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International tax law. Profit attribution to permanent establishments

Directorate-General for Tax Policy and Legislation, Consumer Taxes, Customs and International Affairs

Decree of 14 June 2022, no. 2022-0000143421, Government Gazette 2022, no. 16683

The State Secretary for Finance has ordered as follows.

This Decree provides further insight into my position on profit attribution to permanent establishments. The purpose of this Decree is to clarify how the Tax Administration assesses profit attribution to permanent establishments.

Developments in the field of profit attribution to permanent establishments, including the results of the OECD's BEPS[1] project, have prompted an update of the Decree of 15 January 2011, no. IFZ 2010/457M. This Decree addresses the introduction of the exemption for business income from foreign permanent establishments ('object exemption') in the Corporation Tax Act 1969 (VPB 1969) in 2012, a number of editorial changes has been made, and references to other orders/decrees and documents have been updated.

1. Introduction

1.1 Abbreviations and terms

AOA	Authorised OECD Approach
BEPS	Base Erosion and Profit Shifting
BVDB	Double Taxation (Avoidance) Decree 2001
KERT functions	Key Entrepreneurial Risk-Taking functions
New article 7	Article 7 of the OECD Model Tax Convention as adopted in July 2010
OECD	Organisation for Economic Co-operation and Development
OECD Guidelines	Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
Old article 7	Article 7 of the OECD Model Tax Convention as applicable until July 2010
PE	Permanent Establishment
PE Report	Report on the Attribution of Profits to Permanent Establishments 2010

[1] Base Erosion and Profit Shifting.

VPB 1969 Corporation Tax Act 1969

1.2 Object of this Decree

The purpose of this Decree is to clarify how the Tax Administration assesses profit attribution to permanent establishments. This Decree therefore provides further insight into the Netherlands' positions on profit attribution to permanent establishments. These positions only relate to the attribution of the income and expenses underlying the profit and not to the taxability and deductibility of the individual income and expense items.

The positions are also important for the application of article 15 of the Corporation Tax Act 1969 and the Dividend Tax Act 1965 with regard to the attribution of shares to a permanent establishment situated in the Netherlands.

This Decree does not concern the application of article 5 of the OECD Model Tax Convention regarding the consideration whether a permanent establishment exists, nor does it concern article 9 of the OECD Model Tax Convention regarding the consideration whether associated parties have operated at arm's length.

1.3 Main points of the Dutch policy

<u>Alignment with the PE Report</u>

The Dutch policy on profit attribution to permanent establishments is in line with the conclusions of the PE Report.[2] The PE Report opts for the 'functionally separate entity approach' and thus for the application of the arm's length principle as further elaborated in the OECD Guidelines.

The starting point for profit attribution in the PE Report is the 'Authorised OECD Approach' (AOA). The AOA basically consists of the following steps:

1. In the first step, the assets and risks as well as the capital are attributed to the permanent establishment on the basis of a functional analysis. Broadly speaking, two methods can be distinguished for this purpose: the 'capital allocation approach' and the 'thin capitalisation approach'. Also considering the PE Report's premise that, in principle, the permanent establishment has the same creditworthiness as the entity as a whole, I prefer the capital allocation approach.
2. In the second step, the profit of the permanent establishment is determined on the basis of the analysis in the first step and the application of the arm's length principle. In this respect, the interest expense relating to the attributed debt capital can be determined using two methods: the 'fungibility approach' and the 'tracing approach'. I prefer the fungibility approach, in which, after the capital has been attributed on the basis of the capital allocation approach, the entity's interest expense is attributed to the permanent establishment in proportion to the attributed debt capital.

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[2] OECD (2010). *2010 Report on the Attribution of Profits to Permanent Establishments*. OECD Publishing: Paris.

The object exemption

With effect from 1 January 2012, the object exemption has been introduced for (foreign) permanent establishments by article 15e of the Corporation Tax Act 1969.[3] Since the introduction of the object exemption for foreign business profits, both the positive and negative results of a foreign permanent establishment have been eliminated from the global profits of a Dutch entity.[4]

For profit attribution to permanent establishments in treaty situations, the applicable article in the treaty is relevant. For profit attribution to permanent establishments in non-treaty situations, reference must be made to the most recent version of article 7 of the OECD Model Tax Convention,[5] which means that the OECD commentary on this article and the PE Report are relevant.

Article 7 of the OECD Model Tax Convention

In the Netherlands, when interpreting treaties concluded before amendment of the OECD commentary on the article in question, an effort is made to achieve an outcome that reflects the latest insights concerning the arm's length principle as far as possible. This means that amendments aimed at clarification also apply to treaties concluded before the commentary was amended. The amendments to the commentary on article 7 as adopted in July 2008 constitute such clarifications. These therefore also apply to existing treaties. However, it is not the case that the amendments in the new article 7 and the accompanying commentary are automatically applicable to existing treaties concluded with a different article 7.

The question to what extent the amendments in the new article 7 and the accompanying commentary affect the application of treaties with the old text is not easy to answer. However, uncertainty on this matter is undesirable in practice. To avoid uncertainty, I am willing to also apply all the principles of the PE Report to treaties containing the text of the old article 7. The Tax Administration will therefore not adjust the arm's length profit attribution to a permanent establishment which is based on the principles of the PE Report and which, as such, has also been consistently applied by the taxpayer in the other country concerned. This also applies in the event of the exemption of foreign profits under article 15e of the Corporation Tax Act 1969 or the taxation of foreign taxpayers in situations where no tax treaty applies.

It is also relevant that the PE Report, the relevant articles of the OECD Model Tax Convention and the accompanying commentary have no direct significance for the application of national tax laws and the Double Taxation (Avoidance) Decree 2001(BVDB), but only for the interpretation of tax treaties concluded by the Netherlands. The provisions on permanent establishments in national tax laws, the BVDB and bilateral

[3] Chapter III (articles 17 et seq.) of the Corporation Tax Act 1969 applies to a foreign entity's permanent establishments in the Netherlands.
[4] This does not apply to low-taxed foreign investment firms (article 15e, paragraph 7 in conjunction with article 15g of the Corporation Tax Act 1969).
[5] In this Decree, the new version of article 7 of the OECD Model Tax Convention, as adopted by the OECD in July 2010, will be referred to as the new article 7. The version of article 7 that was applicable before July 2010 will be referred to in this Decree as the old article 7.

treaties are, however, based on the same principles. This is also shown by the very similar definitions of a permanent establishment and of the method that must be applied for attributing profits to a permanent establishment. Differing interpretations of these provisions may lead to double taxation or double non-taxation, which would be contrary to the purpose of these regulations.

Double non-taxation

In the Netherlands, the main principle is that double non-taxation resulting from different interpretations of the arm's length principle with regard to profit attribution in relation to a tax levied on profit is undesirable and must be avoided as much as possible. If and in so far as a taxpayer makes divergent choices in attributing profits in the countries concerned, resulting in part of the permanent establishment's profits not being subject to profit-based taxation, the Tax Administration may deviate from the policy set out in this Decree so as to achieve an outcome that does not lead to double non-taxation.

2. Profit attribution to permanent establishments

2.1 General

The PE Report was published in July 2008 and amended in 2010.[6,7] It describes how profits[8] must be attributed to permanent establishments. Its purpose is to achieve greater international consensus on the application of article 7 of the OECD Model Tax Convention. Although the version of article 7 as applicable in 2008 included the reference to the functionally separate entity approach in paragraph 2, experience in practice showed that further explanation was necessary. In addition, new insights into profit attribution to permanent establishments were incorporated into the PE Report.

In the context of the implementation of the PE Report, the OECD followed a two-step approach. In so far as the conclusions of the PE Report did not conflict with the commentary existing at that time, the commentary on article 7 of the OECD Model Tax Convention was amended in 2008. This mainly involved clarification or further interpretation. The second step in the implementation process consisted of rewriting the existing article 7 of the OECD Model Tax Convention and the commentary. This was adopted by the OECD in July 2010.

The starting point for profit attribution in the PE Report is the AOA. This approach means that the profits attributed to a permanent establishment must be those it would have made if it had been a separate and unrelated entity with similar functions, risks and assets, acting in the same or similar circumstances. The PE Report calls this the functionally separate entity approach. The underlying idea is that the profits of

[6] The main purpose of these amendments was to bring certain terms in the PE Report into line with terms in the new article 7 of the OECD Model Tax Convention and the updated OECD Guidelines. These amendments did not entail any substantive changes.
[7] After the publication of the PE Report, the OECD published the *Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7* in March 2018. This report does not differ from the Dutch perspective based on the PE Report.
[8] In this Decree, the term 'profits' also includes losses.

permanent establishments must be determined on the basis of the arm's length principle, as is also the case for associated entities under article 9 of the OECD Model Tax Convention and is further elaborated in the OECD commentary on this article and in the OECD Guidelines. An important difference in the application of the arm's length principle based on article 7 of the OECD Model Tax Convention compared with the application based on article 9 of the OECD Model Tax Convention, is that there are no legally binding contracts between a permanent establishment and a head office.

2.2 Authorised OECD approach

The AOA consists of two steps:
1. In the first step, the assets and risks as well as the capital are attributed to the permanent establishment on the basis of the functional analysis.
2. In the second step, the profits of the permanent establishment are determined on the basis of the analysis in the first step and the application of the arm's length principle.

2.2.1. Step 1: Attribution of assets and risks on the basis of the functional analysis

In the first step, the attribution of assets and risks must generally be based on the place where the 'significant people functions' are performed. Significant people functions are related to the people who perform the activities concerning the ownership of assets and the assumption and management of risks. This involves the 'day-to-day' activities that play a decisive role in operational management. The place where these activities are performed determines the attribution of the economic ownership of the assets and the risks incurred by the entity.

Also, in the first step, the equity capital and then the debt capital are attributed to the permanent establishment. The main principle is that sufficient equity capital must be attributed to a permanent establishment in relation to the activities, assets and risks attributed to it. The attribution of the capital therefore takes place after the attribution of the assets and risks on the basis of a functional analysis. The main principle is that the permanent establishment has the same creditworthiness as the entity as a whole.

The PE Report describes various methods for attributing equity capital to the permanent establishment, which can lead to different outcomes:
1. capital allocation approach: this method is based on the current capital structure of the general entity; and
2. thin capitalisation approach: this method is based on the capital structure of unrelated entities comparable to the permanent establishment.

The aim of Dutch policy is that the profits attributed to the permanent establishment should correspond as far as possible to the profits that an unrelated entity would have made with comparable activities in similar circumstances. In this regard, I prefer the capital allocation approach, also considering the PE Report's basic premise that, in principle, the permanent establishment has the same creditworthiness as the entity as a whole.

In order to ensure the same creditworthiness, capital attribution must take into account both the value of the assets and the risks associated with the activities and assets.

An example of the application of the capital allocation approach is set out in an annex to this Decree.

Under the first step of the AOA, the PE Report outlines the circumstances in which dealings between the head office and the permanent establishment must be assumed. These dealings influence the attribution of profits between the head office and the permanent establishment. Section 4 of this Decree takes a closer look at specific dealings regarding intra-group services, intangible fixed assets and financing.

In addition, the following also applies regarding the attribution of equity capital and debt capital:

- When determining the relative importance of the asset side of the permanent establishment in relation to the balance sheet of the entity as a whole, the value of the assets must in principle be determined on the basis of the assets' market value.
- The relative value of the assets must in principle be determined annually.
- In view of the complexity of determining the annual relative value of the assets and recognizing that the attribution of equity capital and debt capital is not an exact science, the Tax Administration will allow a degree of flexibility in its assessment.

2.2.2 Step 2: Attribution of costs and revenues based on the arm's length principle

In the second step, the costs and revenues are attributed at arm's length to the permanent establishment on the basis of the functions, assets, risks, capital and dealings as analysed in the first step. A transfer price must be determined in the second step for the dealings identified in the first step.

After attributing the equity capital and debt capital, an arm's length interest expense must be attributed to the permanent establishment. The PE Report sets out two methods for this purpose:

1. the tracing approach, in which the interest rate is determined as far as possible on the basis of the interest rate of the external loan raised to finance the specific asset; and
2. the fungibility approach, in which the total interest expense of the entity as a whole is attributed to the permanent establishment in proportion to the attributed debt capital and where the historical connection with a loan is not important.

2.2.3 Preferred Dutch method for attributing interest expenses

The main principle of the AOA is that the permanent establishment has the same creditworthiness as the general entity. There can be no internal guarantee and there is limited freedom of choice in the attribution of equity capital and debt capital to the permanent establishment.

I prefer the fungibility approach. This is because the tracing approach takes less account of the specific circumstances of the permanent establishment and may therefore not lead to the attribution of an arm's length interest expense to the permanent establishment.[9]

[9] 'Specific circumstances' refers here to the functions, assets and risks of the permanent establishment.

Under the fungibility approach, this *can* be taken into account if a pro rata portion of the interest expenses of the entire entity, based on the functional analysis, is attributed to the permanent establishment. Using this method, the amount of the interest expense is expected to approach the interest expense that an unrelated lender would charge when financing a similar unrelated entity. After all, the main principle of the AOA is that the deductible interest expense of the permanent establishment does not exceed an arm's length interest expense.

Because the capital allocation approach in combination with the fungibility approach is most in line with the principle of equal creditworthiness, the Tax Administration will, in its assessment, in principle apply the capital allocation approach for the attribution of equity capital to the permanent establishment and the fungibility approach for the attribution of interest expenses.

The Tax Administration will abandon this approach only if the general entity is not financed in accordance with the arm's length principle, resulting for example in too little equity capital and excessive interest expenses attributed to the permanent establishment. The thin capitalisation approach based on external comparison may then be used. In that case, in order to nevertheless determine an arm's length profit for the permanent establishment, the amounts of the permanent establishment's equity capital and interest expenses will be compared with those of unrelated entities that are comparable to the permanent establishment.

An example of the application of the fungibility approach is set out in an annex to this Decree.

2.3 The use of different methods in the countries of the head office and the permanent establishment

As the PE Report does not opt for a specific method, there is a risk of countries adopting different approaches to the attribution of equity capital and interest expenses, resulting in double taxation or double non-taxation.[10] If the application of different approaches to the attribution of interest expenses by different tax authorities results in the taxpayer facing double taxation, I am willing to enter into consultation with the competent authority of the other country when applying a tax treaty with the aim of eliminating the ensuing double taxation, as set out in the Decree of 11 June 2020, no. 2020-0000101607, Government Gazette 2020, 32689.

When applying treaties in which the old article 7 applies, and in accordance with the commentary on that article in paragraph 48, where different capital attribution approaches are used in the countries concerned, the approach adopted in the country of the permanent establishment will be followed if:

1. the different approaches in the countries concerned are the result of choices that are anchored in legislation and regulation; and

[10] See article 12aa, paragraph 1 (g) of the Corporation Tax Act 1969, where a possible mismatch may arise with regard to the attribution of interest, due to the tax authorities adopting different approaches to the attribution of equity capital, debt capital and interest expenses, possibly resulting in double tax deduction.

2. the choice in the country of the permanent establishment is an OECD-authorised choice; and
3. in the specific case in question, this approach leads to a result that can be regarded as arm's length.

As also noted in section 1.3 of this Decree, the Tax Administration may deviate from the policy set out in this Decree to arrive at an outcome that is arm's length and does not lead to double non-taxation.

3. Risk attribution, significant people functions versus control

It is important that the principles used for risk attribution as part of the profit determination of a permanent establishment match the principles for risk attribution in the case of transactions between associated entities as closely as possible. Significant people functions and control are important concepts in this regard.

The PE Report introduced the concept of significant people functions in the context of the *mutatis mutandis* application of the arm's length principle for profit attribution to permanent establishments. Significant people functions are functions relating to actively making decisions on the ownership of assets and the assumption and management of risks. According to the PE Report, this mainly concerns the day-to-day activities that play a decisive role in an entity's operational management.

The part of the PE Report dealing with financial institutions uses the term 'key entrepreneurial risk-taking functions' (KERT functions) for this purpose. The reason for using this divergent terminology lies in the fact that there will be more overlap at financial institutions than at other entities between the significant people functions that determine the attribution of economic ownership of assets and the significant people functions relating to the assumption and management of risks. This is due to the close relationship between assets and risks at financial institutions. A KERT function at a financial institution usually pertains to an activity (significant people function) that is important for both the attribution of an asset and the attribution of a risk (for example, the granting of a loan by a bank).[11]

The OECD Guidelines, which elaborate on the arm's length principle in relation to transactions between associated entities, also address risk allocation. Although the contractual reality is the starting point of the functional analysis in the OECD Guidelines, attention is also paid to the manner in which risks are allocated between parties. In the OECD Guidelines, the concept of control plays an important role in risk allocation. This is defined as follows: '*Control over risk involves [...] (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function.*'[12]

[11] As regards specific considerations for profit attribution to a permanent establishment in the case of financial institutions and financing transactions, I refer to part II (banks) of the 2010 PE Report.
[12] OECD (2022). *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, paragraph 1.65.

The following statement, at the end of paragraph 1.65 of the OECD Guidelines, is important for the allocation of risks: *'a party requires both capability and functional performance as described above in order to exercise control over a risk'.*

The question is what is the precise relationship between the significant people functions and the functions of people who exercise control over certain risks. The activities of the parties that exercise control could have a slightly different character than the activities of the parties that perform the significant people functions, because they may be slightly further removed functionally from the day-to-day activities.

Because the main principle of the PE Report is that the AOA with regard to permanent establishments should correspond to the arm's length principle as much as possible, I assume that, although these concepts could possibly be interpreted differently when elaborated upon, a large overlap can be discerned in the activities of parties that control the risks (in the context of article 9 of the OECD Model Tax Convention) and the day-to-day activities of the significant people functions (in the context of article 7 of the OECD Model Tax Convention). See also the examples in the Transfer Pricing Decree[13] regarding the role of the principal in relation to the performance of research activities.

4. Dealings

Dealings are defined in the PE Report as transactions between the permanent establishment and other parts of the entity to which the permanent establishment belongs, as an equivalent to transactions between unrelated entities.

4.1 Intra-group services

On the basis of the arm's length principle, intra-group services must be remunerated as would have been done in similar circumstances between unrelated entities. The PE Report is fully in line with this approach.

Paragraph 3 of the old article 7 lays down rules for deductible costs at the permanent establishment. According to this article, management costs and general administrative costs are deductible, regardless of where these expenses are incurred. In this regard, this should not be read as a restriction of paragraph 2 of the old article 7, but as a clarification that does not preclude the application of the arm's length principle.

Although paragraph 3 of the old article 7 does not preclude an approach based on the arm's length principle, the commentary on the old article 7 (paragraphs 37 and 38) states that for the services referred to there (including strategic management) the costs are attributed *without* recognising a profit mark-up.[14] This is only different if the services concerned are also provided to unrelated parties on a more than incidental basis or if the services concerned constitute the entity's main activity (paragraphs 35 and 36). It is my view that in the case of internal services, as well as when applying article 9 of the OECD

[13] Decree of the State Secretary for Finance no. 2022-0000139020.
[14] The commentary on the old article 7 means here the commentary on the OECD Model Tax Convention that was revised in 2008.

Model Tax Convention, a profit mark-up should in principle be recognised in order to arrive at an arm's length outcome.

When applying treaties that are not based on the new article 7, I will be flexible in interpreting the old article 7. More specifically, this means that with regard to the services referred to in the commentary, the attribution of costs to a permanent establishment both on the basis of all relevant actual costs without a profit mark-up and at a price based on the arm's length principle will in principle be regarded as appropriate.

The introduction of the new article 7 removes any doubt about the application of the arm's length principle to fictitious intra-group services.

For the determination of the transfer price for an intra-group service, see section 6 of the Transfer Pricing Decree.[15]

4.2 Intangible fixed assets

In the past, paragraph 34 of the commentary on the old article 7 has often been wrongly interpreted as prohibiting the charging of internal notional royalty fees between the head office and the permanent establishment. The paragraph outlines the complexity of attributing intangible fixed assets to part of an entity. On the basis of this observation, the commentary therefore suggests dividing the costs (without a profit mark-up) between the head office and the permanent establishment. If a plausible case is made that the costs of developing the intangible fixed assets can be attributed to only one part of the entity, I believe there is scope for charging a royalty.

My basic position is, wherever possible, to use a system that leads to an outcome that is the same as the outcome in comparable situations with unrelated entities. A decisive factor in the attribution of both self-developed and purchased intangible fixed assets is which part of the entity, based on the significant people functions, makes the active decisions regarding the assumption and management of the risks relating to the intangible fixed assets.

Simply sharing the costs is inappropriate if, in the light of the facts and circumstances, a system based on the arm's length principle is possible and leads to a different outcome.

4.3 Financial transactions

According to the commentary on the old article 7 (paragraphs 41 and 42), there is generally (with the exception of financial institutions such as banks) a prohibition on internal imputed interest. The attribution of equity capital and debt capital to the permanent establishment is predicated on the desire to achieve a capital structure based as much as possible on the arm's length principle. Attribution of the equity capital and debt capital takes place after the assets and risks have been attributed on the basis of

[15] Decree of the State Secretary for Finance no. 2022-0000139020.

the functional analysis. The resulting attributable debt capital and the associated interest expense for the permanent establishment partly determine the profit attribution.[16]

Although, in view of the method of attributing equity capital and debt capital to the permanent establishment as described in the PE Report there seems to be little room for taking internal interest into account, explicit prohibition of internal interest is no longer stipulated and it no longer plays a role in the commentary on the new article 7.

According to the PE Report, internal interest dealings can occur only if and in so far as there are treasury activities that can be regarded as significant people functions and that, based on the functional analysis, justify an arm's length remuneration related to the relevant cash flows and risks. According to the PE Report, these interest dealings affect only the remuneration of the treasury function and not the attribution of the amount of equity capital and debt capital, given that this attribution takes place on the basis of one of the methods as described in the PE Report.

A situation where more debt capital is attributed to the permanent establishment than is actually borrowed by the entity from external parties (related or unrelated) does not fit in with the approach that I advocate. After all, in principle, the capital allocation approach means that, on the one hand, a share in the entity's equity capital and then its debt capital must be attributed to the permanent establishment and, on the other hand, the permanent establishment must have the same creditworthiness as the general entity. The existence of a treasury function cannot lead to the attribution of an interest expense regarding a loan that does not originate from external parties (related or unrelated).[17] These principles apply to both financial and non-financial institutions.

The existence of a treasury function does not automatically lead to interest dealings. Depending on the specific facts and circumstances identified by the functional analysis, the remuneration for the treasury department can also take the form of notional recharging of costs with an appropriate profit mark-up.

As the importance of the separate entity approach is emphasised in the PE Report, a discussion may arise about whether, depending on the specific facts and circumstances, an interest expense or interest income in respect of an internal debt or receivable as a result of supplies of goods and/or services can be taken into account. In view of the approach adopted in the PE Report for attributing equity capital and debt capital on the basis of one of the methods described, it is not logical, in addition to the calculation of the interest expense on the basis of one of these methods, to take into account an interest expense or interest income in relation to outstanding amounts resulting from internal supplies or services. As regards the attribution of profits to a permanent

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[16] It is known that, in practice, banks often have their own internal funds transfer pricing system. That many banks use such a system is also recognised in the PE Report. The report emphasises that it is important for such a system to lead to an attribution of interest expenses that is in accordance with the arm's length principle. Paragraph 169 of part II of the PE Report states that if funds transfer pricing systems are based on 100% debt financing, an adjustment must be made to fulfil the principle that the equity capital attributed to a permanent establishment must be sufficient to support the activities, assets and risks attributed to it. The same paragraph also recognises that it may also be necessary to make an adjustment for more expensive forms of bank debt if these are not adequately handled in the funds transfer pricing system.

[17] See also paragraphs 157 and 158, part I of the PE Report (2010 version).

establishment, the interest expenses or interest income resulting from such transactions in the case of unrelated parties form an implicit part of the interest expenses or interest income calculated on the basis of the capital attribution method used.

5. Specific subjects

5.1 Tangible fixed assets

It is not possible to attribute assets to the permanent establishment on the basis of legal ownership. For that reason, paragraphs 72 to 74 in part I the PE Report (2010 version) pursue an analogy with the concept of economic ownership. Here again, the significant people functions identified by the functional analysis are decisive. In practice, the attribution of tangible fixed assets sometimes gave rise to discussion about whether the significant people functions or the place of use should be decisive for economic ownership. Since 2008, the OECD commentary (through the reference to sections D-2 and D-3 of part I of the PE Report) has opted for the attribution of tangible fixed assets to the permanent establishment if that is their place of use, unless special circumstances warrant a different approach.

In the Netherlands, the Supreme Court has long distinguished between permanent and temporary provision of assets to the permanent establishment. In the case of permanent provision, the permanent establishment is regarded as the economic owner of the tangible fixed assets. If the provision is only temporary, the permanent establishment must be regarded as the lessee of the asset and the head office as the lessor (see BNB 1986/100). I regard temporary provision as a special circumstance that warrants an approach other than the place of use approach as described in the OECD commentary.

5.2 Financial assets

For financial assets (such as liquid assets and receivables), too, economic ownership is attributed to the permanent establishment if the permanent establishment performs the significant people functions relating to the assumption and management of the risks associated with these assets.

An exception to this attribution rule may apply to financial assets held for a specific purpose, such as a planned acquisition or a planned dividend distribution. In that case, these assets must not be attributed to the permanent establishment if it did not make the decision to use these resources for this purpose.

5.3 The agent as permanent representative

The PE Report (see section D-5 of part I) describes how profits must be attributed to a specific permanent establishment, being the permanent establishment of the foreign principal resulting from the designation of a dependent agent, related or otherwise, as permanent representative. In fact, that situation gives rise to two taxpayers: the enterprise of the dependent agent and the permanent establishment of the foreign principal (the ‘dependent agent PE’). The method described emphatically does not apply when determining whether there is a permanent representative. According to the PE

Report, the same profit attribution rules apply to the dependent agent PE as to an ordinary permanent establishment.[18]

I am of the opinion that, given the principle that the agent must be remunerated at arm's length for the conduct of its own business, there is normally no reason to attribute additional profits to any permanent establishment of the foreign principal.

If the foreign principal performs significant people functions with its own personnel by means of a permanent establishment, profits must be attributed to it.

5.4 Certainty in advance

To obtain certainty in advance about the attribution of profits to a permanent establishment, see the Decree of 9 August 2021, no. 2021/16465, Government Gazette 2021, 38442.

6. Entry into force

This Decree enters into force on the day following the date of publication of the Government Gazette in which it appears.

7. Repealed Decree

The following Decree is repealed with effect from the entry into force of this Decree:
- Decree of the State Secretary for Finance of 15 January 2011, no. IFZ2010/457M, Government Gazette 2011, 1375.

8. Short title

This Decree may be cited as: Besluit winstallocatie vaste inrichtingen 2022.

This Decree will be published in the Government Gazette.

The Hague, 14 June 2022

M.L.A. van Rij
State Secretary for Finance

[18] The definition of dependent agent PE was amended in the 2018 OECD report *Additional Guidance on the Attribution of Profits to Permanent Establishments under BEPS Action 7*.

ANNEX TO THE PROFIT ATTRIBUTION (PERMANENT ESTABLISHMENTS) DECREE

Example regarding the implementation of the capital allocation approach and fungibility approach

This example is included to illustrate the capital allocation approach and fungibility approach. The purpose of the method used is the attribution of equity capital and subsequently debt capital to the permanent establishment.

The general entity has the following balance sheet:

Debit		Credit	
Assets	400	Debt	150
		Equity	250
	400		400

Under the first step of the AOA, assets must be attributed to the permanent establishment. Suppose that, based on the analysis of the significant people functions, assets with a value of 200 are attributed to the permanent establishment. Funding amounting to 200 must then be attributed to the permanent establishment. The question is what portion of this should consist of equity capital and what portion should consist of debt capital in order to determine the arm's length interest expense of the permanent establishment.

In elaborating this example, a distinction is made between two situations. In both situations the permanent establishment can be assumed to have the same creditworthiness as the general entity.

<u>Situation 1:</u>

This example assumes that the activities performed, assets used and risks incurred by the permanent establishment are fully comparable to those of the general entity. Application of the capital allocation approach could then lead to equity capital having to be attributed to the permanent establishment in proportion to the value of the assets (in this case 200/400 * 150 = 75). The attributable debt capital would then be 125 (200 – 75).

The permanent establishment's balance sheet then looks as follows.

Debit		Credit	
Assets	200	Debt	75
		Equity	125
	200		200

The interest expense will be calculated in proportion to the attributed debt capital of 125. Since the activities performed and assets used by the permanent establishment have the same risk profile as those of the general entity, it makes sense that when applying the fungibility approach, approximately 50% of the entity's interest expenses must also be attributed to the permanent establishment.

<u>Situation 2:</u>

This example assumes that the activities performed and assets used by the permanent establishment have a lower risk profile than the risk profile of the general entity. Suppose that application of the capital allocation approach leads to the conclusion that 1/3 of the entity's equity capital must be attributed to the permanent establishment. This means that the attributable equity capital is 50 (1/3 * 150) and the attributable debt capital is 150 (200 – 50).

The permanent establishment's balance sheet then looks as follows.

Debit		Credit	
Assets	200	Debt	50
		Equity	150
	200		200

The interest expense will be calculated in proportion to the attributed debt capital of 150. As the permanent establishment has a lower risk profile than the general entity, relatively less equity capital must be attributed to the permanent establishment in situation 2 and therefore also less than in situation 1. The downside is that a relatively large amount of debt capital must be attributed to the permanent establishment, with the result that, in principle, relatively more interest is attributed to it.