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TAX NEWS BULLETIN: NEW DECREE ON PROFIT ALLOCATION TO PERMANENT ESTABLISHMENTS

On 15 January, 2011, the Dutch State Secretary of Finance (hereinafter: State Secretary): issued a new decree on the attribution of profits to permanent establishments (hereinafter: PE's). The reasons for issuing this new decree are (1) the publication of the OESO Report on the Attribution of Profits to Permanent Establishments (hereinafter: OECD PE-Report), (2) the changes in the OECD MC Commentaries (hereinafter: the Commentaries) on article 7 OESO Model Convention (hereinafter: MC) in 2008 and (3) the changes in article 7 MC (including the amended Commentaries thereon) in 2010. In general, the State Secretary supports the conclusions of the OECD PE-report. Below we will summarize the most important views of the State Secretary.

1 Effect of the changes on Dutch Tax Treaties

Changes in the Commentaries which are indented as clarification (such as those in 2008, made pursuant to the OECD PE-report) have direct effect on all Dutch tax treaties (dynamic interpretation), i.e. including those based on the old article 7 MC. In principle, this is not the case for changes in the MC itself and the accompanying amended Commentaries thereon (such as those in 2010). However, in order to avoid uncertainty about the effect of the changes in 2010, the State Secretary has indicated that he will apply the principles of the OECD PE-Report, the new article 7 MC and amended Commentaries also to Dutch tax treaties which are based on the old article 7 MC, even if these principles are not merely a clarification. In other words: the Dutch Tax Administration will not revise an arms length profit allocation which is based on these principles, provided that the same profit allocation is also (consistently) used in the other involved country. The same applies to the avoidance of double taxation under the Dutch (unilateral) decree (in absence of a treaty). The new article 7 MC and amended Commentaries thereon will be the starting point for future Dutch tax treaty negotiations.

2 Profit allocation to PE's

The Authorised OECD approach[1] (hereinafter: AOA) is based on the 'functionally separate entity approach'. The AOA has been accepted as the basis for allocation of profits to PE's, and consists of two steps: 1) allocation of assets, risks and capital to the PE based on the function analysis; and 2) allocation of the profit to the PE based on the results of step 1.

The allocation of capital to the PE can be based on either the 'capital allocation approach' and the 'thin capitalisation approach' The State Secretary prefers the use of the 'capital allocation approach', also because he supports the principle of the PE-Report that the PE and the company as a whole (head office and PE) have the same credit rating[2]. In order to

[1] See the 2008 OECD PE-Report
[2] An example of the application of the 'capital allocation method' has been elaborated in an annex to the Decree

achieve equal credit rating, both the value of the assets and the risks associated with the assets and the activities will be taken into account in the allocation of equity.

Only if the company as a whole is not financed in accordance with the arm's length principle (i.e. has too high a leverage), will the thin capitalisation approach be applied.
The allocation of profits (income and expenses) to the PE should be based on the arm's length principle, by reference to functions, assets, risks, capital, and "dealings" (see paragraph 4).

The allocation of interest expense to the PE can be based, particularly, on the 'tracing approach' and the 'fungibility approach'. The State Secretary prefers the use of the 'fungibility approach' because in that approach a risk-weighted share of the total interest expense of the company is allocated to the PE. The tracing approach is less suitable for taking into account specific functions, assets and risks of the PE.

The OECD PE-Report does not prescribe which approach should be used under certain conditions. This may lead to double taxation or to non-taxation. In case of double taxation, upon the application of a tax treaty, the State Secretary is willing to start a mutual agreement procedure with the competent authorities of the tax treaty partner.

3 "Significant people functions" vs. "control"

The risk allocation for arm's length transactions between the head office and the PE should be, as much as possible, in line with the risk allocation that is used for arm's length transactions between affiliated companies.

According to the OECD PE-Report, the allocation should be based on the 'significant people functions', in part because there are no legal contracts between the head office and the PE. Significant people functions concern active decision making in relation to engaging in, and managing risks of the activities of the enterprise. This primarily entails 'day to day' activities which play a decisive role in the business of an enterprise.

According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter: TP Guidelines) the allocation between affiliated companies should be based on the 'control functions'. The relationship between 'significant people functions' in the OECD PE-Report and the 'control functions' in the TP Guidelines is not entirely clear, but a large degree of overlap is presumed to exist. As the principle of the OECD PE-report was that the AOA should be, as much as possible, in line with the arms length principle, the State Secretary takes the view that risk allocation to the PE is highly similar to risk allocation as it would have been applied, under similar circumstances, to an unaffiliated company which is comparable to the PE.

4 Dealings

"Dealings" are fictitious transactions relating to group services, leasing (or otherwise making available) of intangible assets, and financial transactions between head office and PE.

4.1 Corporate services

According to the OECD PE-report, the remuneration for corporate services (i.e. general administrative costs) should be based on the arm's length principle,. However, paragraph 38 and 39 of the Commentaries to the old article 7 MC state that, under conditions, the costs of these services should be allocated without a profit mark up. According to the State Secretary

both calculation methods (allocation of costs with or without profit mark up) may be used under tax treaties that are based on the old article 7 MC. However, for tax treaties that are based on the new article 7 MC the calculation should be based on the arm's length principle (i.e. allocation of costs with profit mark up). The existing policy, allowing allocation of actual costs without profit mark up, will be continued for certain "auxiliary" or "administrative support" services.

4.2 Intangible assets

Paragraph 34 of the Commentaries on the old article 7 MC used to be interpreted as a general prohibition of charging internal fictitious royalties. Allocation of intangible assets to a part of an enterprise is very complex, which is why a sharing of costs between head office and PE, without a profit mark up, is proposed in the Commentaries. .

According to the State Secretary there is no general prohibition of charging internal royalties. Charging royalties is possible, for example, when all development costs of certain intangible assets are attributable to one part of the enterprise. The starting point is a system which leads to a result comparable to the result in similar situations involving independent enterprises. The decisive criterion is which part of the enterprise takes the active decisions relating to the engaging in, and managing of the risks associated with the intangible assets, which is to be determined on the basis of significant people functions.

4.3 Financial transactions

According to paragraph 41 and 42 of the Commentaries on the old article 7 MC, there is a general prohibition of charging internal fictitious interest ("interest dealings"), except for financial institutions such as banks. According to the State Secretary the "interest dealings" are already implicitly accounted for in the capital allocation.

In the Commentaries on the new article 7, there is no longer an explicit prohibition of internal fictitious interest. However, interest dealings can only arise when treasury activities are carried out which can be classified as a 'significant people function', and which – on the basis of function analysis – justify an arm's length remuneration by reference to the flow of funds and associated risks.

The interest dealings only have consequences for the remuneration of treasury activities, and have no influence on the actual allocation of capital. According to the State Secretary, a treasury function may not lead to a situation where more debt is allocated to the PE than the total debt of the company as a whole (i.e. interest expense can not be allocated on capital which is in fact equity of the company as a whole).

Depending on the facts and circumstances, in stead of applying interest dealings, it is also possible to charge fictitious costs with a profit mark up for treasury activities.

Interest dealings associated with internal delivery of goods or provision of services are already implicitly accounted for in the capital allocation.

5 Specific subjects

5.1 Tangible fixed assets

The allocation of tangible fixed assets is based on the 'place of use', unless there are special circumstances in place. According to the State Secretary, one of this special circumstances

is the temporary leasing /renting (or otherwise making available) of tangible fixed assets to the PE. In that case the PE is just a lessee / tenant.

5.2 Financial assets

Financial assets (cash and liquid assets, receivables) are allocated to the PE if the 'significant people functions' related to the engaging in, and managing of risks associated with those financial assets, are exercised by that PE. There is an exception for financial assets that have a specific purpose (for example: funds destined for acquisitions or for dividend distributions): these financial assets are not allocated to the PE if the decisions to use the funds for the specific purpose were not taken by the PE.

5.3 Dependent agent PE

A special type of PE may arise if a foreign principal uses a dependent agent, affiliated or independent, as a permanent representative. From a Dutch tax perspective, in fact two taxable subjects can be discerned: the enterprise of the dependent agent and the PE of the foreign principal. Based on the principle that the agent receives an arm's length remuneration for his services, there is, according to the State Secretary, no need to allocate any profit to the PE of the foreign principal. However, if (in addition) the principal carries out significant people functions with its own staff through a PE, profit should be allocated to the PE.

5.4 Advance Pricing Agreement (APA) and Advance Tax Ruling (ATR)

A taxpayer can obtain advance certainty from the Dutch Tax Authorities with regard to the allocation of assets and risks (step 1 in the PE-Report). Advance certainty is also possible for the arm's length profit allocation (step 2 in the PE-Report). If a taxpayer seeks advance certainty for both steps, it can request for an APA.

Advance certainty may also be obtained for the allocation of shares to a PE.