and, likewise, the relevant paragraph in the Commentary[30] has been adjusted to reflect this change in position. The Dutch Supreme Court has also accepted (albeit indirectly and to a limited extent) the possibility of internal interest. It referred to "exceptional cases where the arm's length character of the internal loan cannot be disputed, like internal supplier credit". It will be interesting to see whether or not the courts will allow for more categories of internal debt, given the functionally separate entity approach and the explicit lifting of the ban on internal interest.

The lifting of the ban on internal interest from 2010 onwards offers taxpayers the opportunity to take internal interest into account as remuneration for the treasury function. Since the SoF has made a commitment to also apply the Report to tax treaties based on the Pre-2010 OECD Model, internal interest could also be taken into account when attributing profits to PEs under existing treaties. To accomplish this, taxpayers will have to deviate from the preference of the Decree, which is for the fungibility method (which does not give rise to internal interest), and apply the tracing method. As mentioned above, Dutch courts have confirmed that the tracing method leads to an arm's length outcome. The Dutch tax authorities should then be committed to following the outcome of the tracing approach under Para. 156 of the Report.[31]

11. Tangible Assets

11.1. In general

As the PE is not a body corporate, it cannot legally hold title to assets (and liabilities). Paras. 72-74 of the Report introduce the term "economic ownership", which should, in principle, be allocated on the basis of SPFs that follow from the functional analysis. However, discussions have arisen, in practice, as to whether or not the SPFs or the actual place of use should be the determining factor for the assumption of economic ownership. As of 2008, the Commentary to the OECD Model has allocated tangible assets to the PE if these assets are used where the PE is located (unless special circumstances justify a different view).[32]

In the Netherlands, the Supreme Court has made a distinction for quite some time between a permanent and a temporary disposal of assets (*terbeschikkingstelling*) to the PE. With permanent disposals to the PE, the PE is considered to be the economic owner of the tangible assets. In regard to a temporary disposal, the PE is treated as a lessee of the asset, and the head office as the lessor.[33] This Dutch view is confirmed in the explanation to Art. 9 of the DADT. The SoF considers a temporary disposal to be a special circumstance that justifies a view that differs from that of the Commentary to the OECD Model (i.e. place of use).

11.2. The authors' comments

The Dutch Supreme Court has its own view on the allocation of tangible assets to a PE. There is a substantial list of case law dating back to 1960 on this subject.[34] However, it is clear that there are multiple factors that are taken into account when the Dutch courts are faced with a question on the allocation of tangible assets. In general, however,

28. Para. 41 of the Commentary on Art. 7 of the Pre-2010 OECD Model states: "The treatment of interest charges raises particular issues. First, there might be amounts which, under the name of interest, are charged by a head office to its permanent establishment with respect to internal "loans" by the former to the latter. Except for financial enterprises such as banks, it is generally agreed that such internal "interest" need not be recognised […]".
29. See Para. 151 of the Report, which provides that: "(…) Under the authorized OECD approach the attribution can include, in appropriate circumstances, the recognition of internal "interest" dealings. […]".
30. Para. 42 of the Commentary on Art. 7 of the Pre-2010 OECD Model.
31. Para. 156 of the Report states that: "[…] The important point to stress is that the goal of all approaches described above is the same, i.e. that the amount of interest expense claimed by the PE does not exceed an arm's length amount and that any treasury functions are appropriately rewarded. Accordingly, all these approaches should be treated as authorised under the authorised OECD approach […]."
32. See Para. 75 of the Report.
33. Dutch Supreme Court, 23 January 1974, No 17 237, amongst others published as BNB 1986/100.
34. See Hans Pijl, note 10.

the courts prefer a function-based approach.[35] It appears that the SoF has struggled to reconcile the views of the Dutch court with the AOA on the place of use. As such, the SoF tries to convince the reader that a temporary disposal must be treated as a special circumstance. However, in the authors' view, the positions of the Dutch courts are compatible with the AOA.[36]

12. Agent as Permanent Representative

12.1. In general

The Decree refers to D5 of Part 1 of the Report, which discusses the issue of dependent agent PEs. It describes the necessity for an AOA for dependent agent PEs and the need to abandon the "single taxpayer" approach. The AOA confirms the attribution of profits to two different taxpayers in one jurisdiction in cases where the dependent agent carries out SPFs for the non-resident enterprise. However, in the view of the SoF, there is normally no need to attribute profits to a PE of a non-resident enterprise, i.e. the dependent agent PE, in cases where a dependent agent of this enterprise receives an arm's length remuneration for services conducted by this dependent agent in the course of its own enterprise. There would be a need to attribute profits to the extent that a non-resident enterprise carries out SPFs with its own personnel through a PE.

12.2. The authors' comments

The authors presume that the word "normally" refers to all situations where the non-resident enterprise carries out SPFs through a PE without its own personnel. By stating that there is normally no need to attribute profits to a PE of a non-resident enterprise in cases where a dependent agent of this enterprise receives an arm's length remuneration for services conducted by the dependent agent in the course of its own enterprise, no profit is, in fact, allocated to the PE for risks assumed and assets employed. The Sof, therefore, seems to deviate from the AOA.

The authors welcome this practical approach, since it limits the administrative burden on taxpayers in another treaty state in cases where the taxable income of such a PE is so limited that it would not justify the costs associated with administering the Dutch presence. The use of the term "normally", however, should prevent the loss of any substantial amounts of tax revenue for the Netherlands, since the Netherlands does not relinquish its taxation rights.

13. Certainty in Advance

13.1. In general

As the Report and the Decree contain new elements and views and practical experience is limited, the Decree concludes by mentioning the different procedures that apply when taxpayers want to obtain certainty in advance on the attribution of profits to a PE. In this respect, three bodies are relevant:

(1) All requests for certainty in advance are to be addressed to the competent tax inspector (this being the local tax inspector in respect of a Dutch head office or the tax inspectorate for non-Dutch enterprises in Heerlen for enterprises that are not yet registered in regard to Dutch PEs);

(2) The tax inspector then needs to coordinate questions regarding AOA step 2 with the Advance Pricing Agreement (APA) and Advance Tax Ruling (ATR) team of the Dutch tax authorities in Rotterdam;

(3) Questions regarding AOA step 1 and any positions possibly containing general policy aspects for AOA step 2 that are not yet published are dealt with by the Dutch Coordination Group for Transfer Pricing in order to secure uniform policy and execution.

A request for certainty in advance on both AOA steps 1 and 2 is dealt with by the Dutch tax authorities in an APA. Finally, the Decree confirms the possibility of obtaining certainty in advance on the attribution of shares to a Dutch PE – as specified in an earlier decree of 11 August 2004.[37]

13.2. The authors' comments

The Netherlands has an APA and an ATR practice, which is a very popular facility amongst taxpayers. The possibility to obtain certainty in advance by means of a (binding) ATR and/or APA is one of the attractive elements of the Dutch tax system. A good example of the open approach envisaged by the SoF is the clear description of the ATR and/or APA system applicable to PEs. This, however, leaves the question of whether or not all AOA step 1 requests must be considered by the Coordination Group for Transfer Pricing – as specified in the Decree, since, contrary to AOA step 2, there is no possibility mentioned for the competent tax inspector and/or the APA/ATR team to deal with such matters. This might be unintended but it will otherwise lead to a substantial increase in the Coordination Group's workload.

14. Recent Development regarding Dutch Head Offices with Foreign PEs

14.1. In general

On 14 April 2011, the SoF forwarded his fiscal agenda (the Agenda)[38] to the Dutch parliament. This Agenda is the starting point for the preparation of a legislative proposal, which will be presented to parliament in the second

35. The case mentioned specifically in the Decree revolves around the question of whether or not a dredger owned by a Dutch enterprise and leased to a consortium to which the Dutch enterprise belonged could be allocated to activities carried out by the consortium in Nigeria. The Supreme Court decided that the lease function was performed from the Netherlands and, as such, any income arising from the lease should be attributed to the Netherlands (and not to Nigeria). Here, the court found it important that the signing of the lease contract (a temporary disposal?) took place in the Netherlands, at the same time that the consortium was established.
36. In this respect, see the Report's position on dealings in Paras. 194-199.
37. Decree of the Dutch State Secretary of Finance,11 August 2004, No. IFZ2004/124M.
38. Policy Document of the Ministry of Finance,14 April 2011, "De Fiscale agenda".

half of 2011 and, presumably, will enter into force as per 1 January 2012.

It deals with various changes in the field of personal income tax, value added tax and corporate income tax. However, one topic is relevant in this context, being the introduction of an object exemption for foreign PEs of Dutch resident enterprises. In summary, the Agenda proposes to align the tax treatment of foreign PEs with that of (foreign) participations of Dutch resident enterprises.

Currently, Dutch resident enterprises are subject to Dutch corporate income tax on their worldwide income. Consequently, profits and losses of foreign PEs are directly included in the tax base of a Dutch head office. To the extent profits are attributable to a foreign PE, double taxation is avoided through either a credit for foreign taxation or, as is usually the case, a tax exemption for the foreign profit. However, losses are currently not covered by a credit or exemption, so they can be deducted directly from the profit of the head office. A recapture of such losses is only applicable to the extent that profits arise in future years. This, in the view of the SoF, apparently led to (undesirable) timing advantages as, in practice, a recapture can, amongst other things, be postponed by converting the PE into a subsidiary before it becomes profitable.

In response to this timing advantage, the SoF has announced the introduction of an object exemption for foreign PEs of Dutch resident enterprises. This means that the income of a foreign PE will be entirely excluded from the worldwide income of the Dutch head office. Consequently, losses incurred by a PE can no longer be set off against profits of the Dutch head office. This exemption should also apply to active PEs that are not subject to taxation. Further, an exception will be introduced for losses incurred upon liquidation of the PE, comparable to the current possibility of claiming a deduction for losses incurred upon liquidation of a qualifying participation.

14.2. The authors' comments

The introduction of this object exemption should not directly impact the discussion on profit allocation to a PE. However, given that Dutch head offices will no longer be able to directly set off PE losses against their Dutch profits, the allocation of risks between a PE and its head office may become even more relevant. The authors expect that, in certain circumstances, taxpayers will try to allocate assets and risks (and expenses and losses arising from these assets and risks) to the Dutch head office instead of the PE. For instance, it may be more desirable if the head office were to attract debt funding and most of the equity were to be attributed to the PE. Similarly, important assets may be acquired by the head office and (temporarily) put at the disposal of the PE by way of a lease. In the authors' view, the Decree and the Report provide opportunities for this type of "tax planning".

15. Concluding Remarks

With the publication of the Decree, the Netherlands has met its obligations under the Recommendations but also goes beyond these Recommendations by applying the Report and the Commentary to the 2010 OECD Model to treaties with a Pre-2010 Art. 7. In addition, by publishing its preferences, the SoF has provided additional guidance for taxpayers that are confronted with decisions relating to the attribution of profits to PEs where the Netherlands is involved. However, there are a number of discrepancies between the Dutch preferences and Dutch case law. Further, the administrative burden on taxpayers has been increased by the Decree due to the requirement for an annual (re) valuation at fair market value of all the assets of the enterprise in order to determine the capital to be attributed to the PE. Further, the safe harbour provided by the SoF may be useful for some, but certainly not all taxpayers. In situations where these safe harbour rules do not result in a desirable outcome, taxpayers are still free to select alternative approaches (provided that these result in an arm's length attribution of profits to the PE). It remains to be seen whether or not Dutch courts will follow the SoF's preferences, as laid down in the Decree. Finally, the object exemption for PEs of Dutch head offices, announced in the Agenda, will enhance the importance of allocation discussions in a PE context.

