

Attribution of profit to a permanent establishment involved in electronic commerce transactions

A discussion paper from the Technical Advisory Group on monitoring the application of existing treaty norms for the taxation of business profits (Draft for public comment; deadline: 30 June 2001)

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[1.] Foreword

1. To date, much attention has been focused on the question of in what circumstances do electronic commerce activities, especially the operation of a server in a particular jurisdiction, lead to the recognition of the existence of permanent establishment in that jurisdiction (the threshold question) under Article 5 of the OECD Model Tax Convention. Indeed, the Committee on Fiscal Affairs has recently published a Report adding to the existing Model Commentary on Article 5 to clarify the application of the provisions of the Article in respect of web sites and servers. The clarification will be incorporated in the next update of the Model Tax Convention.

2. Now that the threshold question has been settled, at least in respect of the application of the existing rules, attention turns naturally to what profits can be attributed to e-commerce activities that have passed the threshold of Article 5 so that a permanent establishment is held to exist. The allocation of the taxing rights between the jurisdiction of the enterprise and the jurisdiction of the permanent establishment are determined under Article 7 of the OECD Model Tax Convention. This discussion paper is a first attempt at exploring the interpretation and application of Article 7 to a PE carrying on retail e-commerce activities (“e-tailing”).

3. The discussion paper has been produced by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (“Business Profits TAG”).

This group was set up to assist in implementing the Ottawa Framework Conditions with a mandate to examine how the current tax treaty rules for the taxation of business profits apply in the context of electronic commerce and to consider proposals for alternative rules. This paper is a discussion draft only and does not represent a consensus view of the government or business members of the Business Profits TAG. However, the intention of releasing the discussion paper is to stimulate debate on how to attribute profit to a permanent establishment in an e-commerce context. This should assist in the ultimate development of an internationally agreed consensus on the interpretation and application of Article 7 amongst business, OECD Member and non-member Governments.

4. Accordingly, comments on this discussion paper are invited, and indeed, positively encouraged by 30 June 2001. Areas where comments would be particularly welcome are referred to directly in the text. Comments can be posted on the public EDG (<http://appli1.oecd.org/daf/taxandel.nsf> (to register for the EDG, if you are not already a member, please see: http://www.oecd.org/daf/fa/e_com/e_rego.htm) or e-mailed to Jeffrey Owens, Head of Fiscal Affairs (daffa.contact@oecd.org) and copied to John Neighbour, Head of Transfer Pricing and Financial Transactions Unit (john.neighbour@oecd.org).

[2.] Executive summary

5. This discussion paper from the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits (“Business Profits TAG”) provides a detailed analysis of the transfer pricing issues arising in attributing profit to a permanent establishment involved in electronic commerce activities, in the context of an enterprise engaged in the retail distribution of entertainment products (“e-tailing”). The paper provides an overview of the current treaty rules for attributing profit to a permanent establishment under Article 7 of the OECD Model Tax Convention. It also refers to the on-going work of the Committee on Fiscal Affairs in this area, which is attempting to develop a common interpretation of Article 7 that is in accordance with the articulation of the arm's length principle found in the Transfer Pricing Guidelines, and foreshadows some of issues raised in the context of this review in the *Discussion Draft on the Attribution of Profits to Permanent Establishments*¹, a discussion paper issued on 8 February 2001 by the Committee on Fiscal Affairs (CFA). That document looks at issues relating to the attribution of profits to permanent establishments in general and is not confined to permanent establishments in the e-commerce sector (“CFA general discussion draft”).

6. This paper illustrates the various steps of the analysis that are required to attribute profit to a permanent establishment, in the context of a specific example of an enterprise distributing products over the internet through a web site hosted on a server situated in a permanent establishment in another country. Four different variations of the example are developed and analysed. The first variation is the extreme case of a stand-alone computer server performing automated functions (in particular, online processing of transactions and transmission of digitised products) without the presence of personnel in the permanent establishment. The second variation examines the case of multiple servers per-

¹ See <http://www.oecd.daf.dfa> for a link to the Discussion Draft on the Attribution of Profits to Permanent Establishments, posted 8 February 2001.

forming identical tasks. The third variation assumes the presence of personnel in the permanent establishment to provide online services and maintain the server. The last variation assumes that the development of the hardware and software used by the permanent establishment was entirely performed in the permanent establishment.

7. The paper provides an analysis of the likely outcome of the application of the arm's length principle to the four examples and identifies some issues arising under the current interpretation of Article 7 that may prevent, in certain circumstances, a profit attribution to the permanent establishment that is fully consistent with the arm's length principle. These issues are developed more fully in the CFA general discussion draft.

8. In summary, it is found that under the arm's length principle, the amount of profit to be attributed to the permanent establishment will be related to the nature of the functions that it performs (taking into account the assets used and risks assumed). Given the importance of intangible assets in the earning of profits from e-commerce activities, it is also essential to determine which part of the enterprise economically "owns" or has created the intangible assets used by the permanent establishment. In the context of the stand-alone computer server (and the multiple server variation), the functional and factual analysis is likely to show that the permanent establishment is performing only routine functions and is reliant on other parts of the enterprise to provide the intangible assets necessary for it to perform most, if not all, of those functions. Accordingly, the activities of the permanent establishment are very unlikely to warrant it being attributed with a substantial share of the profit associated with the distribution activities of the enterprise conducted through the server. Further, it is suggested that the nature of this type of server-permanent establishment, especially its lack of personnel, is likely to mean that tasks performed by the server would likely be conducted under a "contract service provider" arrangement that would leave all substantial assets and risks with the head office and attribute to the permanent establishment the profits associated with the physical operation of the computer server. Under an alternative interpretation of the arrangement, whereby the permanent establishment is considered to be instead an "independent service provider", the conclusion would be similar, given the need for the permanent establishment to recognise, in computing profit, the arm's length value of the tangible and intangible property that it uses and that were contributed to it by other parts of the enterprise.

9. Where personnel are present in the permanent establishment to perform maintenance and online services tasks, the quantum of the profit attributable to the permanent establishment would be commensurate with what independent service providers would be expected to earn in a similar situation. Finally, the last variation (in-house development of server and web site) is likely to produce a more substantial attribution of profit to the permanent establishment, as it assumes sufficient development risks to be considered as the economic owner of the intangible property developed to operate the server and the web site and, therefore, is entitled to the profit associated with the exploitation of such property.

10. This discussion paper is limited to an analysis of an "e-tailing" situation. The implications for Article 7 of the transfer pricing issues raised by other business models could warrant further work. The paper is also limited to an analysis of transfer pricing issues and does not address issues of compliance or other administrative aspects. Finally, the paper is meant to provide a technical analysis of current rules under the OECD Model Tax Convention, and does not offer a policy evaluation of the effectiveness or appropriateness of the rules. These issues are currently being examined by the Business Profits TAG.

11. Views are invited on the analysis contained in this discussion paper and on areas where further work could be undertaken by the Business Profits TAG (please see the Foreword for details of where to send comments).

[3.] Introduction

12. The purpose of this discussion paper is to examine the issues surrounding the attribution of profit to a permanent establishment involved in electronic commerce transactions. In particular, the discussion paper provides a detailed analysis of the steps required to attribute, in accordance with the arm's length principle, profit to a permanent establishment that would be considered to exist under Article 5 of the OECD Model Tax Convention² as a result of the use by an enterprise of a stand-alone computer server in a foreign jurisdiction in the course of processing online retail transactions. The assumption that the operation of a computer server by an enterprise in a country can give rise to a permanent establishment in that country is based on the conclusions reached by Working Party No. 1 on Tax Conventions and Related Questions and, in particular, on the recently released additions it has proposed to the Commentary to the

² *Model Tax Convention on Income and on Capital*, OECD Committee on Fiscal Affairs, Paris.

Model Tax Convention. The scope of this paper is limited to a technical interpretation and application of the arm's length principle to such a permanent establishment. The wider policy issue of whether the current provisions of the OECD Model Tax Convention regarding the taxation of permanent establishments are the most appropriate to deal with the issues presented by the development of electronic commerce is not discussed in this note and is another item on the work programme of the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits ("Business Profits TAG").

13. The starting point for the analysis contained in this discussion paper is the current Commentary to the Business Profits Article (Article 7) of the OECD Model Tax Convention.

However, the analysis also takes into account the preliminary results of a review currently on-going within the Committee on Fiscal Affairs, whose aim is to test and develop an interpretation of Article 7 that is more consistent with the interpretation of the arm's length principle in the Associated Enterprise Article (Article 9) and that takes into account the important evolution contained in the revised 1995 Transfer Pricing Guidelines. The preliminary results of the review, conducted on the basis of a "working hypothesis" that does not bind OECD Member countries, can be found in *Discussion Draft on the Attribution of Profits to Permanent Establishments*, released by the CFA on 8 February 2001. That document ("CFA general discussion draft") looks at issues relating to the attribution of profits to permanent establishments in general and is not confined to permanent establishments in the e-commerce sector.

14. The next section outlines the principles that are relevant in attributing profit to permanent establishments in general. The third section begins with a detailed example of a commercial retail operation relying on a stand-alone computer server to host its web site and process online transactions with customers. Then, a detailed analysis of the application of the arm's length principle is performed on the basis of the parameters of the example, setting out the steps that must be followed in order to attribute profit to such a permanent establishment. Considerable analysis is devoted to this first scenario. Three additional variations on the basic example are then examined in order to show how different fact patterns affect the analysis. The second variation assumes the existence of several servers in as many foreign jurisdictions performing identical tasks. The third variation assumes the presence of technical personnel in the permanent establishment. The last variation illustrates the attribution of profit when hardware and software used in the business are developed within the permanent establishment.

15. Several other variations could have been considered. Likewise, it is recognised that electronic commerce can occur under other forms of business models. The example examined in this discussion paper illustrates a so-called "e-tailing" operation. Other models include "B2B" (business-to-business transactions), the auction model (whereby a virtual bidding forum for purchasers and suppliers is provided) and web hosting. The principles applied in this discussion paper with regard to "e-tailing" could equally apply to other forms of e-commerce but would need to be adapted to the particular factual situation.

16. This discussion paper does not consider issues of compliance by taxpayers and administration by tax authorities that may be raised in the context of the example examined in the third section. These issues are to be considered as part of the wider policy analysis currently conducted by the Business Profits TAG.

[4.] General principles for attributing profit to a permanent establishment

17. The purpose of this section is to provide an overview of the rules governing the attribution of profits to permanent establishments under Article 7 of the OECD Model Tax Convention, including the latest developments on the interpretation and application of Article 7, as reflected in the CFA general discussion draft released on 8 February 2001. The description of the rules and latest developments in this section will serve as a starting point for a more thorough analysis, in the next section, of their possible application to various forms of permanent establishments involved in electronic commerce activities. Some of the challenges that may be faced in attributing profit to a permanent establishment in an electronic commerce environment are already apparent in this part. Readers are referred to the CFA general discussion draft for a more detailed analysis of the issues and explanation of the background to the review of Article 7. In brief, the CFA has noted that there is currently not a consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation of Article 7 can lead to double, or less than single taxation. The development of global trading of financial products and of electronic commerce has helped to focus attention on this unsatisfactory situation and on the need to establish a consensus position regarding the interpretation and practical application of Article 7.

18. As a first step in establishing a consensus position, a working hypothesis (WH) has been developed as to the *preferred* approach for attributing profit to a permanent establishment under Article 7. The WH has been tested by considering how it would apply in practice to attribute profit both to permanent establishments in general and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread. The CFA has released a general discussion draft that contains the results of testing the application of the WH to permanent establishments in general (Part I) and to permanent establishments of banking enterprises (Part II).

19. The analysis in this discussion paper is based on the WH and how it might be applied to attribute profit to a permanent establishment of an e-tailer. Differences between the results of applying the WH and of applying the existing interpretation of Article 7 are identified and discussed. It should be noted that the use of the WH in this discussion paper should not be interpreted as implying support for the adoption of the WH by any of the business or government representatives on the Business Profits TAG.

20. The rest of this section provides more detail on the existing interpretation of the first three paragraphs of Article 7 and on how the WH might apply to those paragraphs.

[5.] Article 7(1) - Calculating profit to be allocated to a permanent establishment

21. Article 7 of the OECD Model Tax Convention sets out the rules for allocating profits to a permanent establishment. Article 7(1) provides that only so much of the “profits of an enterprise” as are attributable to a permanent establishment in a country may be taxed in that country. The Commentary to this paragraph confirms that the profits attributable to a permanent establishment do not include profits that an enterprise may derive otherwise than through the permanent establishment. This limits the taxing rights of a host country so that profits of a non-resident enterprise that are not attributable to the permanent establishment cannot be subject to tax, for example under the “force of attraction” principle.

22. The OECD Model Commentary provides little additional guidance concerning how the term “profits of an enterprise” is to be interpreted; in particular, whether the profits attributable to the permanent establishment are limited by the profits of the entire enterprise. Historically, there has been a lack of consensus amongst countries on how far to take the “distinct and separate enterprise” approach of Article 7(2). Some countries put more weight on treating a permanent establishment as far as possible as if it were a separate enterprise, the “separate enterprise” approach, while others put greater weight on the fact that the permanent establishment is only a part of a single legal entity, the “single entity”^F approach. Between these two polar approaches, several nuances are also possible.

23. In order to attain its goal of achieving an international consensus on the interpretation and practical application of Article 7, the WH adopts a single interpretation (the “functionally separate entity” approach). This approach requires that the profits to be attributed to a permanent establishment are the profits that it would have earned at arm's length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm's length principle of Article 7(2). The phrase “profits of an enterprise” in Article 7(1) should not therefore be interpreted as affecting the determination of the quantum of profits that can be attributed to the permanent establishment but rather as limiting the profits to “only so much of them as is attributable to that permanent establishment” and in particular as providing specific confirmation that “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment” (i.e. there should be no “force of attraction” principle).

UN Model Convention

24. A number of bilateral tax treaties adopt features of the UN Model Convention. Article 7 of the UN Model Convention generally follows the principles of the corresponding Article of the OECD Model Tax Convention with respect to the attribution of profit to a permanent establishment.

However, there are differences between the two models. The major difference between the two models is that the UN Model extends source country taxing rights beyond the strict attribution of profit to a permanent establishment and grants a host country the right to tax profits attributable to sales made by the non-resident enterprise in the country's territory “of goods or merchandise of the same or similar kind as those sold through that permanent establishment”. This is the so-called “limited force of attraction” principle. This paper does not examine the implications of the

application of this principle to electronic commerce transactions. Instead, it is written on the assumption that the arm's length principle is the most appropriate principle to apply when attributing profit to a permanent establishment in the contexts of both electronic and traditional commerce.

[6.] Article 7(2) of the OECD Model Tax Convention

25. Paragraph 2 of Article 7 states the arm's length principle in the context of permanent establishments, and is the key paragraph for attributing profits to a permanent establishment. It states that the profits to be attributed to a permanent establishment are those that it would have made if it had been a separate enterprise engaged in the same or similar activities, under the same or similar conditions, dealing with other parts of the enterprise wholly independently.

26. The Commentary confirms that Article 7(2) is to be considered a statement of the arm's length principle of Article 9 in the context of permanent establishments. The OECD Transfer Pricing Guidelines ("the Guidelines") contain detailed guidance on how to apply the arm's length principle under Article 9 in the context of associated enterprises. The WH is based on the premise that the guidance on the application of the arm's length principle of Article 9 given by the Guidelines should be applied to the attribution of profit to a permanent establishment using the arm's length principle under Article 7(2). However, this guidance has to be applied by analogy rather than directly as it is based on evaluating *transactions* between associated enterprises, rather than *dealings* within the same enterprise.

27. The preferred interpretation of Article 7(2) under the WH is that a two-step analysis is required: first, a functional and factual analysis, in order to appropriately hypothesise the permanent establishment and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks; second, an analysis of the Guidelines relevant to applying the arm's length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. Each of these steps is discussed below.

First step: Determining the characteristics and functions of the hypothesised distinct and separate enterprise

28. Following, by analogy, the approach adopted in the Guidelines, the technique of functional analysis can be used to determine what economically significant activities are undertaken by the enterprise as a whole. The functional analysis must go on to determine which of the identified activities of the enterprise are associated with the permanent establishment, and to what extent.

29. The functional analysis must also take into account the assets used and risks assumed by the permanent establishment. As regards assets, the working hypothesis is to undertake a functional analysis that takes into account "assets used" (emphasis added), with no reference to legal ownership.

The facts and circumstances must be examined in order to determine the extent to which the assets of the enterprise are used in the business activity carried on by the permanent establishment. To the extent that assets are used in the business activity carried on by the permanent establishment, the use of those assets should be taken into account in rewarding the functions performed by the permanent establishment. Assets of the enterprise that are not used by the permanent establishment should not be taken into account for the purposes of attributing profits to it.

30. Following the analysis of assets, the working hypothesis is to treat the permanent establishment as assuming certain risks, even though legally it is the enterprise as a whole that assumes those risks. Indeed, the permanent establishment should be considered as assuming any risks inherent in, or created by, the permanent establishment's own functions (i.e. for the purpose of the permanent establishment), and any risks that relate directly to those activities. The division of risks assumed and functions performed by the head office and the permanent establishment respectively may be set out in writing, in the same manner as risks and functions may be documented contractually between separate legal entities. However, in the absence of contractual terms between the permanent establishment and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the permanent establishment will have to be highly fact specific. Following, by analogy, paragraph 1.28 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be "deduced from their [the parties] conduct and the economic principles that govern relationships between independent enterprises." This deduction may be aided by examining internal practices of the enterprise (e.g. compensation arrangements), by making a comparison with what similar

independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risks has been made.

31. In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the permanent establishment, the assumption of those risks should be taken into account when attributing profit to the performance of that function by the permanent establishment. If risks are found not to have been assumed by the enterprise as a result of a function performed by the permanent establishment, the assumption of those risks should not be taken into account for the purposes of attributing profits to the permanent establishment. It should be noted that this discussion of risk only relates to the assumption of risks, inherent in, or created by, the performance of a function.

Second step: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis

32. The WH provides for the choice and application of methods described in the Guidelines to be applicable when determining the profits to be attributed to a permanent establishment based upon its functions performed (taking into account assets used and risks assumed). The permanent establishment should obtain an arm's length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise.

33. A functional analysis of the permanent establishment will already have been accomplished in the process of constructing the hypothesised "distinct and separate" enterprise under the first step of the analysis. Additionally, the working hypothesis is to undertake a comparison of *dealings* between the permanent establishment and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the permanent establishment context means either that there are no differences materially affecting the measure used to attribute profit to the permanent establishment, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences.

34. An important question is whether inter-branch dealings have taken place and so should be recognised for the purposes of attributing profit. In the associated enterprise situation it will usually be self-evident that a transaction has occurred, e.g. the transaction will have legal consequences other than for tax purposes. However, a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is often inferred solely for the purpose of determining an arm's length attribution of profit. Consequently, it will be necessary at the outset to determine whether any dealing exists before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm's length attribution of profit.

35. Under the WH, a "dealing" will be recognised, for the purpose of attributing profit, where it relates to a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, the use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.). A functional analysis should be used to determine whether such an event has occurred and should be taken into account as an inter-branch dealing of economic significance. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the "dealing". In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction, following the guidance on contractual terms found in paragraphs 1.28 and 1.29 of the Guidelines. This guidance should be applied by analogy in the permanent establishment context.

36. Once the above threshold has been passed and a dealing recognised as existing, the WH applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the permanent establishment and the other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *permanent establishment and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a permanent establishment and so "should not disregard the actual dealings or substitute other dealings for them."

37. Where the permanent establishment has dealings with other parts of the enterprise, those dealings are an important factor to be considered and will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the permanent establishment and the other parts of the enterprise, taking into account assets used and risks assumed. Such inter-branch dealings should have the same effect on the attribution of profits between the permanent establishment and other parts of the enterprise, as would comparable transactions between independent enterprises.

However, the inter-branch dealings are postulated **solely** for the purpose of attributing the appropriate amount of profit to the permanent establishment.

38. The comparability analysis might determine that there has been a provision of goods, services or assets, etc. between one part of the enterprise and another, that is comparable to a provision of goods, services or assets, etc. between independent enterprises. Accordingly, the part of the enterprise making such a “provision” should receive the return which an independent enterprise would have received for making a comparable “provision” in a transaction at arm's length. Another outcome of the comparability analysis might be that the permanent establishment and the other part of the enterprise dealing with it are found to be acting, under all the facts and circumstances, in a comparable manner to economic co-participants in an activity corresponding theoretically to a cost contribution arrangement (CCA). If the permanent establishment and the rest of the enterprise are found to be economic co-participants in such an activity, then the dealings would result in the attribution of profits in a manner similar to transactions between associated enterprises in a CCA. The comparability analysis may result in other outcomes and these should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

Article 7(3) of the OECD Model Tax Convention

39. Historically, some countries interpreted Article 7(3) as mandating an allocation of costs (without any profit element). However, most Member countries, including those that interpret Article 7(3) as requiring modifications to the arm's length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm's length principle of Article 7(2). Accordingly, the working hypothesis is that the role of Article 7(3) should be just to ensure that the expenses associated with a permanent establishment's activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the permanent establishment's jurisdiction, or is not incurred exclusively for the permanent establishment.

[7.] Special considerations in attributing profit to a permanent establishment in an electronic commerce environment

[7.1] Server creates a permanent establishment

40. This section is developed on the basis of a hypothetical example with a basic scenario and a number of variations. The example focuses only on the computer server as a tool to support a retail distribution function. It is assumed, under the proposed additions to the Commentary to Article 5 of the Model Tax Convention, that the server constitutes a permanent establishment of the enterprise so that the jurisdiction of the permanent establishment has a right to tax the profits of the non-resident enterprise attributable to that permanent establishment.

[7.2] Variation 1: Single server

[7.2.1. Introduction]

41. Starco Inc., a hypothetical corporation resident in country A, is an online distributor of music and video products worldwide. Starco purchases the right to distribute music and full-length movies from producers in several countries and makes various types of products available at the retail level to consumers over the World Wide Web through its well-known web site.

42. Starco's web site, much like a catalogue, displays the entire range of Starco's products and allows visitors to purchase its products on line. Consumers have the choice to order a physical copy of the product they wish to purchase (available on various supports, such as CD, DVD, VHS cassettes, etc.) or to download a digitised version of the product

on line from its server to the consumer's computer, once the payment is confirmed. Most of Starco's products are available in digitised form.

43. Starco hosts its web site on a single server in country B. The server was installed toward the end of 1998 and has been operational since 1 January 1999, the beginning of Starco's financial year. The web site became well-known as a result of an aggressive worldwide publicity campaign conducted by Starco prior to and around the time it was launched. No personnel attended the server throughout the 1999 financial year and the server performed as expected. The server is a powerful computer fitted with software programmed to:

- i. Display the various pages of Starco's web site.
- ii. Process orders placed by customers for the purchase of physical products.
- iii. Process orders placed by customers for the purchase of digitised products.
- iv. Hold a digitised copy of all available products.
- v. Transmit digitised products on line to the computer of customers.

44. Here is how a typical transaction takes place:

- i. The customer considers the list of products available on the web site and selects the products that he/she wishes to purchase and the mode of delivery - physical support or digitised transmission.
- ii. The customer fills in an order form with all the required information, and provides a credit card number as the means of payment for the products to be purchased.
- iii. The customer sends the order on line.
- iv. The customer receives, on line, within two minutes, confirmation that his/her order has been received and that the credit card company has accepted the transaction. Where a physical product was ordered, the message includes an estimate of the delay before delivery by mail. Where a digitised product was ordered, downloading of the product may commence after the customer received the purchase confirmation. Where technical problems occur, the consumer may contact Starco either via a toll-free telephone number or e-mail.

45. Here is how the server operates in the course of this typical transaction:

- i. The order is received by the server in country B. The server is programmed to contact by phone the credit card company of the customer in order to secure immediately payment for the product purchased. Once the transaction is accepted by the credit card company, payment is made by it to a Starco bank account in country A. Where the payment is made as directed, the server moves on to the next step. If the payment is, for whatever reason, not authorised, notice is sent to the customer that the transaction cannot be completed.
- ii. The next step depends on the form of the product ordered. If a physical product was ordered, the server sends a notice to the customer informing him/her of the delay before the product is delivered by mail. At the same time, a message is sent to the computer of Starco's central warehouse in country A, requesting that the products selected by the customer be delivered at the address provided in the order. In most occasions, the products to be delivered can be drawn directly from the warehouse's extensive inventory. However, it may also be required, in order to fulfil the customer's order, to purchase products from its suppliers.
- iii. If a digitised product was ordered, the server provides permission to the customer to download a copy of the product immediately. Downloading entails sending on line a copy of digitised product ordered, which sits in a digitised format on the server. The customer may perform the downloading once. When the downloading is successfully completed, the server sends notice that the transaction is completed. If the downloading is interrupted before completion, the customer may resume downloading until it is successfully completed. The server provides a menu of troubleshooting options to handle the most common problems encountered by customers during the downloading process.

46. On the basis of the interpretation of Article 5 recently issued by the Committee on Fiscal Affairs, it is assumed, under the fact pattern described above, that Starco's server in country B constitutes, for tax purposes, a permanent establishment of Starco.

[7.2.2.] General considerations

47. The analysis below is concerned with attributing profit to the permanent establishment for the 1999 financial year. The attribution of profit to a permanent establishment begins with a functional analysis, which establishes the role of the permanent establishment in the enterprise and informs the next step, which requires one to hypothesise the attributes of the permanent establishment as a separate and distinct enterprise as well as the nature of the "dealings"

between the permanent establishment and the rest of the enterprise, in order to apply the appropriate transfer pricing method to attribute profit to the permanent establishment.

[7.2.3.] *First step: Determining the conditions of the hypothesised distinct and separate enterprise*

Functions performed

48. The functional analysis will show that the permanent establishment performs the following functions autonomously:

- The establishment of an internet connection between the server and any person with a computer, a modem and an internet browser through an interface created by the joint operation of the permanent establishment's hardware and software, the web site;
- Presentation of Starco, of Starco's products, of instructions for visitors to enter into a commercial transaction with Starco, of phone numbers to handle any inquiries about products or about online transactions.
- Processing of orders submitted by customers on line, immediate validation of payments provided by customers with credit card companies, immediate approval or refusal of orders on line, processing of instructions to Starco for the subsequent physical delivery of products, performance of online transmission of digitised products, provision of online trouble-shooting.

Assets used

49. The functional and factual analysis will show that the permanent establishment requires assets, in the form of both hardware and software to undertake the above functions. The permanent establishment of Starco in country B consists of both hardware and software located in an office space rented by Starco. The hardware, a physical asset, is a powerful computer with the latest communication devices capable of handling a large volume of traffic. The software, which is intangible property either acquired or developed by Starco³, consists of the sums of all the programs required to ensure that: (i) the computer can be operational autonomously; (ii) the computer can be linked via communication lines with one or more Starco's computers in other locations, including Starco's head office and warehouse in country A; (iii) the computer can be linked via modem lines (or similar means of communication) with any person seeking to access Starco's web site; (iv) the computer can maintain Starco's web site and (v) the computer can perform operations relating to the processing of commercial transactions with customers, including seeking and obtaining authorisation from the financial institution for the payment to be made. "Software", therefore, is given a wide meaning in the following discussion and is not limited to commercial software widely available on the market (for example, a computer's operating system), but encompasses the product resulting from the development work necessary for the creation and all aspects of the operation of Starco's web site. Such development work is specific to the needs of Starco and results in the creation of "custom" software. The cost of such development work (whether incurred internally or under contract with outside experts) is expected to represent the bulk of the cost of the software installed in the permanent establishment.

50. Hardware and software do not, on their own, ensure that commercial activities occur on a web site. The permanent establishment also makes use of Starco's other intangible assets. The most obvious of these assets is the marketing intangible associated with the enterprise. The main component of this intangible is the enterprise's own brand name, which will attract potential customers on the web site and, therefore, result in commercial transactions occurring through the permanent establishment. Another intangible (an "e-commerce marketing intangible") may be directly related to the operation of the web site. For example, is it laid out clearly, is it fun to use, does it carry interviews with "hot" groups or musicians, does it manage the purchases of its supplies and process customer orders quickly and efficiently. Both these intangibles are directly relevant to the success of a commercial web site.

51. It is not sufficient, for purposes of attributing profit to Starco's permanent establishment, to determine which intangible assets are used by it. One needs to determine which part of the enterprise is entitled to the benefits associated with the use of the intangibles by the permanent establishment. The reward associated with an intangible prop-

³ Software is, for the purpose of this note, referred to as "intangible" property, notwithstanding the broader issue of how it is characterised under the Model Tax Convention or domestic law. While the software may or may not be intellectual property of the enterprise (depending, for example, on whether the software was acquired on the market or developed by the enterprise), this paper avoids making the distinction. Of course, such a distinction can potentially be material to the determination of the arm's length compensation associated with a transaction involving such property.

erty does not necessarily accrue to the part of the enterprise making use of it, but rather to the part of the enterprise that developed or otherwise contributed the intangible.

Risks assumed

52. Having determined the functions performed and assets (including intangible property) “used” by the permanent establishment, one also needs to determine the risks assumed respectively by the permanent establishment and the rest of the enterprise.

53. Legally, these risks are borne by the enterprise as a whole. The challenge, for the purpose of attributing profit to the permanent establishment, is to determine which risks, if any, should be attributed to the permanent establishment as opposed to the rest of Starco. Under the WH, the functional and factual analysis will determine the extent to which the permanent establishment should be considered to assume any risks inherent in or created by its own functions or that relate directly to those functions. The rest of this sub-section looks at the various types of risk inherent in the business of Starco.

Credit risk

54. The extent of the credit risk assumed by Starco will depend on how transactions are processed. In the vast majority of cases, payment will likely be made with a credit card. Where Starco seeks some form of corroboration (e.g. a confirmation number) from the issuer of the credit card before proceeding with the transaction, payment for the transaction will be effectively guaranteed. In such cases, credit risk is probably negligible. However, where such validation is not performed systematically, for example where single payments to Starco are of a low monetary value, Starco would assume the credit risk in respect of these transactions.

55. Under the WH, the associated credit risk would be treated as assumed by the part of the enterprise carrying out the function leading to the creation of that risk. This raises the question of which part of Starco carries out that function. Is it the permanent establishment because it accepts the customer's order or is it the head office because it has provided the software that enables the permanent establishment to accept that order? In short, can risk be assumed by the actions of a computer or is human intervention required? The WH links the assumption of risk with the carrying out of functions and so would be indifferent to whether the function leading to the assumption of risk was carried out with, or without, human intervention. Views on this issue would be particularly welcome.

Market risks

56. The cost of holding physical inventory depends on the nature of the arrangements between Starco and its suppliers. If the arrangements allow Starco to return unsold inventory after a given period of time, then the market risk is mostly borne by Starco's suppliers - Starco's share of the risk would be commensurate with the transactions costs that may be involved in returning unsold inventory. If no such possibility exists, all of the market risk is borne by Starco. The extent of this market risk, in turn, depends on the nature of the consideration paid by Starco for the intangible property element of the products it acquires from suppliers. Let us assume that for both digital and physical products, a payment is made to suppliers each time a product is purchased by a customer. Market risks include the transactional costs associated with the possibility of having to replace a defective product - the cost of the defective product itself would not ordinarily be borne by Starco as arrangements with suppliers may provide for the replacement of such products at no charge.

57. In the case of digitised products, the cost of the physical support is irrelevant. The server is able to provide a digitised version of each product, and to transfer that product to the customer each time a transaction is entered into with a customer on line.

58. Therefore, under a per-unit payment arrangement, Starco's market risk is limited to the cost of the physical support of the products acquired from suppliers, since royalties are payable only when products are sold on the retail market. The cost of the marginal physical support is infinitesimal in the case of digitised products (assuming that the business is successful). Therefore, the risk borne by Starco of having to replace a defective digitised product amounts to

the extra royalty that may become payable (depending on the nature of the arrangement with Starco's suppliers) when the customer is allowed to download again the product.

59. Conversely, Starco's credit risk is the sum of both the cost of the physical support and the payment made in connection with the delivery of a product for which the proceeds of transactions may later prove to be non-existent where the customer made a fraudulent use of a credit card or where there was no corroboration of the transaction by the credit card company. In the case of a digitised transmission, the cost is limited to the royalty payable by Starco.

Technological risks

60. The foregoing also has implications for determining which part of the enterprise bears the technological risks associated with the operation of the server in country B. Two broad categories of technological risks can be distinguished. The first category encompasses risks that directly affect the volume of business of the enterprises, for example, where the malfunctioning of the hardware or software in the server results in the loss of business for the permanent establishment. The second category includes other risks that result from the performance of routine automated functions, for example, where the server is used by hackers to spread defamatory material about one of the artists featured on the site, or where a customer's credit card number is obtained from the site and used fraudulently. Arguably, the activities of the permanent establishment create this second category of risks and so the permanent establishment should be treated as assuming this category of risk.

61. For the permanent establishment to be considered to solely assume the first category of risk, the economic position of the head office should be unaffected by the realisation of the risks - for example, as in the case where perishable goods are transferred to a permanent establishment and the permanent establishment assumes the entire inventory risk. It is arguable that this is not the case for Starco's permanent establishment, as loss of business by the permanent establishment due to the permanent establishment's own making is, in fact, a revenue loss for the head office, given the nature of the "inventory" held by the permanent establishment - digitised products on a hard drive are not "inventory" and the permanent establishment does not have any inventory of physical products. On the other hand, it may be argued that functions of the permanent establishment are such that it does expose the enterprise to at least limited market risk - if it fails then the enterprise may forego current revenues and, possibly, because of the premium put on instant availability of the latest fashionable releases, future customers. Because the permanent establishment is the source of such risk, it may be appropriate to allocate limited market risk to the permanent establishment. In other circumstances, where the permanent establishment is able, for example through sophisticated software,⁴ to perform a function comparable to that of a full function distributor, the sharing of risk may be different.

Implications of the functional analysis

62. In order to appropriately hypothesise the permanent establishment as a distinct and separate enterprise, for example as the equivalent of a retail outlet or a service provider, it is necessary to consider the result of the functional and factual analysis and to perform a comparison with the functions usually associated with such enterprises, including the division of risks inherent to such functions. The functions ordinarily associated with a retail outlet include: decision-making regarding the ordering of inventory and the level of inventory to be held; negotiations regarding terms with suppliers; decisions on product pricing, marketing and promotion; establishing contacts with customers; concluding contracts with customers; the physical distribution of goods; credit control, including decisions on credit arrangements for customers; the management of incoming funds; accounting functions such as cash flow control. A functional analysis must include determining the extent to which these functions are carried out in Starco's permanent establishment.

63. It is likely that a functional analysis of Starco will reveal that the head office in country A and not the permanent establishment in country B carries out many of these functions exclusively. The lack of human or artificial intelligence in the permanent establishment precludes any ability to bargain, make key decisions or carry out many of these elements of a normal sales or distribution function.

There are also likely to be conceptual difficulties in regarding digital information on the permanent establishment's server as "inventory", which could be the implied conclusion if the permanent establishment was considered to be akin to

⁴ One could imagine a situation where the server PE had software that researched the latest consumer trends, ordered material from suppliers based on that research and on the basis of the lowest possible cost. The question arises as to whether, in such a situation, the functional and factual analysis could show that the permanent establishment was actually assuming some market risk.

an independent retail outlet. Therefore, while the permanent establishment can be considered to carry out routine (autonomous) aspects of a sales function, it cannot be regarded as having all the attributes of a conventional retail outlet nor to carry out the various functions that give rise to the substantive market and credit risks. As a result, it would not be consistent with the factual and functional analysis to assume that the permanent establishment has notionally “acquired” digital inventory from the head office. The same conclusion could be reached for the market risks associated with the sale of physical products. They clearly arise from, and are associated with, the functions carried out by Starco's head office. The factual and functional analysis would show that the permanent establishment could not be considered to notionally hold title to physical products sold through its server. Indeed, the sales functions of the permanent establishment do not include the actual handling of physical products obtained from suppliers and shipped to purchasers (the actual shipping is performed by the head office), which is a core function of most conventional retail outlets. The situation is less clear-cut with credit and technological risks, as these appear to be more associated with the routine functions of accepting and handling customer transactions that are performed by the permanent establishment.

64. The foregoing suggests that, in the context of this example, the permanent establishment's functions are closer to that of a service provider.

65. However, within such a characterisation, more than one type of arrangement is possible, essentially depending on the sharing of risk between the service provider and the beneficiary of such services. The issue is whether the permanent establishment can be said to bear the full technological risk associated with the operation of its server. In a similar arrangement between arm's length parties, the purchaser of the service would not be expected to reward a service supplier incapable, for a given period of time, of providing the service, which it undertook to provide. On the other hand, the provider of the service would not be expected to fully compensate the purchaser for lost transactions.

66. One possibility is to that the permanent establishment is acting as the equivalent of an independent service provider. Under this model, the permanent establishment is considered to have acquired at arm's length prices the hardware and software necessary for the provision of services and, crucially, it assumes the risks usually associated with the operation of such an enterprise.

67. However, it is also possible that the permanent establishment is acting like a “contract service provider”. Under this model, Starco's head office is considered to retain control (“economic ownership”) of all the property (tangible and intangible) transferred to the permanent establishment.

This means that the risks associated with the use of such assets are also considered to remain with the head office. The only risk for the permanent establishment is that it might not be compensated adequately for the services that it has performed.

68. Between independent enterprises, an analysis of the contractual terms would assist considerably in determining how the responsibilities, risks and benefits of a service arrangement are to be divided between the parties and consequently whether the arrangement is that of a contract service provider or as an independent service provider. As noted in the section regarding Article 7(2) above, the WH applies the guidance on this matter in the Guidelines (paragraph 1.28) by analogy and by reference to the conduct of the parties and the economic principles that govern relationships between independent enterprises. Following the guidance in the WH should enable a determination to be made as to whether the permanent establishment is acting as a contract service provider or as an independent service provider.

Conclusions

69. The result of the functional and factual analysis, and in particular the determination of risks assumed by the permanent establishment, will determine the true nature of the operations of the permanent establishment. For a permanent establishment carrying out e-tailing activities, the analysis may reveal that the permanent establishment is performing functions, using assets and assuming risks akin to those performed by a retail outlet, i.e. the purchasing and distributing of products for a profit. Or it may reveal that the functions performed, assets used and risks assumed by the permanent establishment are similar to those of a service provider, providing services⁵ for and on behalf another part of the enterprise

⁵ The “service provider” model should not be confused with the approach that consists of treating transactions in digitised products as “services” for purposes of value added taxes. This model is only meant to imply that the revenues of the permanent establishment are in the form of a fee for services performed for the benefit of the head office. The issue of the characterisation of transactions in digitised products occurring between Starco and customers is not relevant to the issue of the attribution of income to the permanent establishment and, therefore, is not considered further in this discussion paper.

70. However, it would appear that under the fact pattern of this example, the factual and functional analysis is unlikely to show that the permanent establishment is performing many of the functions, or assuming many of the risks, of an independent retail outlet. The lack of personnel at the permanent establishment under this fact pattern makes it hard to envisage the permanent establishment assuming anything but the most routine risks that are directly related to the automated functions it performs. The functions it performs are more akin to sales support functions or to back office functions in a global trading business. The “service provider” model is therefore likely to be the most useful tool for analysing this type of server-permanent establishment and for finding comparables under the second step of the analysis described below. In the case of Starco, the limited functionality of the permanent establishment means one could credibly characterise the arrangement as one similar to that of a “contract service provider”, whereby the permanent establishment is mandated to provide services to the head office using tangible and intangible property provided by, and remaining under the control and responsibility of, the head office.

71. On the basis of these findings, the proper attributes of the permanent establishment and the nature of the “dealings” that it is assumed to have with the rest of the enterprise can be established for purposes of applying the principles of Article 7 of the Model Tax Convention.

[7.2.4.] Second step: Determining the profits of the hypothesised distinct and separate enterprise

72. Because the permanent establishment of Starco in country B does not have a distinct legal personality, transactions entered into by a customer on its web site hosted on its server in country B are legally entered into with all of Starco. However, the legal aspect of the transaction is of little relevance to the task of attributing profit to the permanent establishment. The question to be answered is what profit the permanent establishment would earn, in similar circumstances, if it were dealing at arm's length with the rest of Starco, under the relevant business model. Because of the lack of legal personality of the permanent establishment, it cannot enter into legally enforceable transactions with the rest of Starco, because an enterprise cannot transact with itself. However, in order to provide an answer to the above question, one is required to establish whether “dealings” occurred between the permanent establishment and the rest of the enterprise and to determine the true nature of such “dealings”, in order to be able to apply the arm's length principle, as if a transaction had occurred between two distinct and separate enterprises.

73. The response to the above question will differ according to whether the relevant dealings of the permanent establishment can best be compared to transactions undertaken by a “retail outlet”, an “independent service provider” or a “contract service provider”. In the case of the particular fact pattern examined in this note, the analysis of the previous section suggested that the functions performed, assets used and risks assumed by the permanent establishment were unlikely to be comparable to those of a “retail outlet”, although the conclusion may differ in different circumstances.

The rest of the section will therefore focus on comparing the dealings undertaken by the permanent establishment with the two variants of the “service provider” model.

“Contract service provider” model

74. Under this model, a functional and comparability analysis is likely to find that there have been few dealings between the permanent establishment and the head office. In the pre-commercial exploitation phase, property (hardware and software) was transferred from the head office to the permanent establishment. As noted in the section regarding Article 7(2) above, a dealing will be recognised where it results in an economically significant transfer of risks and responsibilities between the parties. Any such transfer would, in the absence of contractual terms, have to be deduced from the conduct of the parties and the economic principles that govern relationships between independent enterprises. Once again, the limited nature of the functions that can be performed by the permanent establishment due to its lack of personnel, leads to the provisional conclusion that the analysis is unlikely to show the head office as notionally disposing of such property for tax purposes but rather as retaining control and “economic ownership” of such valuable property. Therefore, it is not considered that a “dealing” is likely to have taken place between both parts of the enterprise at that time. During the commercial exploitation stage, the permanent establishment performs services for the benefit of Starco and, therefore, the functional and comparability analysis is thought likely to characterise dealings as a notional service contract between the head office and the permanent establishment, where the head office retains most of the responsibilities, risks and benefits of the service arrangement. Such an arrangement gives rise to a dealing in respect of which an arm's length consideration must be established.

“Independent service provider” model

75. Under this model, the functional and comparability analyses are likely to recognise a number of dealings that take place between the different parts of the enterprise.

76. As under the previously examined model, a transfer of tangible and intangible assets occurred prior to the commercial exploitation phase of the web site hosted in the permanent establishment. Where the permanent establishment is considered to perform functions, use assets and assume risks in a manner comparable to a full service provider, these transfers give rise to “dealings”, in that the permanent establishment is considered to notionally acquire assets, or the right to use assets, as the case may be, much like would be the case if the permanent establishment were an independent enterprise. In a conventional situation where such transfers occur, the permanent establishment would compute its profit so as to recognise an arm's length compensation for the head office in consideration for the provision of such property. This is so because the head office originally acquired the hardware and the digitised products and developed the software contributed to the permanent establishment and arm's length parties would seek remuneration for the transfer of such property.

77. The next paragraphs consider closely the particular issues arising from the transfer to the permanent establishment of each category of property.

Software

78. A question may arise as to the exact nature of the right acquired by the permanent establishment when software was transferred to it from the head office. The functional and factual analysis is unlikely to show that the head office has relinquished any significant rights associated with the software, other than the right to use the software, given the limited capacity of a permanent establishment that lacks personnel. The enterprise is likely to make continuing use of the software in head office, in other permanent establishments or in subsidiaries it controls. Moreover, the permanent establishment has clearly not acquired the right to resell or modify the software, given the nature of the activity of the permanent establishment (and *a fortiori* because of the lack of human or artificial intelligence at the location of the permanent establishment). Therefore, the appropriate analysis of the nature of this dealing is to consider that the permanent establishment has notionally acquired a right to use the software. In computing its profit, the permanent establishment would consequently deduct an amount that represents what arm's length parties would pay for the acquisition of such a right.

Marketing intangibles

79. A question arises as to whether a similar analysis should apply in the case of the marketing intangible (for example, the brand name) used on the web site hosted on the permanent establishment's server. Whereas it would be appropriate to assume that the permanent establishment had acquired the notional right to use Starco's marketing intangible if it had been viewed as the equivalent of a retail outlet, it is not apparent that such an assumption remains suitable where the permanent establishment is considered to be the equivalent of a provider of services to the rest of Starco. This is because it is arguably the head office that is considered to exploit the marketing intangible - comparable independent service providers would not need to acquire a marketing intangible for purposes of providing services to Starco, and Starco would not need to cede the right to use it if it dealt with an arm's length service provider. Moreover, it is not clear how the service provider could exploit or benefit from the marketing intangible. Should a dealing be recognised, an independent enterprise utilising a marketing intangible (or benefiting from other organisational expertise) developed by another enterprise would, under the arm's length principle, be expected to compensate the latter for the use of such an intangible and, therefore, an arm's length charge in an equivalent amount should be deducted in computing the profit of the permanent establishment. Views on the appropriate treatment of marketing intangible in the context of this example and more generally are welcome.

80. A subsidiary issue, assuming the existence of a dealing for marketing intangibles, is whether the activities of permanent establishment could ever be such as to increase the value of a marketing intangible provided by the head office and, therefore, entitle the permanent establishment to some of the profits associated with the use of such an intangible (to the same extent observed between associated enterprises). Views are invited on this issue, in particular in the context of this example.

81. A question also arises as to which part of the enterprise would be the economic owner of any “e-commerce marketing intangible”, related to the web site. Similar issues might arise for other marketing intangibles: for example where the permanent establishment collects customer information, does it mean that the permanent establishment is treated as the economic “owner” of the resulting marketing intangible, a customer list? If the permanent establishment is treated as the sole economic “owner” of these intangibles then no dealings need to be recognised in relation to them, unless other parts of the enterprise start to exploit them.

82. Similar issues arise in relation to digitised products on the permanent establishment's server. If such property is considered to remain under the economic ownership of the head office (as would likely be the case for a service provider), there would be no dealings to take into account.

[7.2.5] Application of Article 7 in the case of intangible property

83. The above discussion suggests that where the existence of dealings in respect of software, marketing intangible or other intangibles needs to be recognised, consideration for such dealings needs to be determined under the arm's length principle. However, Article 7 of the Model Tax Convention does not presently permit such an outcome with respect to software and marketing intangible. While the Commentary clearly mandates a mark-up in accordance with the arm's length principle where stock in trade is being transferred from one part of an enterprise to another, such is not the case with regard to other types of property, in particular intangibles. There is no explicit authority in the current Commentary to assess the transfer of economic value (other than for inventory) from the head office to the permanent establishment at market value under the arm's length principle. Consider the current Model Tax Convention Commentary on intangible property:

“In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g. payments of royalties or cost sharing arrangements) cannot be applied in respect of the relation between parts of the same enterprise. Indeed, it may be extremely difficult to allocate “ownership” of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances, it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty.”⁶

84. This implies that such transfers are valued at cost. In our example, this produces a somewhat perverse result, as it amounts to treating the new permanent establishment as the effective economic “owner” of the software and of other relevant intangibles that were created before it came into existence. In that sense, the permanent establishment is getting a “free ride” on the back of the efforts and expertise of the head office.

85. The problem with this approach is that the market value of software or of other intangibles may not bear much relation to the cost of creating it. This is a particular problem with intellectual property such as software, which is based fairly directly on ideas and that does not necessarily require the presence of a large infrastructure to create. Also the original cost may have been depreciated before the permanent establishment came into existence so that there are no costs of the enterprise to attribute to the permanent establishment.

86. The undesirable consequences of the rather outdated approach of the current Commentary can be seen by supposing that Starco sets up an identical server performing identical functions in Country Z but that it forms a subsidiary to own and operate the server. If the market value of the intangible is substantially greater than the costs of creating it, then the subsidiary in Country Z will, under the arm's length principle, have to pay far more to Starco for the continuing right to use the intangible than the permanent establishment in Country B will have to pay in order to reimburse Starco for its share of the historical costs of creating that intangible. Of course, the situation would be the reverse if the market value of the intangible was less than the historical costs of creating it.

87. In either case, a different tax result is obtained simply by virtue of whether the same economic function is performed through a subsidiary or through a permanent establishment. This does not seem sensible tax policy and points

⁶ Paragraph 17.4 of the Commentary to the OECD Model Tax Convention.

to a limitation to the current Commentary to Article 7. While it is true that such a situation is not unique to electronic commerce, such differences of result between a permanent establishment and a subsidiary are likely to be greater and more frequent in the e-commerce context because of the prevalence of intangibles, especially those based on ideas. These issues are discussed in greater detail in the CFA general discussion draft, and the Committee on Fiscal Affairs is actively considering the issues relating to the attribution of profit to permanent establishments. Views from the public are invited on these important issues.

88. Finally, the allocation of costs (for example pursuant to a cost contribution arrangement) may, indeed, be appropriate where the permanent establishment is in existence at the time of the development of the intangible and the enterprise intends to have the permanent establishment make use of the intangible, when and if developed.

Hardware

89. Finally, the facts and circumstances (including any internal documentation) regarding the transfer of the hardware to the permanent establishment must be examined in order to determine the character of such a transfer (“dealing”) and especially the division of the risks and responsibilities of ownership between the parties. Under the WH, the determination must be made by making a full examination of the facts and circumstances surrounding the change in use, including the subsequent conduct of the parties and any relevant documentation. The intent of the enterprise in effecting this change of use, as documented and as corroborated by its conduct, will be relevant in determining the nature of the dealing. Once the full facts and circumstances have been established, the nature of the inter-branch dealing (sale, lease or licence) would be determined by reference to the nature of comparable transactions between independent enterprises. In this context, it may be relevant to establish whether the enterprise itself owns the assets, leases it or rents it from an independent supplier and to know what independent parties would do in similar circumstances. While the documentation of the arrangement will assist in the determination, if the conduct of the parties is inconsistent with this documentation, consideration must be given to the actual conduct of the permanent establishment and the rest of the enterprise in order to establish the true nature of the arrangement. One result of this examination could be to characterise the transfer as a lease arrangement between the head office and the permanent establishment, in which case a notional arm's length lease payment would be deductible in computing the profit of the permanent establishment. Another possible result would be to characterise the dealing as an outright sale, i.e. that the head office has disposed of the hardware and that the permanent establishment has acquired it at its fair market value. In such a case, capital cost allowance in accordance with the depreciation system of country B would be deducted in computing the permanent establishment's profit. The issue of how to account for the transfer of tangible property between two parts of a single enterprise is discussed in details in Part I of the CFA general discussion draft, in which the wider issue of attribution of profit to permanent establishments is examined. The question here is whether the above guidance has much relevance to a fact pattern such as this, given the lack of personnel of the permanent establishment, so making any analysis of the intention of the parties is only relevant from the head office perspective.

90. In the commercial exploitation stage, a dealing assumed to take place under the “independent service provider” model between the permanent establishment and the head office in the form of a service contract notionally concluded between both parties, whereby the permanent establishment is considered to have performed functions on behalf, and for the benefit of the head office. These include hosting a web site, handling transactions with customers and channeling proceeds of transactions to Starco. The value of the fee payable pursuant to this notional contract is to be determined under the arm's length principle.

91. Therefore, under the “independent service provider” model, the setting up of a server by Starco in country B can be characterised as an initial provision of tangible and intangible property to the permanent establishment in order to enable the permanent establishment to provide a service to the rest of the enterprise. Having established the attributes of the permanent establishment and the nature of its “dealings” with the rest of the enterprise, one can now apply a traditional transfer pricing analysis on such “dealings” in order to determine the arm's length compensation for each dealing. This will determine the quantum of profit attributable to the permanent establishment.

[7.2.6.] Application of transfer pricing methods

“Contract service provider” model

92. Under this model, the only arm's length charge to be determined relates to the provision of services to the head office. Remuneration between independent enterprises for such services would take the form of a fee, which reflects the value of the functions performed by it and the relatively risk-less nature of the arrangement from its point of view.

93. The starting point for the analysis would be to examine if there were comparable transactions undertaken by arm's length contract service providers such that a comparable uncontrolled price (CUP) could be applied. The transactions would have to be comparable in terms of the functions performed, assets used and risks (indeed lack of risks) assumed. Views on the likely availability of CUPs are welcome. Where the CUP method cannot be applied reliably, it may be possible to apply a cost plus method to determine an arm's length reward for such a permanent establishment. The costs to be taken into account would be the direct and indirect costs incurred in the permanent establishment in the course of providing the service (rent, insurance, electricity, communication lines, etc.), but would not take into account any capital costs associated with tangible and intangible assets, on the basis that the head office is assumed to retain economic “ownership” of such property. An arm's length profit margin could be found by considering the mark up charged in similar arrangements entered into by independent enterprises. Other transfer pricing methods found in the Guidelines may also be applied where the comparability standard in Chapter 1 can be satisfied.

“Independent service provider” model

94. In this model, arm's length charges must be established for “dealings” assumed to take place between the permanent establishment and the rest of the enterprise before and during the commercial exploitation stage. Dealings for the former include the provision of the hardware and of intangible property in the form of software by the head office to the permanent establishment.

95. Application of the arm's length principle requires one to find comparable products and services traded in comparable transactions between independent parties, or at least comparable functions performed by independent parties.

96. Finding a CUP for both the hardware and the software (to the extent authorised under the Model Tax Convention, as discussed previously) may be possible. However, establishing the arm's length compensation for the transfer of the right to use the software may not be a straightforward exercise, because of the difficulty of finding products that are sufficiently comparable. Where no exact CUP can be found, one could attempt to find the arm's length price for software used for comparable functions.

97. The costs of the permanent establishment are not limited to the arm's length charge to be recognised in consideration for the use of both tangible and intangible property. Expenses are incurred in the permanent establishment in the form of payment for the use of the premises, the cost of electricity and communication lines, the payment of insurance premiums, etc. Unlike conventional situations, such payments are not actually made out of actual revenue earned by the permanent establishment but are presumably paid by the head office. An argument can be had over whether these costs are the costs of the permanent establishment or costs of the head office incurred for the purpose of the permanent establishment, which must be recognised, pursuant to Article 7(3) of the Model Tax Convention, in computing the permanent establishment's profits. In practice, this is an issue of little consequence since, in either case, such cost should reduce the taxable profit of the permanent establishment.

98. During the commercial exploitation stage, one must establish an arm's length compensation for the service provided to the head office by the permanent establishment. It may be that independent enterprises, making use of similar hardware and software are in the business of providing similar web hosting services to other enterprises. If such comparable enterprises can be found, a CUP for a similar type of transaction would be the best estimation of an arm's length price. If a CUP is not available, a cost-plus charge for the provision of similar services would be appropriate. Internet service suppliers would be an obvious source of either CUP or comparable gross margins for similar service arrangements, provided adjustments are made to take into account any differences between the services provided by an internet service provider and the permanent establishment. Care would also need to be exercised to ensure that the cost base from which the gross margin is derived is similar to that used for the permanent establishment. Unlike the determination made in the “contract service provider” model, the cost base to be used for purposes of applying the cost plus

method would take into account the notional expenses associated with the transfer to and use by the permanent establishment of the tangible and intangible property contributed by the head office.

99. The use of a profit method, especially a transaction net margin method (TNMM,) should not be overlooked where it is not possible to apply traditional transaction methods reliably. A net margin analysis over costs may be possible.

100. The above analysis of the “independent service provider” model shows that one needs to posit several intra-company dealings that raise complex valuation issues under the arm’s length principle. Furthermore, the arm’s length character of such estimates is in doubt under the current interpretation of Article 7. This suggests that this model may not represent the most appropriate or practical model to apply to the fact pattern provided in this section.⁷ However, it is not denied that it may be appropriate in different circumstances.

[7.2.7.] *Conclusion*

101. While it is difficult, in abstract, to determine how significant the quantum of profit attributed to Starco’s permanent establishment would be, a number of observations can be offered.

102. Under the “independent service provider” model, the profit margin of the permanent establishment is computed as the difference between the arm’s length compensation that can be charged on the market for the service provided to the head office and the arm’s length charge that must be recognised for the use of the tangible and intangible property contributed by the head office. Such a calculation is not necessarily indicative of the profit margin that would be earned by an independent enterprise whose business is to provide such services to third parties, given that such an enterprise would likely own the hardware and develop the software itself (see Variation 4). The profit margin of such an independent enterprise would be mostly attributable to the value added associated with the development of software and the renting of either the hardware or of space on a server. It is probably fair to say that the profit accruing to a typical internet service provider would exceed the profit accruing to the permanent establishment in this variation of the example. An internet service provider will typically host the software developed or acquired by its customer but use its own software (which it has developed or acquired itself) in order to provide a portal into the internet. In this variation of the example, the head office has provided the permanent establishment with all software, including that needed to establish a portal into the internet.

103. Ultimately, the profit generated by the permanent establishment comes from two main sources. The first source stems from the on-going operation of a package of hardware and software that makes up the server and supports a web site. If the compensation for the transfer of this package from the head office to the permanent establishment were done on arm’s length terms, substantially all of the profit associated with the exploitation of such assets would effectively accrue to the head office.

The second source relates to the exploitation of marketing intangibles, including “e-commerce marketing intangibles”. Again, substantially all of the profits associated with the exploitation of such assets would accrue to the head office provided that the intangibles are “owned” by the head office.

This would appear to be the case for marketing intangibles such as the brand but may be less clear cut for “e-commerce marketing intangibles” which are more closely related to the operations of the web site.

104. This outcome is explicitly achieved under the “contract service provider” model, whereby the profit of the permanent establishment will likely be determined by reference to a cost plus calculation performed on the basis of the direct operating costs incurred in the permanent establishment. Therefore, the computation of the compensation attributable to the permanent establishment specifically ignores the value of the tangible and intangible property used by it, which de facto attributes the reward for such property to the head office.⁸

105. Therefore, for this example, the application of the functional and factual analyses described in the guidance on the arm’s length principle of Article 9 found in the Guidelines would, in all likelihood, leave the permanent establishment with a quantum of profit that is insignificant relative to either the value of transactions processed through the perma-

⁷ The reader may be left wondering why so much of the analysis is devoted to approaches that may not prove to be practical or appropriate in the circumstances. There are two answers to this question: first, this paper is meant to illustrate the thought process that takes place while performing a functional and factual analysis where the outcome cannot necessarily be anticipated at the outset. Second, whereas the discussion in this note is based on a specific and simple example and, consequently, could allow one to perform precise analysis leading to specific conclusions, reliance on such a specific example is also, by definition, limiting in nature, because one cannot necessarily infer that the analysis and conclusions are of general application. This is why it is useful to identify in this paper the different directions that may be adopted in the course of performing a functional and factual analysis when the fact pattern is different and more complex.

ment establishment or the arm's length cost of securing the use of the hardware and software required to ensure the continuous operation of the server without human intervention. An independent enterprise providing the same software and hardware to the permanent establishment would insist on an arm's length reward for the exploitation of both types of property. Under this fact pattern, the permanent establishment is only performing low-level automated functions that make up only a small proportion of the functions necessary to act as a full function retail outlet/distributor or as a full function service provider. The level of profit earned is likely to be commensurately low and be very significantly less than that earned by full function retail outlet/distributors or full function service providers.

106. Given these observations, the question to be answered is whether the existing international tax policy rules for taxing business profits (Articles 7 and 9 of the OECD Model Tax Convention) allow this result. The guidance on the application of that Article found in the Guidelines applies the arm's length principle of Article 9 without restriction and in a manner based on economic reality.

However, although Article 7 contains a provision similar to the arm's length principle of Article 9 [Article 7(2)], the Model Commentary appears to restrict the application of that principle in a number of ways (see previous remarks on the transfer of software and marketing intangible). More details on this issue can be found in the CFA general discussion draft released on 8 February 2001. Views on this issue are welcome.

107. The prohibition of a deduction in computing the profits of the permanent establishment for an amount equivalent to the market value for using software or intangible property developed by the head office, if mandated under the current interpretation of Article 7, would lead to an over-attribution of profit to the permanent establishment, where the market value exceeds the allocation of costs related to the intangible property in accordance with the current interpretation of Article 7. When undertaking a comparability analysis with transactions between independent enterprises (CUP method), the permanent establishment would be treated as having the right to use the software and the marketing intangible and so the arm's length price would have to reflect the use of such property. Similarly, when making a comparison with gross margins earned by independent enterprises (cost plus or resale price methods), the arm's length gross margin earned by the permanent establishment would reflect the use of the intangible.

108. However, it would seem to follow from the above prohibition that, although the permanent establishment would obtain the same price or gross margin as the independents (based on use of the software and marketing intangible), it would be able to earn a higher net profit as it would not have to recognise, in computing its profit for tax purposes, the full market value for using such property (assuming that the market value is greater than historic costs of developing it). In such cases, the permanent establishment would be a "free-rider" as it would be rewarded for functions and activities it had not carried out and that it could never have carried out given its lack of either human or artificial intelligence. In cases where the market value of the intangible is lower than historic costs of developing it, the permanent establishment would earn less profit due to factors outside its control (inefficiency of the head office R&D function).

109. Another issue that arises is whether the above problems occur when, in last resort situations, profit methods are used such that a net, rather than a gross margin are compared. The comparable net margin will have been computed by deducting operating expenses (including any payments made for the use of intangible property) from the gross margins. To be consistent with the current interpretation of Article 7, would it be necessary to add back any payments for the use of intangible property to arrive at the comparable net margin?

110. In conclusion, it is questionable whether, under the "independent service provider" model, the current rules for Article 7 are capable of producing a result that leads to an attribution of profit that is fully consistent with the arm's length principle as articulated in the Guidelines (when applied to permanent establishments by analogy). To the extent that they are not, results would differ depending on whether the particular economic function is carried out through a subsidiary or through a permanent establishment. Arguably, such a result is not desirable on tax policy grounds and so the Model Commentary on Article 7 would need to be changed. As described in the section above on Article 7(2) above, a preferable approach might be to apply the arm's length principle of Article 7 in a manner as similar as possible to the

⁸ The server-permanent establishment is peculiar as, unlike more conventional situations, both types of property are not used as input in a human process creating value added - the mere autonomous operation of both types of property creates the value added. For example, where a manufacturing intangible developed by an enterprise is contributed to either a permanent establishment or a subsidiary of the enterprise for commercial exploitation, the resulting value created by the manufacturing function using the intangible is the sum of the value added attributable to the pure manufacturing function and the value added associated with the exploitation of the intangible. Manufacturing absent the intangible would not create the same value and the value could only be extracted by the intangible where it is used in a manufacturing function. In the case of the computer server, the exploitation of the combination of the hardware and software is essentially a passive function, in that no other significant factors of productions need be involved. A possible exception is the use of the information gathering function to create marketing intangibles such as customer lists and e-commerce marketing intangibles. The value of these intangibles will depend respectively on the nature of the information obtained and the operation of the web site. Both of these are a function of the complexity of the relevant software.

guidance on the application of the arm's length principle of Article 9 found in the Guidelines. Views are invited on this important issue in the context of a permanent establishment undertaking e-commerce activities.

[7.3.] Variation 2: Multiple servers

[7.3.1. In general]

111. The facts are the same as in the previous example, except for the following modifications:

112. Starco's web page is hosted on four different servers located in country B (Americas), country C (Western Europe), country D (Eastern Europe and Asia) and Country E (Southern Hemisphere). When a person attempts to connect to Starco's web site, the person is connected to a given server according to a predetermined procedure, programmed on and managed by the server located in country B, that takes into account the geographical proximity of the person and the traffic on each server. Once a connection has been established between a would-be customer and a given server, all aspects of the transactions are performed on the same server.⁹

113. The benefits, from Starco's point of view, of relying on multiple servers include: speeding up the customer's access to, and interaction with, the web site; providing extra security for both the enterprise and its clients; and reducing the risks associated with technology breakdowns.

114. The main relevant difference, from a tax point of view, between this example and the previous example is that the functions that were performed exclusively by Starco's server in country B are now duplicated by several servers. However, the range of functions performed by any one server in respect of a transaction (from the time that the prospective customer establishes communication with Starco's web site until the customer receives delivery of products) remains the same. But the volume of transactions will now be shared among servers in different countries. The existence of several servers performing identical functions contributes to reducing the risks associated with the operation of any given server.

115. The principles developed in the previous section on Variation 1 remain applicable to this example, although the administrative and compliance issues may be more difficult. The "contract service provider" model, under which profit will likely be attributed to the permanent establishment on the basis of the cost plus method, may be the model that best suits the facts and circumstances. Alternatively, the "independent service provider" model may be contemplated. The functional and factual analysis would determine whether and to what extent the *de facto* pooling of risks among several servers would affect the quantum of reward attributable to each permanent establishment. Of course, the more difficult transfer pricing issues occurring between the head office and the permanent establishment under this model, such as the determination of the proper charge for the right to use the software and marketing intangible, would be increased four-fold.

116. This example assumes that all the steps of commercial transactions are performed by a single server, once the particular server has been selected. Therefore, no transfer pricing issue arises in connection with "dealings" between two or more server because no such "dealings" take place. On the other hand, if one had assumed that the billing of the transaction took place in a server while electronic delivery of a digitised product occurred from another server, one would have had to consider how to allocate the remuneration associated with each step among the different permanent establishments.

[7.3.2.] Server is part of an existing permanent establishment

117. Two variations from the initial example are examined briefly where personnel are present in the permanent establishment in country B and are involved in attending the operation of the server. In the first variation, the personnel have installed hardware specified by the head office and software created by the head office in country A. In the second variation, all of the programming and software development is assumed to have taken place within the permanent establishment in country B and on-going improvements to the web site are performed in the permanent establishment.

⁹ Another variation, where different aspects of a transaction are performed by different servers, could also be examined. However, such an assumption raises the threshold issue of whether performance of certain activities and not others would still qualify any of the particular servers as a permanent establishments under Article 5 of the Model Tax Convention.

[7.4.] Variation 3: Technical support staff in permanent establishment

[7.4.1. Introduction]

118. The facts relating to Starco's operations and the characteristics of the server in country B are the same as in the first variation. However, personnel are present in country B to perform the following tasks: ensure the maintenance of the server, perform repairs to the hardware and address any problems affecting the operation of the web site. The personnel are also responsible for handling trouble-shooting with customers or web site visitors worldwide experiencing difficulties with the web site, in particular in connection with online transactions. Finally, the personnel provide after-sales services and support to customers. Interactions with customers or would-be customers either occur on line or, exceptionally, on the telephone.

[7.4.2.] General considerations

119. This example moves away from the extreme situation where a combination of tangible and intangible assets can, on their own, constitute a permanent establishment and presents a situation more commonly found in commercial arrangements. One peculiarity remains: contacts between the permanent establishment and customers remain virtual, as they occur on line, as opposed to face-to-face. However, this is not a critical consideration in the following analysis.

[7.4.3.] Functional analysis and conditions of the hypothesised distinct and separate enterprise

120. The presence of personnel in the permanent establishment to maintain the continuous operation of the server and to provide technical support to online customers changes the nature of the functions performed by the respective parts of the enterprise and adds additional functions to the existing routine automated functions already performed by the permanent establishment. Whereas the additional functions were performed by personnel situated in Starco's head office in previous examples, they are now functions performed within the permanent establishment.

121. A functional and factual analysis would also reveal that personnel in the permanent establishment are required to make use of both tangible assets (for example, computers) and intangible assets (for example, software) over and above those required by the permanent establishment posited in Variation 1 in order to provide technical services to customers. In both cases, such assets will either have been provided by the enterprise or acquired by personnel of the permanent establishment from third parties. Depending on the nature of the arrangement between the head office and the permanent establishment, the existence of "dealings" between the head office and the permanent establishment may need to be recognised in order to account for the use of the assets of the enterprise by the permanent establishment.

122. An important consideration to take into account is that the services provided by personnel of the permanent establishment to customers are not separately charged to them. The cost of the provision of services by Starco is internalised in the prices it charges customers for its products. Therefore, any incremental provision of services does not directly increase Starco's revenue - although it may indirectly contribute to increase its market share by gaining a reputation as an efficient e-business because of the service support originating from the permanent establishment and thereby lead to the creation of an e-commerce marketing intangible.

123. Likewise, the incremental provision of services does not increase Starco's costs, since personnel are basically on stand-by, available at any time to deal with customer's queries.

124. Given the nature of the operation of the permanent establishment, and in the light of the analysis of the situation described in the previous section on Variation 1, it is unlikely that the functional and comparability analyses would characterise the permanent establishment as undertaking functions, using assets and assuming risks comparable to those of a "retail outlet". Therefore, the following focuses on the two variants of the "service provider" model as being the most likely outcomes of the functional and comparability analyses. Views on whether the retail outlet is an unlikely outcome are particularly invited.

125. Under this model, the functions performed by the server remain a service provided by the permanent establishment to the rest of the enterprise. The additional functions, the provision of services to Starco's customers, represent services either provided to the rest of the enterprise or provided to third parties on behalf of the enterprise. The perma-

nent establishment cannot be said to bear significant risk from the provision of such services (except the small risk arising from the fact that the extra arm's length remuneration received for performing additional services may not cover the extra costs of performing those services). As under the previous model, the head office bears the full market risk associated with the possible loss of business due to a failure to help would-be customers. The revenues of the permanent establishment associated with the provision of online services to customers would not be a function of the outcome of performing particular services, but would be structured as a fee for the continuous availability of the service.

126. As under the first two examples, the functional and factual analysis could reveal that the nature of the arrangement is one similar to that of a "contract service provider". In such cases, the only dealing that needs to be taken into account is the remuneration of the permanent establishment for the services it provides to, and on behalf of, the rest of the enterprise. However, the same analysis could also reveal that the permanent establishment is better characterised as an "independent service provider", fully equipped to provide the services sought by Starco and seeking to cover both capital and operating costs and earn a profit. In such cases, as explained earlier, dealings would need to be recognised with respect to the transfer of tangible and intangible property to the permanent establishment, as well as for the provision of services by it. Comments on the above conclusions would be welcome.

[7.4.4.] Application of transfer pricing methods

127. This portion of the analysis is similar to that found in the previous section on Variation 1. However, under this version of the "contract service provider" model, the remuneration for the permanent establishment would be more substantial than under the first two variations, owing to the additional functions performed within the permanent establishment. Where a cost plus method is applied, the cost base by reference to which a cost plus calculation would be performed would reflect the additional direct and indirect costs incurred in the permanent establishment (principally employee compensation). Similarly, the applicable arm's length margin would reflect the different nature and functions of the permanent establishment.

128. Under the "independent service provider" model, a CUP, if available, would be the best estimation of an arm's length price and should first be sought, assuming that one can determine the market price for services of an identical nature (or of a sufficiently similar nature to allow for adjustments to make it sufficiently comparable) provided on the market by independent suppliers. Where a CUP is not available, a service fee determined on a cost plus basis, based on the gross mark-up associated with the provision of similar services, would be appropriate. Alternatively, the application of TNMM could be considered if it does not prove possible to apply with sufficient reliability one of the traditional transaction methods. The permanent establishment would also, under this model, be attributed a more significant quantum of profit than under the first two variations, given the additional functions performed therein.

[7.5.] Variation 4: Web site fully developed in permanent establishment

[7.5.1. Introduction]

129. The facts relating to Starco's operations and the characteristics of the server in country B are the same as in Variation 1. However, the history of the creation of the web site differs. It is assumed that the server was set up in 1997 and that personnel in country B performed throughout 1997 and 1998 further developments to the software, gradually upgrading the configuration of the web site to its present form. Significant development costs were incurred during that time within the permanent establishment in country B.

[7.5.2.] General considerations

130. There is a fundamental difference between this example and the previous ones. In the previous examples, the earnings associated with the development of the software required to create an operational server and a web site in a remote location were clearly attributable to Starco's head office, where all development efforts took place and development costs were incurred.

131. This example assumes (arguably somewhat unrealistically) that the full development efforts and costs toward the development of the server and the web site were expended in country B, for purposes of subsequently exploiting the server and hosting the web site so developed.¹⁰ Consequently, under the WH the permanent establishment is treated as

the economic “owner” of the intangibles. It should be noted that the WH looks to a number of factors, not just where the developments took place, in order to determine which part of the enterprise is the economic “owner” of an intangible. See the CFA general discussion draft for further details. The determination of the economic “owner” of the intangible property impacts significantly on the allocation of earnings attributable to the creation of such property within the enterprise under the arm's length principle.

[7.5.3.] Functional analysis and conditions of the hypothesised distinct and separate enterprise

132. Unlike the previous example, tangible and intangible assets (except for the marketing intangible) are not transferred from the head office to the permanent establishment. Starco sets up a completely new operation in country B (presumably because of favourable external factors such as proximity of similar businesses, the presence of a fully-trained work force or attractive tax incentives) and capitalises it with the financial resources required to develop the hardware and software necessary to launch and operate a commercial web site for the benefit of Starco.

133. A functional and factual analysis is likely to reveal that the permanent establishment is in the business of providing services related to Starco's e-tailing activities. The activities and functions that the permanent establishment carries out in the commercial exploitation phase are unchanged in comparison with Variation 3. The key difference is that the permanent establishment can be considered, for tax purposes, to utilise software over which it has economic ownership in order to carry out those functions and this situation should be reflected in the attribution of profit.

134. The development phase leading to the creation of a web site entails the development of intangible property, akin to a research and development project. Following the guidance in the section on Article 7(2), on determining the divisions of responsibilities, risk and benefits of a transaction in the absence of contractual terms, the financial risk associated with this development of the software was incurred in the permanent establishment. Because the permanent establishment is considered to be the economic “owner” of the web site, it follows that the economic benefit derived from the commercial exploitation of the web site should accrue to the permanent establishment. That is, the permanent establishment would be considered, under the separate enterprise fiction required by Article 7 of the Model Tax Convention, to be the economic owner of the software that supports the web site. This can be contrasted to the example in Variation 1 where the permanent establishment could not be considered to be the economic owner of these intangibles. In that example, the profit margin of the permanent establishment was computed either on a cost plus basis or as the difference between (a) the arm's length compensation for the service provided to the head office and (b) the arm's length charge payable for the use of the tangible and intangible property contributed by the head office. In the present variation of the example, the latter element would be nil (no dealings would need to be taken into account) or at least much reduced so that the compensation to the permanent establishment comprise (a), net of the costs of development of the software incurred by the permanent establishment.

135. The permanent establishment can be seen to derive profit from the exploitation of tangible and intangible property that it notionally “owns”, in an economic sense. Unlike the issue raised in the discussion under Variation 1 regarding the internal transfer of software, there is no doubt that this framework of analysis is consistent with Article 7 and its current interpretation found in the OECD Model Commentary. Therefore, the profit of the permanent establishment should be the reward that a separate independent entity exploiting the same “package” of assets would be expected to earn.

However, similar problems with Article 7 would arise where the permanent establishment makes its intangible property available to other parts of Starco, for example where new server/web sites are set up in other jurisdictions.

136. A situation in between those described under Variation 1 and this section, whereby some of the development work towards the creation of, say, software, would be undertaken at head office and some subsequent development would take place within the permanent establishment, could also be imagined. The basic analysis developed in both sections would remain applicable: an appropriate proportion of the profit directly associated with the commercial exploitation of that software would be attributed to the head office and another would be attributable to the permanent establishment. The appropriate proportion would reflect the relative value of the contribution made by the permanent establishment and by the head office towards the development of the software.

¹⁰ In other words, the development was undertaken with the intention of providing a long-term benefit for the PE itself and was not developed on behalf of, or for the benefit of, other parts of Starco.

[7.5.4.] *Application of transfer pricing methods*

137. The best estimate of the profit to be attributed to the permanent establishment would be obtained from the service fee that similar operations conducted by independent enterprises would charge for a similar service (a CUP). It may be possible, for this purpose, to find operations with similar characteristics, or with a sufficient degree of comparability to permit relevant adjustments to be made. It is useful to compare this with the service typically provided by an internet service provider. In this variation it is probably fair to say that the reward to the permanent establishment would exceed that expected to be earned by a typical internet service provider. The latter will typically host the software developed or acquired by its customer but use its own software (which it has developed or acquired itself) in order to provide a portal into the internet. In this variation the permanent establishment does more than this: it develops the software that the “customer” has on its server as well as provides a portal into the internet. Nevertheless, an internet service provider may provide a reasonable comparable in this case provided that sufficiently reliable adjustments can be made to compensate for functional differences.

138. Where a CUP for the service fee is not available, other transfer pricing methods authorised by the Guidelines would have to be applied. These may include profit methods that require the difficult task of arriving at an arm's length valuation of the return on the intangible property used in Starco's business.

[8.] Conclusions

139. This discussion paper has provided a detailed analysis of the issues surrounding the attribution of profit to different types of permanent establishments involved in the “e-tailing” business of an enterprise. It is recognised that electronic commerce is not limited to “e-tailing” and that other types of business models (“B2B”, auctioning) exist. It would have been beyond the scope of this discussion paper to analyse the tax implications of all types of business models. However, the general principles developed in this paper, in particular in the case where the permanent establishment operates autonomously without the presence of personnel, is capable of application to other business models. However, these principles may need to be adapted to the particular factual situation.

140. The foregoing analysis, intended to determine how, and to what extent, one would attribute profit to a permanent establishment involved, with or without the assistance of personnel, in electronic commerce activities, has resulted in the following provisional findings based on the WH:

- Where, as in Variations 1 and 2, a permanent establishment consists only of a server supporting a web site through which commercial transactions and transmission of digitised products take place, the bulk of the benefit generated by the permanent establishment derives from the exploitation of hardware and software used by the permanent establishment and from marketing intangibles. Under a “contract service provider” arrangement, economic ownership and most risks associated with the property and the marketing intangibles is likely to remain with the head office. Under an “independent service provider” arrangement, where the head office transferred such a package of assets to the permanent establishment, an arm's length charge in consideration for such transfer would attribute substantially all of the profits directly associated with such a package to the head office, thereby leaving comparatively little profit to the permanent establishment, in relation to the value of the commercial activities carried on through it. The computer server in the permanent establishment is only performing low-level automated support functions that make up only a small proportion of the functions necessary to act as a full function retail outlet/distributor or as a full function service provider. The level of profit earned is likely to be commensurately low and be very significantly less than that earned by full function retail outlet/distributors or full function service providers. However, issues do arise as to whether some of the return related to the use of “e-commerce marketing intangibles” and the assumption of credit risk and technology risks, would be attributed to the permanent establishment on the basis that they are related to the operation of the web site itself and to the functions performed by the permanent establishment.
- Where, as in Variation 3, personnel are present in the permanent establishment to ensure the continuous operation of the web site and provide technical support to customers and would-be customers, the permanent establishment should be expected to be attributed the profit associated with such service functions, in accordance with the arm's length principle. However, the profit directly associated with the exploitation of the hardware and software created by the enterprise and from marketing intangibles would continue to be largely attributed to the head office, as under the previous examples.
- Finally, where, as in Variation 4, the hardware and software is entirely developed and constructed by personnel of the permanent establishment such that the permanent establishment is treated as the economic owner of the intangible property, the profit directly associated with the commercial operation of such assets is attributable, under the principles of Article 7 and the arm's length principle, to the permanent establishment. Where the software is developed

partially by head office and partially by the permanent establishment, the relevant proportion, determined under the arm's length principle, of the profit directly associated with the commercial exploitation of that software is attributable to the permanent establishment. Such a proportion would reflect the relative value of the contribution made by the permanent establishment and by the head office.

141. The analysis of the first variation has demonstrated the difficulty of developing a factual and functional analysis in the extreme case where a computer server is considered to constitute a permanent establishment and to apply the arm's length principle. In particular, it can be difficult to determine which part of the enterprise should be treated as the economic "owner" of "e-commerce marketing intangibles" that are related to the operations of the web site itself. It may also be difficult to apply the arm's length principle to "dealings" involving the transfer of intangible property between two parts of an enterprise, as valuation for this type of property, in particular finding suitable comparable transactions, can be challenging. Further, one of the key, and most difficult determination that has to be made in the permanent establishment context relates to the assumption of risks and the allocation of risks assumed by the enterprise as a whole to its various parts. The approach generally taken under the WH is to apply the approach taken for associated enterprises, i.e. the concept of contractual terms, by analogy to the relationships between, say, the permanent establishment and head office. This requires an analysis of the conduct of the parties and of the economic relationships that generally govern the relationships between independent enterprises. Where the permanent establishment lacks personnel, it is difficult to apply this approach. One possibility might be to say that it is not really possible for the permanent establishment to assume risks except those that arise as a direct result of the functions it performs. For example, where the permanent establishment accepts and settles customer transactions, it could be viewed as assuming the credit risk associated with such transactions.

142. Issues similar to those described in this discussion paper would arise in the situation where the server is owned and operated by a subsidiary of Starco, such that the paradigm moves from Article 7 to Article 9 of the OECD Model Tax Convention. Indeed, the conclusions reached above are based more on an analysis of the arm's length principle of Article 9 (as elaborated by the Guidelines) than on the Commentary to Article 7. The conclusions may therefore not always be consistent with the current interpretation of Article 7 of the Model Tax Convention.

143. However, as already noted, the current interpretation of Article 7 does not appear to produce a result that is consistent with the arm's length principle as developed in the Guidelines where "dealings" involving intangible property must be taken into account in attributing profit to the permanent establishment. Further, the result will differ depending on whether the particular economic function is carried out through a subsidiary or through a permanent establishment. Such a result is not desirable on tax policy grounds and may require the Model Commentary on Article 7 to be changed. A preferable approach would be to apply the arm's length principle of Article 7 in a manner as similar as possible to the guidance on the application of the arm's length principle of Article 9 found in the Guidelines. The extent to which this approach is desirable and, if so, how it might best be achieved, is under active consideration by the Committee on Fiscal Affairs.

144. This discussion paper does not pretend to offer the definitive answer to the question of the attribution of profit to the type of permanent establishments examined therein. The purpose of this draft discussion paper is to elicit a discussion of the relevant issues and to invite interested parties to share their views on this important subject for consideration by the Business Profit TAG and by the Committee on Fiscal Affairs.