Dutch tax aspects of outsourcing

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Summary and conclusions

In the Netherlands we have seen and still see the growing phenomenon of outsourcing, both inbound and outbound.

The Dutch Corporate Income Tax contains certain measures which are relevant in the area of outsourcing. Important are the participation exemption and research and development facilities. The Netherlands strictly adheres to the OECD transfer pricing guidelines. Based on this guidelines and national regulation, certain support services can be charged at all relevant costs. In the Netherlands there's a cooperative compliance program and also an well-known APA/ATR-program. The extensive treaty network and national regulations may eliminate or mitigate situations of double taxation.

Most of the Dutch tax treaties are in line with article 5 of the OECD Model Convention. Because of that these paragraphs and the OECD Commentary play an important role in recognizing a PE. The Dutch Tax Authorities are confronted with situations in which functions are performed by a Dutch entity, but one could argue that the performance of these functions theoretically creates a PE of the foreign service recipient. When the transfer price for the Dutch functions reported by the entity performing the functions is at arm's length, the Dutch Tax Authorities regards the existence of a PE rather as a theoretical discussion and prefers the practical approach of levying tax on the arm's length remuneration reported by the Dutch entity. It would be useful if this approach would get a broader sympathy in the international context.

In case outsourcing creates a permanent establishment, one of the major issues is how to determine the consequences of this permanent establishment for the taxation of the tax payers involved. The Dutch Ministry of Finance enacted a decree that explains more about its position on attribution of profits to a permanent establishment. The Netherlands adopted the Authorised OECD Approach which means that profits must be allocated to the permanent establishment which it would have realized if it acted as an independent enterprise with the same or similar functions in the same or equivalent circumstances.

In the Netherlands there's a strong focus on transfer pricing issues triggered by outsourcing arrangements. Outsourcing for example can trigger discussions in relation to business restructuring and location savings. As mentioned before, the Netherlands adheres strictly to the OECD transfer pricing guidelines.

Because the Netherlands only levies withholding tax on dividend, the most important question in relation to withholding tax and outsourcing is whether the Netherlands is obliged to provide avoidance of double taxation. If according to the Tax Authorities a payment does not qualify as a royalty, they generally refuse providing avoidance of double taxation.

Multinationals more and more have their key personnel at locations in different countries where the most appropriate persons are available. As a consequence the location where the business is effectively managed is less clear. This raises an interesting question that should be dealt with in the near future.

1. Introduction

During the past decades we have seen increasing globalisation under the influence of rapidly evolving technology. This globalisation leads to a steadily more refined international division of labour and this in turn explains ever-increasing international outsourcing.

We can find many definitions of the concept of outsourcing in the literature. For this contribution outsourcing will be defined as the delegation of particular processes or activities, to non-related parties but also to related parties within the group. This delegation often takes place by actually transferring these processes or activities, with or without any accompanying assets and/or employees. As the definition assumes the delegation of processes or activities, this contribution will not deal in any substantial way with the growing phenomenon of functions not being exercised in a single location but at various different places in a variety of countries.

Enterprises and especially multinational enterprises have to keep on adapting to ever-changing circumstances to be able to survive the competitive struggle. This is why it is important for an enterprise to concentrate on the processes by which it knows it can differentiate itself from its competitors, its strategic functions. In particular functions with a low strategic value for the enterprise are being outsourced. The primary reasons cited as why enterprises are involved in outsourcing are cost reduction and flexibility. In general an enterprise tries to realise a higher return on capital investments by investing less in assets so that the enterprise can re-orientate itself more quickly in a changing market situation. Risks associated with outsourcing lie particularly in the vulnerability of supply chains, political unrest in the chosen area and difficulties in the communication.

Traditionally the Netherlands has been a country with an open economy explained in part by a small domestic market. The Netherlands has a rich tradition of trading in goods and services with the outside world.

Caused by the globalisation and relatively high salary costs, during the past decades we have seen that Dutch companies outsourced activities. In particular production and particular forms of services e.g. IT and less complicated administrative work. These kinds of activities are mainly outsourced to countries with lower levels of costs.

On the other hand the Netherlands has a highly educated workforce, innovation oriented environment, superior logistics and technology infrastructure, a business oriented, stable government a strategic location, and an attractive quality of life. That's why we have seen foreign companies outsourcing services in the area of logistics (the Netherlands is a very important transhipment country for goods within Europe), R&D, financial and more complex administrative services to companies established in the Netherlands.

We see all kinds of outsourcing arrangements, intra group and to third parties, both inbound and outbound.

In this contribution to the discussion we will deal with some important consequences of outsourcing for levying taxes. First we will describe national tax laws, regulations and jurisprudence in this area. In addition, looking at things from a Dutch point of view, we will answer the question whether outsourcing leads to a permanent establishment and if so what the tax consequences are. We will also deal with the consequences in relation to transfer pricing in situations where outsourcing takes place within a multinational enterprise.

2. Domestic law provisions

General

The Netherlands is regularly involved in both inbound and outbound outsourcing. As will be described in more detail in the next chapters, this sometimes creates situations in which the Dutch tax position raises discussions with the tax authorities.

In the past years there have been a lot of developments in the area of enhanced relationship between the tax authorities and taxpayers. The foundation for enhanced relationship is mutual confidence between the Tax Authorities and the taxpayer. Where traditionally vertical monitoring is based on retrospective audits by the Tax Authorities, the starting point for enhanced relationship is working in the present. Although vertical monitoring will not disappear completely, enhanced relationship will become more and more important. Benefits of enhanced relationship are, getting certainty about the tax position of companies more quickly, transparency, mutual trust and more focus on current matters in dealings with the Tax Authorities. The Tax Authorities and tax payers can conclude Advance Tax Rulings and Advance Pricing Agreements in which they agree the way tax legislation applies to specific situations. The tax treatment does not differ from the taxation of companies that don't have such agreement but the timing differs (before the situation arises instead of three years after the situation). Businesses consider this an important benefit.

Corporate Income Tax

Corporate income tax is levied by virtue of the Corporate Income Taxes Act of 1969 (hereafter "CITA"). The Netherlands levies corporate income tax on corporate entities that are resident in the Netherlands or that are non-resident but deriving income from Netherlands sources.

Netherlands tax resident companies are: (1) companies that are incorporated under Netherlands law, and companies that have their place of effective management in the Netherlands. The rate of corporate income tax is 25% of taxable income[1]. Resident companies are subject to corporate income tax on their worldwide income. Taxable income includes all income and capital gains unless an exemption applies. Expenses and losses are deductible unless a specific provision renders them non-deductible.

The most important exception to the rule that all income and capital gains are taxable, is the participation exemption. Provided certain requirements are met, dividends and capital gains derived in connection with shareholdings in which a Dutch company holds at least 5% of the outstanding share capital are exempted from taxation. The objective of the exemption is to avoid multiple taxation of profits that flow through a chain of companies. The participation exemption may apply to qualifying participations in both resident and non-resident companies. Subsidiaries that perform outsourced functions almost always qualify for the participation exemption.

Another important exception is the so called "Innovation Box". The Innovation Box exempts from taxation 80% of the related profits. To qualify for the Innovation Box the taxpayer must have generated an intangible asset for which a patent has been granted or for which a so-called 'R&D statement" from the Dutch government has been obtained. The purpose of the Innovation Box is to stimulate innovative

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[1] If the taxable amount is < 200.000 euro the tax rate is 20%.

research and development in the Netherlands. Potentially stimulated by the Innovation Box, more and more multinationals outsource R&D activities to the Netherlands.

In addition, the legislation calls for additional deduction in respect of qualifying costs made for R&D. The qualifying costs specifically exclude costs related to outsourced R&D. On the other hand, if another entity outsources R&D to a Dutch taxable person, the Dutch taxable person is entitled to the additional deduction.

Generally speaking, foreign income is fully included in the gross taxable income of a resident taxpayer. The Netherlands tax treaties and the 2001 Decree for the Avoidance of Double Taxation (hereafter "2001 Decree") may eliminate or mitigate international double taxation by means of a proportional tax exemption or foreign tax credit. Tax treaties generally restrict the right to tax business income to the country in which the income is generated, provided the taxpayer has a presence in that country in the form of a permanent establishment. The term "permanent establishment" will be discussed in chapter 3. Before January 1, 2012 foreign income derived though a permanent establishment or from foreign real property was included in the taxable base. As a result foreign business losses were deductible from the Dutch tax base. As of January 1, 2012 the method of avoidance of double taxation for corporate taxpayers has changed. To the extent profits or losses are attributable to a foreign permanent establishment or foreign real property, the annual profits and losses are excluded from the Dutch taxable base (object exemption).

An entity that is neither incorporated under Dutch law nor effectively managed in the Netherlands may still be subject to tax as a non-resident on income derived from Dutch sources as (i) business profits derived from an enterprise carried on in the Netherlands through a permanent establishment or permanent representative in the Netherlands (ii) the provision of management services to Dutch companies.[2]

Both for resident and non-resident taxpayers the Netherlands strictly adheres to the OECD transfer pricing guidelines. With respect to outsourcing a Dutch decree on transfer pricing, showing the tax authorities perspective, indicates an arm's length consideration for intra-group support services is generally determined on the basis of the cost-plus method with a cost base made up of the (estimated) direct and indirect costs. For certain support services however it is allowed, based on sub-section 7.37 of the OECD Guidelines, to charge all relevant actual costs without a mark up. In general services with respect to book keeping, legal affairs, tax matters and personnel may be considered to be such support services. An adjustment will, however, be made in these cases if the Tax Administration makes a reasonable case that i) activities are rendered that make up or which add more than marginal value to the primary business operations or ii) the respective services are performed on behalf of non-associated parties on a more than an incidental basis. In addition, the Tax Administration is permitted, in accordance with sub-section 7.37 of the OECD Guidelines, to allow, at the taxpayer's advance request, all relevant actual costs to be charged instead of an arm's length consideration for support services other than the ones mentioned above, provided the taxpayer substantiates the fact that the activities(i) do not make up or add more than marginal value to the primary business operations of the MNE group and (ii) are not rendered to third parties on a more than incidental basis.

[2] Most tax treaties disallow the Netherlans levying non-resident taxation for management services to Dutch companies.

Wage tax

A company employing personnel in the Netherlands has the obligation to withhold wage taxes on the wages paid to their employees. This wage tax is an advance levy and can be credited against the personal income tax liability of the respective employee.

In the Netherlands there are rebates available for companies employing personnel on the total amount of wage taxes that they have to pay to the Dutch tax authorities. These rebates are de-facto a wage costs subsidy because it is a benefit for the company itself and not for the employee and hence lowering the total amount of wage costs for the company. These incentives regularly apply in the context of outsourcing. There are rebates available for R&D activities, shipping activities and special educational programs for own personnel.

Employees assigned to the Netherlands who have specific expertise (which is not available or that is scarce on the Dutch labour market) are eligible to apply for a tax-exempt allowance of 30 percent of their salary. Basically, this rule provides for a lump sum allowance to cover the extra expenses as a consequence of the temporary stay outside the country of origin.

In case of outsourcing one should care about "contractor chain liability" rules: Entities outsourcing to an entity that is obliged to pay Dutch wages taxes in respect of its employees, could be held liable for these wages taxes if the entity that has the primary obligation does not pay the taxes.

Value Added Taxes

The Dutch domestic legislation contains little specific VAT rules concerning outsourcing. The only specific rules is the potential liability for entities that outsource construction activities to other entities. These entities could be held liable for the VAT due by the entities that are performing the construction activities. In practice outsourcing does create discussions concerning the application of regular VAT legislation. Specifically regarding the place of service and/or delivery and the rendering of services to VAT exempt entities. Often VAT liabilities arise where the recipient is not able to claim a full refund of the VAT. Primarily businesses in the financial sector often incur additional VAT liabilities if they outsource part of their functions.

3. PE in source country

General

In the Netherlands, outsourcing sometimes creates discussions concerning the existence of a PE either in the Netherlands (to be able to levy Dutch taxes) or outside the Netherlands (to claim exemption from Dutch taxation for income earned outside the Netherlands).

Non resident tax payers are subject to Dutch corporate income tax, amongst others, to the extent they have a PE in the Netherlands. In case of a treaty situation, the treaty definition of PE in the applicable tax treaty applies. The Dutch tax treaties generally follow the OECD Model. Consequently, the OECD commentary to Article 5 OECD MC is an important source of information. As of 1 January 2012 the Dutch Corporate Income Tax Act ("**CITA**") contains a definition of permanent establishment ("**PE**") in Article 15f CITA for non-treaty situations. Article 15f CITA describes a PE as "a fixed place of an enterprise through which the activities of that enterprise are being wholly or partly carried on". In addition the article describes what does not constitute a PE. The definition of PE as mentioned in Article 15f CITA is materially the same as the definition of PE in Article 5 OECD MC. Where the wording of Article 15f CITA differs from the wording in Article 5 OECD MC, explicitly no change in content is intended.[3] Consequently, the OECD commentary to Article 5 OECD MC is important in respect of Article 15f CITA as well.

In 2012, in respect of Dutch resident tax payers, the method for the avoidance of international double taxation for qualifying non-Dutch PEs has been changed. Profits and losses of qualifying PEs are excluded from the Dutch taxable base (object exemption), with the exception of final losses upon permanent wind-up of a PE. Under the rules before 2012, losses of a non-Dutch PE were included in the Dutch taxable income and immediately reduced the Dutch taxable base. According to the Parliamentary documents, the introduction of the object exemption does not intend changing the methodology to allocate profits to allocable to a PE.

If requested the Dutch Tax authorities give certainty in advance on the "existence" or "non-existence" of a PE.

3.1. Fixed place PE

As explained above the Netherlands closely follows the OECD MC in respect of the existence of a PE. Therefore, a "fixed place PE" should meet the following conditions:

- The existence of a 'place of business'
- This place of business must be 'fixed'
- The carrying on of the business of the enterprise through this fixed place of business.

In case of outsourced activities to a legal entity in the Netherlands, the Dutch tax authorities generally refrain from arguing the existence of a fixed place PE if the profits related to the functions performed in the Netherlands are reported appropriately by the entity performing the functions. For example, in case functions performed by a service provider located in the Netherlands are under full control of the related foreign service recipient (other legal entity) in a matrix organization and the service recipient also has

[3] Kamerstukken II, 2011-2012, 33 003, nr. 3, p. 97.

office space at its disposal, technically the Netherlands could argue the existence of a fixed place PE. However, generally the amount of tax payable in the Netherlands, would not increase in case of such PE because the functions performed in the Netherlands would already be taxed at the service provider. Of course if the profits related to the functions performed in the Netherlands are not reported appropriately by the service provider, the Tax authorities will claim a fixed place PE. Based on this attitude to avoid finding PEs, discussions on the existence of a fixed place PE rarely reach a detailed level.

For example, there is very little “conventional wisdom” on the Dutch tax authorities position concerning (i) the importance of the legal rights of the service recipient to the premises in the other country, and (ii) the nature of the service (preparatory and auxiliary). Maintenance of stocks and/or delivery to clients only leads to discussions if the service recipient actively targets Dutch customers without a sales (assistance) function in the Netherlands that is taxed in respect of these sales (see also paragraph 3.2. hereafter).

3.2. Agency PE

As previously indicated, the Dutch Corporate Income Tax legislation contains a definition of PE in Article 15f. The same definition can be found in Article 2 of the Decree on Avoidance of Double Taxation. Both describe a PE as " a fixed place through which the activities of that enterprise are being wholly or partly carried on". In addition, they describe what does not constitute a PE. Besides these articles there is not much guidance in the domestic law regarding PEs in general and Agency PEs in particular.

As said before, in the legislative process it has been stated that the Netherlands conforms to the definition and explanations in the OECD Model. Because of that Article 5 paragraphs 5 and 6 and the OECD Commentary play an important role. Most of the Dutch tax treaties are in line with these paragraphs.

Art. 5(5) of the OECD Model and its equivalent in most Dutch tax-treaties state that a person, other than an independent agent, who acts on behalf of an enterprise situated in the other contracting state and regularly exercises the authority to conclude contracts in the name of such enterprise, creates a permanent establishment of that enterprise. This applies to any activities undertaken by that person on behalf of the enterprise, except activities excluded from the definition of permanent establishment under Article 5(4). Most of the treaties state that an enterprise shall not deemed to have a permanent establishment merely because it carries on business through a broker, general commission agent or any other agent if such person acts in the ordinary course of his business.

Most of the cases in the Netherlands in relation to an Agency PE are dealing about commissionaire and other limited-risk type of sale structures. Although the definitions in Article 15f of the Corporate Income Tax and Article 2 of the Decree on Avoidance of Double Taxation are only valid in situations where no tax treaty applies, they provide some guidance on how the term Agency PE could be defined.

For the purpose of both articles a person does not create an Agency PE if he is a fully independent or is not authorized to conclude contracts in the name of the non-resident taxpayer. Both articles state further, in line with article 5(6) OECD Model, that there is no agency PE when the agent is acting in the ordinary course of his business.

Based on the Dutch tax treaties an Agency PE is deemed to exist in case the following criteria are met:
1. The representative is dependent on a non-resident taxpayer
2. The representative does have the authority to conclude contracts on behalf of a non-resident taxpayer;
2. The representative habitually exercises this authority and
4. The representative is not acting in the ordinary course of his own business.

1. Dependent
Dependency of the representative on the non-resident taxpayer can be either legal or economical. The representative is legally dependent when he receives detailed instructions and is continuously accountable to its principal. The extent to which the representative is bearing entrepreneurial risks is an indication for his economic dependency. Case law shows that the number of principals of the representative is a relevant factor[4]. The more principals he's representing, the less dependency.

2. Authority to conclude contracts
Although the representative should have the authority to conclude contracts on behalf of the non-resident taxpayer, a formal authorization is not per definition required. Case law shows that the Dutch courts take a substance over form approach[5]. Similar to the Commentary to the OECD Model[6], this is in line with the Dutch commentary to tax treaties that the actual facts and circumstances should be decisive. So the factual behavior of the representative is decisive rather then the legal form of the authority.

3. Habitually
The question whether a representative habitually exercises his authority depends on the period of his authority but also the frequency of exercising. Also the characteristics of the contracts seem to be relevant. A representative who concludes only a few large contracts in a year can trigger an Agency PE.

4. Not acting in the ordinary course of his own business
Based on case law a representative can be both an independent agent and a dependent agent in relation to the same principal. In this case the Dutch Court decided that a representative could act in the ordinary course of his own business in relation to the principal for certain activities, while he's dependent on the same principal for other activities[7].

When the criteria are met and an Agency PE exists for the non-resident taxpayer, the Dutch tax authorities have taxing rights over two legal entities, the agent and the non-resident taxpayer, which has an Agency PE in the Netherlands. As a result the tax authorities have two possibilities for challenging the profits allocated to the Dutch activities. On the one hand an arm's length remuneration for the (routine) activities performed by the agent and in addition an arm's length profit allocation to the Agency PE. On the other hand the Dutch tax authorities may challenge the transfer price between the principal and the agent, which will have an impact on the Agent's profitability.

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[4] Supreme Court, 15 June 1988, BNB 1988/258 (Cargadoor)
[5] Court of Appeal, 20 June 1978, BNB 1979/190, & Supreme Court, 28 March 2001, BNB 2001/239.
[6] Par 32.1 Commentary to article 5(5)
[7] Supreme Court, 15 June 1988, BNB 1988/258

The Dutch tax authorities in general take a more factual rather than legalistic approach. This also applies to their view in relation to the Agency PE. The Ministry of Finance issued a Decree in which is stated that two taxable subjects can be recognized, the enterprise of the agent and (the Agency PE of) the non-resident taxpayer. Based on the assumption that the enterprise of the agent in the exercise of his own business receives an arm's length remuneration, there is normally no need to allocate any additional profit to an Agency PE. However, if the non-resident taxpayer carries out "significant people functions" with its own staff through a PE, profits should be allocated to that PE[8].

So when the transfer price for the Dutch activities of the agent is at arm's length and the principal's staff does not create a PE in the Netherlands, from a Dutch perspective the PE discussion in the context of principal and Agent seems a more theoretical discussion.

3.3. Service PE

Several countries, expand the PE definition with so-called Service PEs. The UN Model Convention defines Service PEs as “[t]he furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned”. The OECD has included limitations to the Service PE in its commentary. Under the OECD Commentary, a Service PE as under the UN Model only can arise if the Services are performed in the source state and the services are rendered to a third party[9].In its treaty negotiations, the Netherlands attempts not expanding the scope of the permanent establishment definition to Service PEs. However, several of the more recent treaties include the Service PE anyway.

If a treaty includes a Service PE clause, based on the OECD Commentary it is not expected that taxation in the source country will often take place caused by the presence of a Service PE . That is because the services (outsourced activities) will generally be provided to the enterprise itself and not to third parties as is required by the OECD Commentary. The location of customers of the services recipient likely will not matter.

Based on the Dutch preference not to assess a Service PE, little experience exists concerning the potential Services PE of the service recipient in case the service recipient trains or directs the service provider. Therefore, currently no guidance is available concerning the (i) time thresholds and (ii) the specific contents of the services (for example stewardship). Of course, the local functions of the service recipient could create a permanent establishment as fixed place PE or as agent PE.

As mentioned above in paragraph 2, an entity that is neither incorporated under Dutch law nor effectively managed in the Netherlands may still be subject to tax as a non-resident on income derived from Dutch sources the provision of management services to Dutch companies. Although this legislation could subject to taxation Service PE type of services, most tax treaties disallow the Netherlands levying non-resident taxation for these services.

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[8] Decree of 15 January 2011, nr. IFZ2010/457M, BNB 2011/91

[9] Par. 42.30 OECD Commentary.

3.4. *Illustrations*
In scenario 1 if SUBCAR would be a Dutch resident company the Dutch tax authorities will be reluctant arguing the existence of a PE of CARCO under domestic law if CARCO does not perform any significant functions in the Netherlands. The existence of a tax treaty will generally not change this position. Whether or not the parts are owned by SUBCAR or CARCO also does not materially impact the position. The authorities generally strictly look at the functions performed, assets used and risks assumed in the Netherlands and want to secure the tax connection with these functions is taxed in the Netherlands. In scenario 1 the tax residency of SUBCAR will allow the Dutch tax authorities to levy this tax. If the Netherlands could somehow not tax these functions performed in the Netherlands adequately, they could claim the existence of a PE in situation where this possible based on national law and the Dutch tax treaties..

In scenario 1 if CARCO would be a Dutch resident company under domestic legislation the Netherlands tax authorities will not easily grant reduction of Dutch taxes under the PE exemption rules if CARCO does not perform any significant functions in the SUBCAR's country as (1) the facts would not create a CARCO PE in the other country, and (2) if a PE would exist anyway the Dutch authorities would allocate little if any profit to such PE (see chapter 4). Under a treaty they would strictly adhere to the treaty PE clause. It is unlikely, however, the Netherlands would easily accept a substantial profit allocation to such PE.

Scenario 2
This scenario could in theory create a PE of ICO in the Netherlands. In practice the Dutch Tax Authorities will take a closer look to the functions performed, assets used and risks assumed in the Netherlands. It will levy tax at the level of OCO based on an arm's length remuneration. The Dutch tax authorities firmly take the position in such situation a sales related remuneration is more in line with the describes functions. The Tax Authorities will, in principle, take the same position in the outbound situation unless the treaty partner correctly recognizes a PE of ICO and ICO is held to have taxable presence in the PE-country. Also when OCO is a third party service provider in general that would not lead to a different position.

4. Attribution of profits to a Permanent Establishment arising from outsourced activities.

In case outsourcing creates a permanent establishment, one of the major issues is how to determine the consequences of this permanent establishment for the taxation of the tax payers involved. This chapter is dedicated to the approach of the Dutch Tax Authorities with respect to the attribution of profits to a permanent establishment.

4.1 The Dutch Decree on the attribution of profits to a permanent establishment IFZ2010/457M

On January 15th 2011 the Dutch Ministry of Finance enacted a decree (IFZ2010/457), hereinafter to be referred to as “the Decree”, that explains more about its position on attribution of profits to permanent establishments.

The Decree ties up with the conclusions of the “Report on the Attribution of Profits to Permanent Establishments” published in 2008 and amended in 2010 from the OECD hereinafter to be referred to as the “PE Report”. The Dutch Ministry of Finance regards the PE Report as an elaboration of the principles that prior to July 2010 formed the basis for Article 7 of the OECD Model Treaty.

In the Netherlands, when explaining treaties, according to the tax authorities the dynamic method is applied using an amended OECD commentary. Also according to the tax authorities amendments in the Commentary “undisputably” intended as clarifications generally also apply to treaties concluded prior to amendments to the commentary. This approach has not been brought before a court yet. According to the Decree the amendments to the commentary of July 2008 are regarded as being just such amendments. It is however not the case that amendments in the new Article 7 of the OECD Model Treaty, hereinafter to be referred to as “OMT” and the accompanying commentary automatically extend to the existing treaties that came about using another Article 7. The Dutch Ministry of Finance has however declared itself prepared to apply the principles of the OECD PE Report to the treaties in which the old Article 7 was incorporated hereinafter “7 Old OMT”, as far as this cannot be seen as a clarification of the old Article 7. The Dutch Tax Authority therefore will not challenge an arm’s length profit allocation to permanent establishments based on the PE Report that is also consistently applied in another Member State.

Part 4.2 shows the Dutch Ministry of Finance’s point of view as incorporated in the Decree.

4.2 Attribution of profits to a permanent establishment

4.2.1 General

In the PE Report, the starting point as far as profit attribution is concerned, is the Authorised OECD Approach, hereinafter “AOA”. This approach means the permanent establishment is allocated the profit it would have realized as an independent enterprise with the same or similar functions in the same or equivalent circumstances. In doing so the PE Report confirms the “functionally separate entity approach”. The background to this is that determining the profits of a permanent establishment should be based on the arm’s-length principle such as also applies to affiliated undertakings under Article 9 of the OMT. An important difference in applying the arm's-length principle under Article 7 OMT is however created by the fact that legally binding contracts are lacking in one and the same legal entity

4.2.2 Authorised OECD Approach

4.2.2.1 General

The AOA contains a two-step approach. In the first step the assets and liabilities as well as the equity capital is allocated to the permanent establishment based on a functional analysis. In the second step the permanent establishment's profits are determined on the basis of the analysis in the first step and the application of the arm's-length principle.

4.2.2.2 Step one, allocation of assets, risks and equity capital to the permanent establishment

For allocation of the assets and risks to take place, in general there needs to be a connection with the place where so-called "significant people functions" are performed. Such functions are related to the people who conduct the activities to do with entering into and managing risks. These are the so-called "day to day" activities that play such an important role when running a business. The place where these activities are conducted determines the allocation of the economic ownership of the assets and the risks.

The starting point for the allocation of the equity capital and later on the loan capital to a permanent establishment is that sufficient equity capital should be allocated to support its activities, assets and risks. This is why allocation of the equity capital takes place after the assets and risks have been allocated based on the functional analysis. In general the basic assumption is that the credit worthiness of a permanent establishment is equal to that of the entity as a whole.

The PE Report describes the various methods for attribution of equity capital to the permanent establishment. This can lead to a variety of different outcomes. On the one hand the methods that start from the actual capital structure of the general undertaking, the "capital allocation approach" and on the other hand methods that start from the capital structure of independent undertakings comparable to the permanent establishment, the so-called "thin capitalisation approach". To link up with the arm's-length principle, the policy of the Netherlands is focused on choosing the method for allocating equity and loan capital that leads to profit attribution and with it the allocation of interest to the permanent establishment that leads as much as possible to a profit that non-affiliated undertakings would have gained with comparable activities under comparable circumstances. In part because the PE Report maintains as its basic assumption that the creditworthiness of the permanent establishment has to be the same as that of the entity as a whole, the Dutch Ministry of Finance expresses its preference for the "capital allocation approach". The tax authorities currently do have a focus on to the approaches taken by companies, including banks.

4.2.2.3 Step two: determination of the permanent establishment's profit

In the second step the allocation of profit and loss to the permanent establishment is based on the "arm's-length principle". Proceeds and expenses are therefore allocated based on the functions performed, the assets used , the risks assumed , the equity capital and the "dealings" such as analysed in step 1.

In step two an arm's-length interest charge is attributed to the permanent establishment. The PE Report describes various methods. On the one hand the "tracing approach" in particular by which, in order to determine the interest charge, as far as possible a link is made to the interest percentage of the external loan actively taken on to finance the specific object. On the other hand this concerns the "fungibility approach" by which the total interest burden of the general undertaking is allocated proportionally. The historical link with a loan is not relevant here. In the Decree the Dutch Ministry of Finance expresses a preference for the "fungibility approach". Reasons for this are that just as the "capital allocation approach" the "fungibility approach" takes a risk assessment as the basis on which to allocate the interest charges. The "tracing approach" however takes the specific circumstances of the permanent establishment less into account and will in the view of the Dutch Ministry of Finance not always lead to allocation of arms-length interest charges for the permanent establishment whilst the AOA's starting point is that the tax-deductible interest charges may not exceed an arms-length interest charge.

In the opinion of the Dutch Ministry of Finance, the "capital allocation approach" combined with the "fungibility approach" links up best with the starting point of equal creditworthiness. This means the Dutch Tax Authority will maintain the "capital allocation approach" when assessing allocation of equity capital for the permanent establishment and the "fungibility approach" when allocating interest charges. After all in the opinion of the Dutch Ministry of Finance both methods, based on internal comparison, allocate capital and interest charges to the permanent establishment's in a risk weighted way and thus link up with each other in a logical way.

As the PE Report describes several methods, different countries could maintain different methods. Where this leads to double taxation, the Dutch Ministry of Finance has expressed its readiness to enter into discussion with the competent authority of the other country to strive to eliminate double taxation.

4.2.2.4 Significant people, functions and control

Due to a lack of legally-binding contracts between head office and the permanent establishment, "significant people functions" determine the allocation of assets and risks to the permanent establishment. "Significant people functions" are those functions that relate to actively taking decisions and taking on and managing the risk related to the activity within the undertaking. According to the PE Report this is about the "day to day" activities particularly, that play an important role in the running of any undertaking.

In the view of the Dutch Ministry of Finance one can deduce from the OECD Guidelines that the concept of "control" plays an important role in the way in which risk allocation is designed between non-affiliated parties.. As the starting point of the PE Report in relation to permanent establishments was to have the AOA linked up with the arm's-length principle as much as possible, the Dutch Ministry of Finance assumes that, although in practice the concepts could be interpreted in different ways, we can discern a large overlap in the activities of the parties who have control over the risks in the context of

Article 9 OMT and the “day to day” activities of the “significant people functions” in the context of Article 7. This is why the Dutch Ministry of Finance is of the opinion that to a great extent the risk allocation for the permanent establishment should be comparable to the risk allocation for a similar non-affiliated undertaking in similar circumstances.

4.2.2.5 Dealings

4.2.2.5.1 Intra Group services

The arm’s-length principle means that group services should be remunerated in such a way as to match up with what would have been agreed on between non-affiliated undertakings. The PE Report fits in with this approach perfectly. According to the PE Report the costs of management and the general running of the undertaking form part of the tax-deductible costs irrespective of where such costs are incurred. The third paragraph of Article 7 Old OMT must therefore not be read as a limitation but as a clarification that does not stand in the way of the arm’s-length principle. Although we can read in the commentary to Article 7 Old OMT that for services referred to there, including strategic management, the costs can be allocated without profit mark-up, the Dutch Ministry of Finance is of the opinion that where internal group services are rendered, as where Article 9 OMT is applied, in principle a profit mark-up should be taken into account. In the Decree, when applying treaties not based on Article 7 New OMT, the Dutch Ministry of Finance undertakes to regard as suitable the allocation of costs relating to the services referred to based on the relevant costs without profit mark-up as a price based on the arm’s-length principle.

4.2.2.5.2 Intangible assets

Paragraph 34 of the commentary to Article 7 Old OMT was often explained as a ban on calculating internal fictitious royalties between head office and the permanent establishment. Given the complexity of allocating intangible fixed assets to a part of the undertaking, the commentary suggests sharing the costs between head office and the permanent establishment, without a profit mark-up.

The Dutch Ministry of Finance is of the opinion that there is room for calculating a royalty if it can be made plausible that the costs of developing intangible fixed assets can only be attributed to a part of the undertaking. There is thus no absolute ban on internal royalties. What determines the allocation of both self-developed and acquired intangible fixed assets is what part of the undertaking takes the active decisions about entering into and managing the risks relating to the intangible fixed assets based on the “significant people functions”.

The Dutch Ministry of Finance is of the opinion that just sharing the costs would not be suitable if a methodology based on the arm’s-length principle and on facts and circumstances can be applied that would lead to a better outcome.

4.2.2.6 Tangible fixed assets

As of 2008 the OECD commentary elected to attribute material fixed assets to permanent establishments if they are used there under the so-called “place of use” principle, unless special circumstances justified another approach.

In the Netherlands the Dutch Supreme Court has drawn a distinction between permanent and temporary attribution to a permanent establishment whereby in the former case the permanent establishment becomes the owner and in the latter case it becomes a lessor and the head office is regarded as the lessee. The Dutch Ministry of Finance designates any such temporary attribution as a special situation justifying another approach under the “place of use” principle as described in the OECD commentary.

4.3. Parts II, III and IV of the PE Report

Parts II, III and IV provide specific guidance with respect to the allocation of profits to permanent establishments of banks, enterprises carrying on global trading of financial instruments and insurance companies. We have decided not to get into detail with respect to these parts in this contribution. What is worth mentioning here is that the Dutch Tax Administration has a focus on these parts of the PE report in practice.

5. Transfer pricing aspects of outsourcing

5.1 General

In the introduction to our contribution to this discussion we have defined "outsourcing" as the delegation of particular company processes or activities. In this part of our contribution we will confine ourselves to cross-border outsourcing to and by related companies and permanent establishments. For convenience sake we refer to "particular company processes or activity" as "functions".

In this part we will go into transfer pricing aspects as they relate to outsourcing from a Dutch perspective. In doing so we will distinguish between those aspects related to (i) the transfer of the functions and (ii) those aspects related to remuneration for the performance of the functions by the other entity. We will also go into the matter of when outsourcing leads us to conclude that the performance of the outsourced functions create a permanent establishment of the party outsourcing them, and what the consequences of this conclusion should be from a Dutch perspective.

5.2 Transfer pricing aspects of cross-border redeployment or transfer of functions.

Chapter 9 of the OECD Guidelines defines a business restructuring as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks. Seen from this perspective outsourcing by transferring functions and engaging another entity to perform these functions should be regarded as a business restructuring.

Such a business restructuring can involve (i) the transfer of value locked up in functions and assets, and/or (ii) termination or renegotiation of existing contracts. Every business restructuring involves a reallocation of profits between entities of the group. The central question in the process is whether any such reallocation of profits takes place in accordance with the arm's-length principle.

Not every reduction of the potential profit of any part of a multinational as a result of outsourcing should necessarily be remunerated. The question is whether independent third parties would have agreed on a remuneration for transfer of functions, assets and/or risks, or for renegotiating or terminating a contract.

The Dutch Tax Authorities adopt the position that it is not likely that independent parties would agree on a remuneration for the transfer of routine functions. The assumption here is that such routine functions are relatively easy to replace. If the service provider does not own any valuable assets used in the performance of his functions, he has little or no bargaining power to demand a remuneration for the transfer itself. Examples of such functions are administrative services and contract manufacturing. Only where the transferor transfers something of value, used in the performance of its functions, ,such as know-how or client databases, a transfer of value has taken place, for which an independent third party would be willing to pay. Examples of these assets would be specific know-how in the area of efficient production processes and distribution functions that have at their disposal valuable clients and/or local marketing intangibles. Transfer of routine functions abroad without simultaneous transfer of valuable assets should not justify a remuneration to the transferor.

It is not certain *per se* that remuneration would be appropriate when an already existing contract is renegotiated or terminated. Naturally here too what independent third parties would agree amongst themselves would be the determining factor. The Dutch Tax Authorities are of the opinion that parties who have to make relatively large investments to enter into a contract to carry out routine functions will try to set conditions when negotiating the contract covering the use of these investments during the agreed lifetime of the contract under the so-called “Hold-up principle”. Any premature termination of the contract could otherwise lead to a loss. An example of such a situation is that of a contract manufacturer who on concluding a ten-year production contract has to make a substantial investment in a new factory to meet the customer’s demands. Any such contract manufacturer would demand certain guarantees from the customer to ensure that their factory will be in use for ten years so that they can recoup their investment particularly when the customer excludes any alternative use of their factory by contract. A premature termination of the contract on the customer’s part would cause the contract manufacturer to suffer a loss. This position of the Dutch Tax Authorities has been challenged by taxpayers but has not been brought before a Court yet. Obviously what has just been referred to in terms of transferring functions and renegotiating or terminating contracts does not apply to cases involving the commencement of new functions.

5.3. Transfer pricing aspects of remunerating outsourced functions

Another aspect relating to outsourcing is that of remunerating the party who performs the outsourced functions. We refer to Chapter 2 of the OECD Transfer Pricing Guidelines with respect to the selection of the transfer pricing method. There is no national legislation in this area.. In any case establishing an arm’s-length remuneration must be based on an adequate functional analysis reflecting the functions performed, the assets used and the risks involved. Obviously the functions can be quite diverse in character from highly routine such as contract manufacturing or the provision of administrative services to functions that are of a more entrepreneurial nature such as basic R&D with all of the accompanying consequences when determining arm’s-length remuneration.

A specific example of outsourcing is setting up/operating a central purchasing function. Arguments about moving towards centralisation of the purchasing activities are

- Bundling the purchasing power and/or the purchasing expertise
- Reducing working capital and
- Improving the quality of the product.
- Eliminating “duplication” of purchasing activities.

Purchasing activities can vary from support to going right to the heart of the business. Remuneration of any such functions will depend on the nature of the activities conducted. Functional analysis will then be focussed in particular on the importance of the purchasing function within the group’s total value chain. The Dutch Ministry of Finance is of the opinion that benefits in the form of savings realised as a result of bundling the purchasing power cannot be attributed to the purchasing office. Any such savings must be attributed to those parts of the group that through sheer purchase volumes place the purchasing office in a position whereby such savings can be realised. On the other hand, savings realised as a result of the specific expertise of the party performing the purchasing activities should be attributed to that party.

A special point of interest is that of how to determine the remuneration for a function that is performed in another country in order to save costs e.g. because the wages are lower in that specific country . This has to do with the phenomenon referred to in paragraph 9.148 of the OECD Transfer Pricing Guidelines as “location savings”. This phenomenon occurs especially when routine functions such as contract manufacturing as mentioned in case study 3, or provision of administrative services are performed in so-called low-cost countries where the costs accompanying these functions are much lower. In applying the “cost plus method” to determine the remuneration for the functions concerned, the question arises as to which costs form part of the basis on which to calculate the profit mark-up. Some countries take the position that the starting point should be the higher costs of the country for which the functions have been performed because the lower level of costs is a characteristic of the local market and should be seen as a local intangible. In this way the “location savings” are for the party that exercises the functions. The Dutch Tax Authority’s position is that the remuneration of the local party performing the function should be determined by making use of local comparables. In as much as they have obtained the location savings in whole or in part that will after all be expressed in their final remuneration. In that case the fact that there are no local comparables present means it will have to be determined whether the local party exercising the function has at its disposal the (i) bargaining power to negotiate and (ii) abilityto make a part of the location savings his own. The greater the function’s routine nature, making it easily replaceable, one would expect the power to negotiate to be smaller and thus the greater the proportion of location savings that has to be attributed to the principal abroad. If however the services provided are highly specialized as mentioned in case study 4 and no other party can exercise the function or only with great difficulty, one would expect the power to negotiate to be greater and the local party exercising the function will be able to make a greater part of the location savings their own.

It is obvious that the division of these location savings is an issue only as long as the parties involved are able to keep them for themselves. As soon as the competitive environment forces them to pass on the local savings to their customers to keep them in a competitive position, the division of location savings between the parties involved is no longer an issue.

5.4 Outsourcing and permanent establishments

Conceivably the performance of functions that an entity outsources might create a permanent establishment in the country where these are performed. In case a permanent establishment is created the result to be allocated to the permanent establishment is determined in accordance with the policy outlined in part 4 of this contribution.

In respect of a “dependent agent“ permanent establishment, the Decree described in part 4 recognises two taxable subjects; the “dependent agent PE” and the entity that is performing the functions and that is or is not affiliated. Taking as the starting point the assumption that the entity that performs the functions receives an arm’s-length remuneration for its functions, assets and risks, there would normally be no reason to attribute any supplementary remuneration to the dependent agent PE.

6. Withholding tax

Payment for outsourced functions can get several different labels under Dutch tax treaties. Under some treaties, the performance of certain functions qualify as royalties, especially the supply of know-how and technical services. Unfortunately, generally it is very difficult classifying a remuneration under such royalty definition or not. Depending on the classification, a country might be allowed to levy withholding taxes (the other country should provide for avoidance of double taxation) or may only tax in case the service recipient has a (deemed) PE in the country where the functions are performed.

As the Netherlands only levies withholding tax on dividend (not on interest and royalties), in the Netherlands the classification mainly triggers discussions about whether the Netherlands is obliged to provide avoidance of double taxation in case the other country classifies a payment as royalty and levies withholding tax. If the payment clearly is a royalty under the tax treaty, the Netherlands will provide avoidance of double taxation (often a tax credit). If according to the Dutch tax authorities the payment does not qualify as a royalty, the Dutch tax authorities generally refuse avoidance of double taxation. From the perspective of the Dutch tax authorities the tax payer should request the other country repayment of the withholding tax. In the view of the Dutch tax authorities ,the tax payer has a receivable (the repayment claim). If the tax payer decides not to pursue such receivable because for example the chances on success are too small or it is too expensive, it receives nothing on its receivable. Arguably the tax payer could claim a deductible loss on its “receivable”. As such loss on the receivable is closely linked to a “tax”, the tax authorities generally do not easily accept the deductibility of the loss.

7. Impact of Anti-deferral regimes on outsourced structures

The Netherlands does have some Anti-deferral rules but they will generally not be applicable in the outsourcing situations as defined in the introduction. For this contribution we can conclude that the Anti-deferral rules are not relevant on outsourced structures.

8. Discussion and suggestion

In the Netherlands the topic of “outsourcing” has triggered little corporate income tax conflicts with the tax authorities. In case of uncertainty, often the Dutch tax authorities and the tax payers resolve the uncertainty by agreeing on practical solutions that result in an appropriate taxation without triggering the need for complex compliance obligations. Although in practice almost no problems arise with the tax authorities in this area, the uncertainty about the existence of PEs and the potential profit to be allocated to these PEs sometimes creates discussions with internal and external auditors in the context of audits and internal positive assurance programs. To reduce these uncertainties, it would be useful if the Dutch attitude concerning Agengy PEs as described in paragraph 3.2 , would get a broader sympathy and maybe even an official status in the OECD Commentary.

For VAT purposes outsourcing creates serious problems if the service recipient is not entitled to a full VAT refund. It would allow more efficient business structures if these VAT challenges would be resolved.

The last couple of years a new situation has arisen which is closely linked to outsourcing. Multinational groups more and more have their key personnel located at the location where this person happens to be available. With modern communication means and good connections, it is not practically required anymore that the key personnel is located at a central location in order to operate a pan-European or global business. Consequently, (i) the location where the business is effectively managed is less clear than in the past and (ii) the specific key function may be operated in one country one year and operated in another country the next year if there is a change in key personnel. From a practical perspective normally these employees are legally employed by a legal entity in the country where they reside. One might classify such situation as a centralized business (probably centralized at the location where most key functions are located) with “outsourced” key functions performed by people employed by various legal entities. In this respect various “new” questions arise: (1) can key functions be outsourced (potentially nobody within the company “controls” this function), (2) what is the residency of the entity that has decentralized key personnel, (3) does the key personnel attract more than routine reimbursement (profit split?), (4) if the successor of an employee performing a key function is hired in another country, does that trigger a business reorganization as described in chapter 9 of the Guidelines, and (5) which tax treaty applies if interest, dividend or royalty payments are made to the entity under the responsibility of key personnel located in another country. We suggest the IFA panel provides some insight in the way tax authorities suggest approaching these questions without calling for a constant stream of exit taxation and discussions about residency. This might have important consequences for the current discussion on the importance of key personnel in the BEPS context.