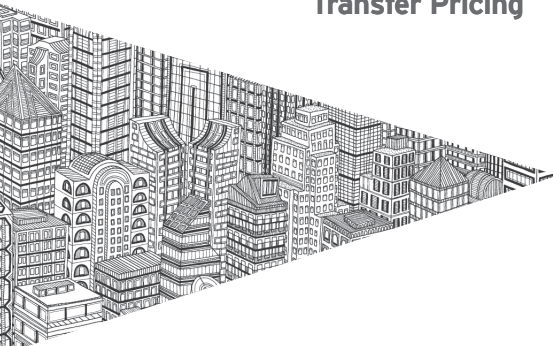


International Tax Alert

News and views from
Transfer Pricing



Dutch decree on attribution of profits to permanent establishments

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On 27 January 2011, a new Dutch decree was published in the Government Gazette concerning the attribution of profits to permanent establishments (the Decree).¹ This Decree provides further insights into the position of the Dutch Tax Administration (DTA) regarding this important topic, following the publication of the 2010 OECD report on the attribution of profits to permanent establishments (PE Report) and the OECD work on article 7 of the OECD Model Tax Convention (MTC), including commentary, in recent years. The Decree, applicable as of 28 January 2011, provides that Dutch policy concurs with the conclusions laid down in the PE Report. Furthermore, it clarifies the DTA's position regarding certain issues, including the endorsement of the conclusions of the PE Report, the dynamic approach in interpreting tax treaties, the preference for the capital allocation approach, certain issues regarding dealings involving group services, intangible assets and financial assets, and certain specific topics, including advance certainty. This Decree is particularly important for those multinational enterprises that operate through a permanent establishment (PE) in the Netherlands.

Arm's length principle

- ▶ The DTA endorses the conclusions of the PE Report, which provides guidance on how to apply the arm's length principle in the framework of article 7 MTC while applying the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations by analogy.
- ▶ The Decree provides that dealings between the PE and another part of the same enterprise of which the PE is a part should be remunerated at an arm's length price unless a restriction was made on such a remuneration by the commentary on article 7, the Dutch decree on the prevention of double taxation 2001 (Bvdb) and / or Dutch case law.

¹ Decree No. IFZ 2010 / 457M of 15 January 2011.

Dynamic approach

- ▶ The guidance in the PE report can partly be characterized as an elaboration of the existing commentary and partly as new guidance as a consequence of which the OECD changed the language of article 7.
- ▶ With respect to the guidance that can be seen as an elaboration of the existing OECD commentary, the DTA applies the “dynamic approach” in interpreting treaties entered into before the subject amendments were made.
- ▶ If, as a consequence of the application of the dynamic approach, the profit attribution as applied by the taxpayer no longer can be considered to be at arm’s length, the DTA will make a reasonable determination regarding to what extent and from which moment onward an adjustment will be necessary. The taxpayer may consider discussing the issue with the DTA.
- ▶ The new article 7 MTC and its commentary also contain guidance that is not directly applicable as a consequence of the dynamic approach. This guidance will require renegotiation of the existing treaty language in order for it to be applicable. However, the DTA is willing to consider these principles where the taxpayer has consistently (i.e., also in the other country concerned) applied an attribution of profit to the PE based on the PE Report.

Preference for capital allocation approach

- ▶ The Decree provides that the DTA has a preference for the “capital allocation” approach (rather than the “thin capitalization” approach) when allocating “free” capital to a PE.
- ▶ The PE requires a certain amount of funding, made up of both free capital and interest-bearing debt. Once the amount of capital is determined, as well as the amount of free capital, the balance is therefore the amount by reference to which the interest deduction is calculated. For the allocation of the amount of interest, the Decree expresses a preference for the “fungibility” approach (rather than the “tracing” approach). It is noted that for the attribution of interest to the PE, a risk-weighted share of the total interest expense should be taken into account.
- ▶ By expressing a preference for the capital allocation approach in combination with the fungibility approach, an attempt is made to stay as close as possible to the underlying principle that the PE has the same creditworthiness as the enterprise as a whole. However, the DTA will not apply this approach in the event that the enterprise as a whole has a non-arm’s length capital structure (i.e., is thinly capitalized). In that case, the attribution of capital to the PE will be based upon the thin capitalization approach.

- ▶ If a taxpayer is faced with double taxation as a consequence of the application of different methods to the determination of interest by the tax authorities concerned, the DTA is willing to consider a mutual agreement procedure under the applicable tax treaty.

“Significant people function” versus “control”

- ▶ The concepts of “significant people function” (in the context of article 7 MTC) and “control” (in the context of article 9 MTC) could be interpreted differently in their application. However, the DTA is of the view that a large overlap can be recognized in the activities of parties who have control over the risks and the “day-to-day” activities of the significant people function.

Dealings

- ▶ With respect to dealings involving group services, a profit markup should be considered. However, the DTA will be flexible in applying treaties based on the old article 7 MTC. The policy laid down in a 2004 transfer pricing decree, allowing a charge of only the relevant actual costs without a profit markup for certain types of supporting activities, is also applicable to internal dealings.
- ▶ With respect to dealings involving intangible assets, the DTA is of the view that it is possible under certain circumstances to charge a royalty between the headquarters and the PE in interpreting article 7 MTC 2008.

▶ With respect to dealings involving financial assets, the following is noted:

- The situation that the PE would be allocated more loan capital than the actual amount of loan capital granted to the enterprise as a whole by external parties does not fit into the DTA policy.
- The existence of a treasury function does not automatically lead to interest dealings.
- It is not likely that in addition to interest resulting from the attribution of capital, interest can be taken into account regarding payments or receivables for internal supply of products or services.

Specific topics and advance certainty

- ▶ There was a broad consensus among the OECD member states that the “place of use” would apply for the attribution of the economic ownership of tangible assets, unless specific circumstances warrant a different approach. The Decree notes that the DTA will consider a temporary attribution of a tangible asset as such a specific circumstance; i.e., in line with Dutch case law, the PE will be considered renting the tangible asset from the head office.
- ▶ With respect to a so-called dependent agent PE, the decree notes that in general there would

be no reason to allocate part of the profit of the dependent agent to the PE of the foreign principal if the agent receives an arm’s length reward for the performance of his business. However, if the foreign principal performs significant people functions with its own staff by making use of such a PE, profit should be attributed to that PE.

- ▶ In the event that a taxpayer would like to have certainty in advance regarding both the attribution of assets and risks, as well as the arm’s length attribution of costs and revenues to the PE, a request for an Advance Pricing Arrangement can be filed.

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