Netherlands

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The Netherlands Supreme Court and Remuneration Borne by a Permanent Establishment – Third Time Lucky!

Decision of the Netherlands Supreme Court of 23 November 2007, BNB 2008/29

According to the Netherlands Supreme Court, remuneration is borne by a permanent establishment (PE) within the meaning of Art. 15(2)(c) of the OECD Model Convention (hereinafter: the OECD Model) if, under Art. 7, the remuneration can be allocated to a PE of the employer in the state of activity. Consequently, the state of activity has primary taxing rights in respect of this remuneration, for which the residence state of the employee must grant double tax relief.

Art. 15 OECD Model

Art. 15 of the OECD Model contains rules on the taxation of income from employment. If the employee exercises his employment in his residence state or in a third state, the exclusive taxing rights on the remuneration for that employment are assigned to the residence state.[1] If the employment is exercised in the other Contracting State (the state of activity), this state has primary taxing rights, at least if, and to the extent that, the remuneration can be attributed to the employment exercised in the state of activity.[2] The residence state must grant relief for double taxation by means of the exemption or the credit method in accordance with Art. 23A or 23B of the OECD Model. The attribution of the primary taxing rights to the state of activity also implies the application of the primary rule in Art. 15 of the OECD Model.[3] Art. 15(2) of the OECD Model, however, contains an important exception. Specifically, if the following three conditions are cumulatively met, the exclusive taxing rights are in any case allocated to the residence state:

(1) the recipient must be present in the state of activity for a period or periods not exceeding in aggregate 183 days during a reference period;
(2) the remuneration must be paid by, or on behalf of, an employer who is not a resident of the state of activity; and
(3) the remuneration may not be borne by a PE that the employer has in the state of activity.

If one of these conditions is not fulfilled, the primary taxing rights on the remuneration that is derived from the employment exercised in the state of activity are attributed to that state.

The Case

The facts

UK Ltd, which was managed from the United Kingdom, acted as a temporary employment agency. The company posted employees to the Netherlands. These employees were present in the Netherlands for less than 183 days in a tax year[4] and they remained residents of the United Kingdom during the period of their posting. The employees worked for various Netherlands clients who were not characterized as employers within the meaning of Art. 15(2)(b) of the 1980 Netherlands–UK tax treaty. In the Netherlands, UK Ltd used the services of a Netherlands resident closed limited partnership, which is transparent for Netherlands tax purposes.

The issue

The Netherlands tax inspector was of the opinion that the activities of the closed limited partnership constituted a PE of UK Ltd. At issue in the decision in question was the condition (see above under (3)) in Art. 15(2)(c) of the 1980 Netherlands–UK tax treaty, which generally follows Art. 15(2)(c) of the OECD Model.[5] In particular, the issue was whether, and if so when, remuneration is borne by a Netherlands PE if the activities are carried out in the Netherlands by UK resident employees who have

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1. Art. 15(1), first part of first sentence, OECD Model.
2. Art. 15(1), last part of first sentence and second sentence, OECD Model.
3. Para. 1 of the Commentary to Art. 15 of the OECD Model.
4. In contrast to Art. 15(2)(a) of the OECD Model, Art. 15(2)(a) of the 1980 Netherlands–UK tax treaty provides that the 183 days must be calculated over the tax year, whereby the tax year is that provided for under the law of the state of activity. This is relevant in particular if the United Kingdom is the state of activity, as, there, the tax year runs from 6 April to 5 April of the following calendar year. In the Netherlands, the tax year is generally the calendar year.
5. In contrast to Art. 15(2)(c) of the OECD Model, the comparable provision in the 1980 Netherlands–UK tax treaty refers to a fixed base. This reference was deleted from the OECD Model from 2000 onwards, as the article in which "fixed base" is used (Art. 14 of the OECD Model) was itself deleted. In contrast, Art. 14 of the 1980 Netherlands–UK tax treaty still has a specific provision on income from independent personal services.

been posted by their UK resident employer (in a situation in which there is no Netherlands resident employer) and who, for this purpose, stay in the Netherlands for less than 183 days in a tax year.

Netherlands Supreme Court's decision

The Court of Appeals of 's-Hertogenbosch held that the remuneration in question was not borne by a PE constituted in the Netherlands within the meaning of Art. 15(2)(c) of the 1980 Netherlands–UK tax treaty, as the remuneration had not resulted in a reduction in the profits tax levied in the Netherlands. The Netherlands Supreme Court has now held that the Court of Appeals' decision was incorrect. In the view of the Netherlands Supreme Court, it was decisive only whether the remuneration under Art. 7 of the 1980 Netherlands–UK tax treaty (Business profits) must be attributed to the PE, i.e. whether the employment activities were carried out for purposes of the PE. According to the Netherlands Supreme Court, this is in accordance with the purport (*strekking*) of Art. 15(2)(c) of the 1963 OECD Model, which served as the basis for Art. 15(2)(c) of the 1980 Netherlands–UK tax treaty, i.e. that the state of activity faces the fact that the salary reduces the profits of the PE and that the related decrease in the tax base in the state of activity should be compensated by taxation in the hands of the employee.

Comment

Interpretation of "borne by"

According to the author the concept "borne by" must be interpreted autonomously and thus not by using Art. 3(2) of the OECD Model, which refers for terms not defined in a tax treaty to the meaning of the term in the national law of the Contracting States.[6] Two arguments can be advanced to support this. On the one hand, the concept "borne by" involved the allocation of the salary costs to the PE and this is largely a factual matter (Art. 3(2) of the OECD Model assumes that the concept being interpreted has a legal connotation).[7] On the other hand, Art. 7 of the OECD Model already provides a definition of the expression "borne by".[8] In its decisions up till now, the Netherlands Supreme Court has also used this kind of autonomous interpretation[9] (see below).

According to the Netherlands Supreme Court, the Commentary to the OECD Model has an important role in the interpretation of tax treaties.[10] Following the changes made in 2000, the Commentary to Art. 15 of the OECD Model[11] takes the view that the attribution under Art. 7 is decisive for the interpretation of the concept "borne by". The Commentary places such an attribution against the background of the object and purpose of Art. 15(2)(c) of the OECD Model (again see below). This object and purpose is such that if the deduction of remuneration is allowed under Art. 7 of the OECD Model when calculating the profits of the PE in the state of activity, it receives the taxing rights on this remuneration as compensation for this deduction.[12] The Commentary does not, however, require that the remuneration in the PE state is actually deducted from the profits. After all, such a deduction is not decisive under the rules of Art. 7 of the OECD Model, either.[13] According to the Commentary to Art. 15 of the OECD Model, what is important is that the costs are deductible as such and for tax purposes, having regard to Art. 7. Again according to the Commentary, this may also be said to be the case if the PE is exempt from taxation in the state of activity if the employer chooses not to take a deduction to which it would normally be entitled or because the remuneration is not deductible because of its nature, as might be the case, for example, with regard to employee stock options.

Netherlands Supreme Court's case law

The case law of the Netherlands Supreme Court did not always present an entirely clear picture. In *Gevudo*,[14] when examining whether the remuneration was borne by the PE within the meaning of Art. 10(2)(c) of the Germany–Netherlands tax treaty of 1959 (comparable with Art. 15(2)(c) of the OECD Model), the Netherlands Supreme Court appeared to consider decisive the bookkeeping and the fact that a separate administration was maintained for purposes of the project with regard to the PE in the Netherlands in which the salary expenses of the employees working there and the employees working in Germany were recorded. In *Gevudo*, the Netherlands Supreme Court did not make explicit reference to the attribution under Art. 5 of the Germany–Netherlands tax treaty. (This provision is, however, in accordance with Art. 7 of the OECD Model.)

In "*Continental shelf PE*",[15] the Netherlands Supreme Court held that the attribution under Art. 7 of the OECD Model is (also?) decisive regarding whether the remuneration is borne by a PE in the state of activity under Art. 15(2)(c).

If *Gevudo* and "*Continental shelf PE*" are considered together, it could be inferred that remuneration is borne by a PE within the meaning of Art. 15(2)(c) of the OECD Model if (1) the employer actually accounted for the remuneration in calculating the profits of the PE and (2) that policy is in conformity with Art. 7.[16] The UK tax

6. F. Pötgens, *Income from International Private Employment: An Analysis of Article 15 of the OECD Model*, Doctoral Series No. 12 (Amsterdam: IBFD, 2006), p. 672.
7. Compare also HR 29 September 1999, BNB 2000/16 and 17 regarding the interpretation of the term "temporary" (*tijdelijk*) in Art. 10(2)(1) of the 1959 Germany–Netherlands tax treaty.
8. Pötgens, note 6, p. 672.
9. HR 9 December 1998, BNB 1999/267 (*Gevudo*); HR 12 October 2001, BNB 2002/125 ("*Continental shelf PE*"); and HR 23 November 2007, BNB 2008/29 (the names given to these cases are based on C. van Raad (complier), *Teksten Internationaal & EG Belastingrecht 2008-2009* (Deventer: Kluwer , 2008). A similar view can be seen in the case law of other jurisdictions, such as Germany (see BFH 24 February 1988, BStBl. II 1988, p. 819).
10. HR 23 September 1992, BNB 1992/379.
11. Para. 7 of the 2000 Commentary to Art. 15 of the OECD Model.
12. Para. 6.2 of the Commentary to Art. 15 of the OECD Model.
13. Para. 7 of the Commentary to Art. 15 of the OECD Model.
14. HR 9 December 1998, BNB 1999/267.
15. HR 12 October 2001, BNB 2002/125.
16. M.J. Ellis and E.P.G. Pötgens, "Enige aspecten van het vaste inrichtingbegrip in het dienstbetrekkingartikel uit de belastingverdragen", *WFR*

authorities, for instance, appear to take the same position.[17]

If the two decisions are placed side by side, the conclusion that the remuneration is borne by the PE if these two conditions are fulfilled would not be in accordance with the interpretation given by the Commentary to the OECD Model, despite the importance that the Netherlands Supreme Court attaches to the role of the Commentary in the interpretation of tax treaties (again see previously). After all, in this regard the Commentary considers attribution under Art. 7 of the OECD Model to be sufficient. It is striking, however, that in not one of the three decisions does the Netherlands Supreme Court refer to Para. 7 of the Commentary to Art. 15 of the OECD Model. One possible explanation could be that the tax treaties that were at issue in these decisions (the 1959 Germany–Netherlands tax treaty in *Gevudo*, the 1992 Netherlands–US treaty in "*Continental shelf PE*" and the 1980 Netherlands–UK tax treaty in the same decision as well as in HR 23 November 2007, BNB 2008/29) pre-date the 2000 changes to the Commentary. Since this revision, Para. 7 of the Commentary to Art. 15 of the OECD Model makes an explicit reference to Art. 7. Presumably the Netherlands Supreme Court does not wish to apply the OECD Commentary dynamically.[18]

In its third decision on the interpretation of "borne by",[19] the Netherlands Supreme Court held that in the interpretation of this concept the only relevant factor is the attribution under Art. 7 of the OECD Model. It is also not required that the remuneration under this provision actually be borne by the PE. The Netherlands Supreme Court made this clear by holding that:

> it is decisive *exclusively* whether the remuneration under Art. 7 of the treaty should be attributed to the permanent establishment, i.e. to the work that is performed on behalf of the PE. (author's unofficial translation, emphasis added)

The question that immediately comes to mind is why the Netherlands Supreme Court did not seize the opportunity to clarify the issue in *Gevudo* by explicitly holding that the attribution under Art. 7 of the OECD Model is decisive regarding whether the remuneration is borne by the employer's PE in the state of activity. Almost ten years after *Gevudo* and in the third decision on the same issue, it has at last been established that only the arm's length attribution under Art. 7 of the OECD Model must be taken into account.

The decision in HR 23 November 2007, BNB 2008/29, is to be applauded. Given the structure and the context of the tax treaty concerned, it is obvious that reference to Art. 7 of the OECD Model should be made in the interpretation of "borne by",[20] just as for the interpretation of the term "permanent establishment".[21] A similar approach is also taken in Para. 7 of the Commentary to Art. 15 of the OECD Model (see previously), although in its decision of 23 November 2007, BNB 2008/29, the Netherlands Supreme Court did not refer to these passages from the Commentary, either. Consequently, according to the Netherlands Supreme Court and the Commentary, it is not necessary that the remuneration for employment actually results in a reduction in the corporate income tax that is levied on the PE in the Netherlands, which is what the Court of Appeals had incorrectly assumed.[22]

Relationship between the activities and the PE

In the quotation from the decision of 23 November 2007, BNB 2008/29, the Netherlands Supreme Court indicates that remuneration under Art. 7 of the OECD Model must be attributed to the PE in the state of activity if the work is on behalf of the PE. This criterion indeed follows from Art. 7 of the OECD Model.[23] In this respect, Art. 7(2) and (3) of the OECD Model contains guidelines for the attribution to a PE of salary costs. Consequently,

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2003/6512, p. 47; S. van Weeghel, note BNB 2002/125, point 4; and C. van Raad, *Cursus Belastingrecht (Internationaal Belastingrecht* (Deventer: Kluwer, loose-leaf), Para. 3.4.5.B.c5. Advocate General Van Ballegooijen, Opinion of 17 July 2006, No. 42.743, Point 5.23 inferred from *Gevudo* (HR 9 December 1998, BNB 1999/267) and "*Continental shelf PE*" (HR 12 October 2001, BNB 2002/125) that only the allocation under Art. 7 of the OECD Model was relevant.

17. Pötgens, note 6, p. 690 and Her Majesty's Revenue & Customs, *Double Taxation Relief Manual*, DT1923.

18. Such a dynamic application is, however, recommended by the Commentary itself. See Paras. 34 and 35 of the Introduction to the Commentary. It is also supported by the Netherlands State Secretary of Finance, *Uitgangspunten van het beleid op het terrein van het internationaal fiscaal (verdragen) recht*, 15 April 1998, V-N 1998, No. 22, p. 1971. This kind of dynamic application entails that changes made to the Commentary affect tax treaties that were concluded before the changes, even where the changes do not simply involve clarifications but substantive changes as well (on this, see the Opinion of Advocate General Van Ballegooijen, 17 July 2006, No. 42.743, point 5.7). To date, the Supreme Court has not confirmed this kind of dynamic application; see Pötgens, note 6, pp. 90-92. Nevertheless, it must be remembered that the revised Commentaries are not entirely without relevance for previously concluded tax treaties. See HR 21 February 2003, BNB 2003/177 and 178, in which the Netherlands Supreme Court seems to consider the revised Commentary to be a supplementary means of interpretation within the meaning of Art. 32 of the Vienna Convention on the Law of Treaties.

19. HR 23 November 2007, BNB 2008/29.

20. Pötgens, note 6, p. 675.

21. In "*Continental shelf PE*" (HR 12 October 2001, BNB 2002/125), the Netherlands Supreme Court held that the deemed PEs that an employer had in respect of its offshore activities in the United States and the United Kingdom (under Art. 27(3) of the 1992 Netherlands–US tax treaty and Art. 22A(3) of the 1980 Netherlands–UK tax treaty, offshore activities that are carried on by a resident of the other state for a period of more than 30 days in a calendar year are regarded as a fictitious PE) also had to be considered a PE within the meaning of the dependent personal services articles of the tax treaties that the Netherlands had concluded with the United States and the United Kingdom. Unlike in the list of examples of PEs in Art. 5(2) of the OECD Model (see HR 26 January 2000, BNB 2000/159 with regard to "a place of management" in Art. 5(2)(a) of the 1980 Netherlands–UK tax treaty), a deemed PE does not have to fulfil the general conditions set out in Art. 5(1) of the OECD Model. See, in respect of the deemed PE of Art. 5(3) of the OECD Model (building site), *Gevudo* (HR 9 December 1998, BNB 1999/267) and, on the interaction between Art. 5 and Art. 15, P. Kavelaars, note, BNB 2002/344, point 3.

22. The same approach as that taken by the Netherlands Court of Appeals was, however, also taken by the Court of Appeal of New Zealand in *J.E.P. Energy v. Commissioner of Inland Revenue* [1989] New Zealand tax cases 682 (for a discussion of this case, see Pötgens, note 6, pp. 673-676; A. Alston, "*J.E.P. Energy Inc. v. Commissioner of Inland Revenue (New Zealand)*", *Bulletin for International Fiscal Documentation* 5 (1991), pp. 211-215; J. Prebble, Interpretation of Double Tax Conventions (New Zealand, National Report), *Cahiers de Droit Fiscal International*, International Fiscal Association (Deventer/Boston: Kluwer, 1993), p. 478); and the High Court of India in *Commissioner of Income tax v. Eltios*, 145 Taxman 210 [23 December 2004] (for a discussion of this, see J. Kariya and R. Gandi, "Indian Court's Conflicting Decisions on Expatriate Taxation", *Tax Notes International*, 14 November 2005, pp. 636-637 and S. Kapadia and S. Sanghvi, "Court Holds Nonresident's Salaries Exempt from Tax", *Tax Notes International*, 25 July 2005, pp. 310-311).

23. Ellis and Pötgens, note 16, p. 49 and Pötgens, note 6, p. 676.

in determining the profits of the PE, costs (including executive and general administrative expenses) may be deducted if they can be attributed to the PE under the "distinct and separate enterprise" provision[24] or if they are incurred for purposes of the PE.[25] As with the Netherlands Supreme Court, the author is of the opinion that the relevant criterion in this regard is that the work must have been carried out for purposes of the PE.[26] The work must, therefore, functionally be to the benefit of the PE.[27] For this to be the case, there must be a link between the employee's activities and the activities of the PE in the state of activity.[28] In the author's opinion, this cannot be said to be the case if an employee merely carries out activities for the benefit of the headquarters' enterprise from a PE located in the state of activity. In this case, the services rendered by the employee do not relate to the activities of the PE, but, rather, to those of the head office. This is not altered by the circumstance that the employee has made use of the facilities of the PE in providing his services.[29]

Object and purpose of Art. 15(2)(c) of the OECD Model

Just as in "*Continental shelf PE*",[30] in its decision of 23 November 2007,[31] the Netherlands Supreme Court also referred to the object and purpose of Art. 15(2)(c) of the OECD Model to substantiate its decision (see previously, where it is noted that Para. 6.2. of the Commentary to Art. 15 of the OECD Model adopts a similar approach). Some comments are called for with regard to this approach. Accordingly, it could be asked whether the state of activity is not being "overcompensated"[32] and whether this approach leads to a consistent solution in every case, for example, if the foreign employer is exempt from tax in the state of activity.[33] It is also striking that, although the Netherlands–UK tax treaty dates from 1980, the Netherlands Supreme Court held with regard to the object and purpose of Art. 15(2)(c) of that treaty that the provision is based on Art. 15(2)(c) of the 1963 OECD Model.[34]

Conclusions

The Netherlands Supreme Court gave the correct decision in its ruling of 23 November 2007.[35] It would have been preferable, however, if the Court had given this decision the first time it ruled on this issue (in *Gevudo*) and not waited until the third opportunity. In determining whether the remuneration is borne by a PE within the meaning of Art. 15(2)(c) of the OECD Model, the criterion of attribution to the PE under Art. 7 is, indeed, decisive. This is also in conformity with the Commentary to the OECD Model. In addition, the Netherlands Supreme Court has clarified the fact that, for this kind of attribution, it is necessary that the employee carry out activities on behalf of the PE. The UK tax authorities, however, adopt the approach that the remuneration must actually be borne by the PE in the state of activity and also that this must be in conformity with Art. 7 of the OECD Model, so that double taxation in the facts of the decision of 23 November 2007,[36] cannot be ruled out.

24. Art. 7(2) OECD Model.
25. The relationship between Art. 7(2) and (3) of the OECD Model is not, however, entirely clear. See further Ellis and Pötgens, note 16, p. 48 and Pötgens, note 6, p. 676.
26. Opinion of Advocate General Van den Berge of 7 February 2001, No. 35.749, point 4.14; Ellis and Pötgens, note 16, p. 47; and Pötgens, note 6, p. 677. It appears as if the Netherlands Supreme Court also followed this approach in its decision of 9 August 2002, BNB 2002/344.
27. OECD Report, "Cross-border Tax Issues Arising from Employee Stock Option Plans", Paris: 2004, Para. 61.
28. On how such a link can be determined, see Pötgens, note 6, p. 677.
29. Ellis and Pötgens, note 16, p. 49; Pötgens, note 6, p. 677; E Wassermeyer, Art. 15 MA, H. Debatin and E Wassermeyer (eds.), *Doppelbesteuerung* (Munich: Verlag C.H. Beck, loose-leaf), Para. 132; and the circular of the Belgian Tax Administration, 25 May 2005, No. AFZ 2005/0652 (AFZ 08/2005).
30. HR 12 October 2001, BNB 2002/125.
31. BNB 2008/29.
32. Pötgens, note 6, p. 471. The state of activity already taxes the profits that are generated by the activities performed by the employee because the employer has a PE therein. Conversely, the state of activity must then allow the deductibility of the salary costs, which already constitutes a neutral operation. In other words, the profits generated by the employee's services are taxed, and in consideration, the salary costs are deductible from these profits, which is already balanced out. Accordingly, if the state of activity additionally has the authority to tax the salary relating to these business activities, it seems that this state has been overcompensated.
33. For more detail, see Ellis and Pötgens, note 16, pp. 48–49.
34. From the Netherlands Explanatory Memorandum to the 1980 Netherlands–UK tax treaty it seems that the treaty is instead based on the OECD Model of 1977. In this regard, see *Nederlandse Regelingen van Internationaal Belastingrecht* (Kluwer, loose-leaf), Convention with the United Kingdom 1980, Chapter 2 (Official Explanation), Para. 1.
35. BNB 2008/29.
36. Id.